Compendium of Industry Specific Internal Audit Guides

(*As on January 1, 2015*)

Volume III

The Institute of Chartered Accountants of India
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Foreword

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

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

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

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

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

Preface

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

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

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

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

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

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

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

Contents

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

I-10

TECHNICAL GUIDE ON INTERNAL AUDIT OF MUTUAL FUND

Foreword

The Indian mutual fund industry has witnessed significant growth in the past few years driven by several favourable economic and demographic factors. It has also seen a number of regulatory developments. These regulatory changes have been made keeping in mind the best interests of the investors. However, these changes will take time to be adapted by industry, intermediaries and the investing public at large.

In this environment, it is necessary for the management to establish operating or program objectives and goals, develop and implement control procedures and accomplish desired results. Internal audit ascertains whether such objectives and goals conform to management plans and are being met.

I am pleased to note that the Internal Audit Standards Board of the Institute is issuing this Technical Guide on Internal Audit of Mutual Funds. This Guide would help not only the members engaged as internal auditors in gaining profound knowledge about the internal audit of mutual fund industry, but also to the others engaged in other capacities to develop an understanding in this area thereby assisting them in carrying out their assignments efficiently.

I wish to place my appreciation to CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and other members of the Board for bringing out this Guide on Internal Audit of Mutual Funds. I am pleased to note that the scope and structure of the Technical Guide is well suited to cater to the professional needs of the members.

I am sure this guide would prove useful to the members, in practice and in industry, as well as others in gaining essential knowledge of various critical aspects related to mutual funds.

November 14, 2011
New Delhi

CA. G. Ramaswamy
President, ICAI

Preface

Internal audit has not remained untouched by the business and economic environment. It faces myriad challenges, which range from meeting the additional expectations emanating from the ever changing global, business, regulatory and economic scenario to finding the best resources to meet those challenges. Stakeholders expect the internal audit to have a larger and strategic role in governance and risk management. Internal audit will increasingly play a more meaningful role in the broader value delivery agenda of organizations. For this, the internal auditor must possess knowledge of the technical, commercial and other aspects of the operations of the enterprise concerned.

The Indian mutual fund industry is one of the fastest growing sectors in the Indian capital and financial markets. With the reforms of economy, reforms of industrial policy, reforms of public sector and reforms of financial sector, the economy has been opened up and many developments have been taking place in the Indian money market and capital market. In order to help the small investors, mutual fund industry has come to occupy an important place. In view of the complexity, volume, growth of the mutual funds industry, internal auditors have a dynamic role to play to support the management in helping fostering this growth. In view of the above, the Internal Audit Standards Board has decided to come up with Technical Guide on Internal Audit of Mutual Funds. The Guide has been divided into various chapters dealing with the fundamental concepts in mutual fund industry. These chapters deal with introduction, technical aspects, regulatory framework of the mutual funds. These chapters also cover need and objectives of the internal audit, professional opportunities for internal audit, framework for internal audit and focus areas for internal audit. The guide contains the internal audit checklists of functional areas and a glossary of terms used in the mutual fund industry to provide valuable guidance to the readers.

At this juncture, I am grateful to CA. Manoj Aggarwal and his study group members for sharing his experience and knowledge with us and preparing the draft of the 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 appreciation for the support of CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers in finalization of the publication.

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

November 14, 2011 — CA. Rajkumar S. Adukia
Mumbai — *Chairman*
Internal Audit Standards Board

Abbreviations

AMC	Asset Management Company
AMFI	Association of Mutual Funds in India
ARMFA	AMFI Registered Mutual Fund Advisor
AUM	Assets Under Management
ECS	Electronic Clearing Service
FMP	Fixed Maturity Plan
HUF	Hindu Undivided Family
ISC	Investor Service Centre
KIM	Key Information Memorandum
KYC	Know Your Customer
KYD	Know Your Distributor
NAV	Net Asset Value
NFO	New Fund Offer
NISM	National Institute of Securities Market
PAN	Permanent Account Number
PDC	Post-dated Cheques
PMLA	Prevention of Money Laundering Act
POA	Power of Attorney / Points of Acceptance
RTA	Registrars and Transfer Agents
SAI	Statement of Additional Information
SEBI	Securities and Exchange Board of India
SID	Scheme Information Document
SIP	Systematic Investment Plan
SLA	Service Level Agreement
STP	Systematic Transfer Plan
SWIFT	Society for Worldwide Interbank Financial Telecommunication
SWP	Systematic Withdrawal Plan

Net Asset Value (NAV)	Net Asset Value is the market value of the assets of the scheme minus its liabilities. The per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the Valuation Date.
Qualified Foreign Investor (QFI)	A person resident in a country that is compliant with Financial Action Task Force (FATF) standards and that is a signatory to International Organization of Securities Commission's (IOSCO's) Multilateral Memorandum of Understanding.
Redemption Price	It is the price at which close-ended schemes redeem their units on maturity. Such prices are NAV related.
Repurchase/ Exit Load	It is a charge collected by a scheme when it buys back the units from the unitholders. Also called 'Back- end' or 'Exit' load.
Repurchase Price	It is the price at which units under open-ended schemes are repurchased by the Mutual Fund. Such prices are NAV related.
Sales/ Entry Load	It is a charge collected by a scheme when it sells the units. Also called, 'Front-end' or 'Entry' load. Schemes that do not charge a load are called 'No Load' schemes.
Sale Price	It is the price you pay when you invest in a scheme. Also called Offer Price. It may include a sales/entry load.

Contents

Chapter 1
Introduction

1.1 India has a strong and a rapidly growing mutual fund industry over the recent years. Since the 1990s when the mutual fund sector was opened up to the private sector, the industry has traversed a long path, adapting itself continuously to the regulatory changes and investor preferences. The industry has grown from a single entity in 1963 to over 40 mutual funds in 2011 with the average total asset under management (AUM) reaching ₹ 5960 billion in 2011, thus growing at over 33% from 2005 to 2011. The growth in mutual fund industry in the last few years is a result of a growing economy, new product introductions (tax saving schemes, fund of fund schemes, gold funds, international funds, systematic investment plans, systematic withdrawal plans, systematic transfer plans), tax exemptions for dividend and capital gains for certain classes of funds and a wider distribution of fund shares. The rising disposal income amongst retail investors and higher corporate earnings seem to have contributed to the overall growth of the Indian economy in recent years though the Industry penetration levels are still low.

1.2 The trend of rising personal income has been witnessed not only amongst the young population, but also amongst the high net worth individual (HNI) segment, which have sizeable sums to invest. India has a strong middle class of 250-300 million, which is expected to double over the next two decades. This has attracted global fund houses and asset management businesses to focus attention on India in the segment of household savings and investments. In today’s volatile market environment, mutual funds are looked upon as a transparent and low cost investment vehicle, which attracts a fair share of investor attention helping spur the growth of the industry. Over time, inclusive growth across the financial sector seems to have taken centre-stage, re-designing all business strategies around this sole objective. The mutual fund industry being no exception, various measures are being taken by fund houses and distributors to spread access and reach to the semi-urban and rural segments.

1.3 The Indian mutual fund industry has high ownership from the corporate and institutions comprising over 55% of the total AUM and the number of retail investor accounts pegged at 46.32 millions and offers opportunities for higher penetrations. The unit holding pattern of mutual fund industry as at March 2011 is as under:

Unit Holding Pattern of Mutual Funds Industry (as on March 31, 2011)				
Category	No of Investors Accounts	% to Total Investors	Net Assets (₹ Crores)	% to Total Net Assets
Retail	46,051,758	97%	162,225.48	27%
High Networth Individuals*	779,226	2%	141,808.54	24%
FIIs	130	0%	2,969.81	0%
Corporates	391,836	1%	263,773.38	44%
Banks/FIs	11,883	0%	26,199.59	4%
TOTAL	47,234,833	100.00%	596,976.80	100.00%

* Note: Defined as individuals investing ₹ 5 lakhs and above.

Source: AMFI

The Scheme wise AUM as at March 31, 2011 is as under:

Types of Schemes	AUM (₹ Cr)	No of Folios
Liquid/Money Market	74699.86	193422
Gilt	3507.29	29178
Debt Oriented	294217	4305777
Equity Oriented	197563	39278085
Balanced	17552	2790050
Gold ETF	4400	319679
ETFs(other than Gold)	2516	103122
Fund of Funds investing Overseas	2520	215520
	596977	47234833

Source: AMFI

1.4 The landscape of the financial sector in India is continuously evolving, accredited to regulatory changes being undertaken, which makes leading market participants like, the Asset Management Companies (AMCs) and distributors to restructure their strategies and adopt business models, which will yield sustainable benefits. The road ahead for the mutual fund industry will be paved by the performance of the capital markets. It is in the backdrop of some of these encouraging statistics that the Indian mutual fund industry has fostered itself.

Regulatory Framework

Securities and Exchange Board of India (SEBI)

1.5 The regulatory authority, namely, the Security Exchange Board of India (SEBI) was formed in 1992, regulates and supervises the mutual fund industry in India for establishment of sound and stable financial system, protection of mutual fund unit holders, market efficiency, privatization and opening of markets, etc. All AMC have to be approved by SEBI for managing the investments. The Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 ('MF regulations') govern*, inter-alia,* the establishment and operation of mutual funds in India. The provisions of the MF Regulations are administered by the SEBI. Mutual funds in India are constituted in the form of a trust under the Indian Trusts Act, 1882.

1.6 In February 2011, SEBI has issued a draft structure of the proposed XBRL (Extensible Business Reporting Language) system for all the regulatory filings to be made by mutual funds. XBRL technology enables the computers to read and divide the information provided in the filings under various heads and thus makes it easy to find any relevant details and to identify any irregularities.

Association of Mutual Funds in India (AMFI)

1.7 The AMFI is dedicated to developing the Indian mutual fund industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders. AMFI's objectives are as follows:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
- To interact with SEBI and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the mutual fund industry.

- To develop a cadre of well-trained agent distributors and to implement a programme of training and certification for all intermediaries and other engaged in the industry.
- To undertake nationwide investor awareness programme to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund industry and to undertake studies and research directly and/or in association with other bodies.

1.8 In the Union Budget 2011-12, the honorable Finance Minister of India has announced that foreign investors can participate in Equity Mutual Fund Schemes in India. This development is likely to attract larger foreign investors to the mutual fund industry in India.

1.9 As the industry grows, with multiple products being launched across asset classes, it becomes imperative that the mutual fund sector in India, introduces robust systems and processes that should not only address the problems related to internal control, financial transparency and equity but also bring effective governance so as to serve the interests of the management, unit holders, consumers and the society, at large. This technical guide is an attempt to disseminate knowledge on the subject of internal audit of mutual funds and provides relevant guidance on related issues. Internal audit is an independent examination of processes and transactions, to provide assurance on the reliability of internal controls. Expectations from internal auditors are expanding. As a result, the traditional role of internal auditor is transforming to include activities that go beyond verification of compliance with policy norms and operating procedures to taking primary responsibility in assessing the effectiveness of the risk management processes in a business.

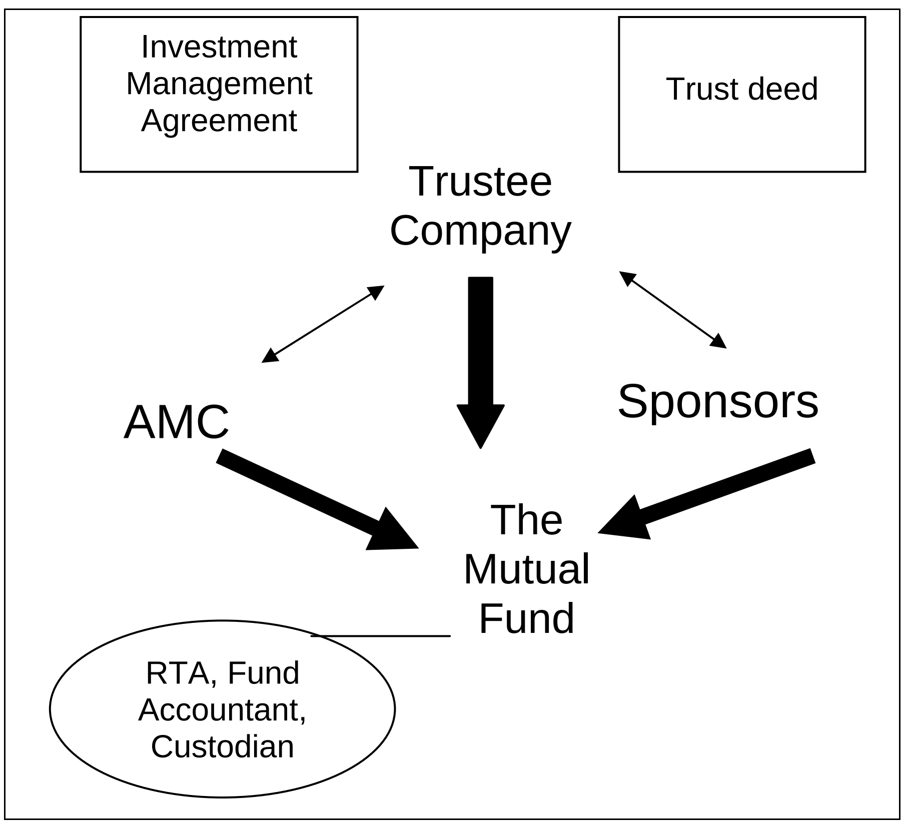
1.10 The emerging role of the internal auditor requires that there is pro-active participation by internal audit team in the process of improving an organization's operations through a combination of assurance and consulting work. The real value derived from the efforts of the internal auditor can only be measured when the audit efforts are aligned to the strategic direction of the organization and operate at a level that improves organizational performance and ultimately delivers better returns to shareholders. This is possible when the internal auditor develops skills and competencies that are sector specific.

Chapter 2

Constitution of a Mutual Fund

Structure of a Mutual Fund

2.1 Typically, a mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money collected is invested in capital market instruments such as, shares, debentures and other securities and money market instruments. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them. A mutual fund offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.



Typical Structure of a Mutual Fund

Sponsor

2.2 The Sponsor(s) are those who establish the Mutual Fund Trust and the Asset Management Company (AMC). They constitute the shareholders of the AMC.

Board of Trustees or Trustee Company

2.3 The trustees of a Mutual Fund could be constituted as a 'Board of Trustees' or could be incorporated as a 'Trustee Company' ['Trustee Company']. Where a Trustee Company is appointed, the duties of the trustee would be discharged through its directors. The Regulation 18 of MF Regulations has laid down the rights and obligations of the trustees. The Trustee Company is entitled to receive trusteeship fees for their services. The Sponsor appoints the trustees for the mutual fund. The trusteeship fee is paid by the mutual fund schemes and forms part of the overall expense ratio approved. The mutual fund's assets belong to the investors and are held in fiduciary capacity for them by trustees. The Trustee Company is the epitome of corporate governance in mutual funds and the trustees are regarded essentially as the front-line regulator. The Trustee Company is entrusted with the responsibility of holding the property of the MF in trust for the benefit of the unit-holders.

Asset Management Company (AMC)

2.4 The AMC is a corporate entity, which floats, markets and manages a mutual fund scheme and in return receives a management fee paid from the fund corpus. The AMC is accountable to the Trust for its actions. Regulation 25 of MF Regulations has laid down the AMC's obligations. In India, the Sponsor or the Trustee appoints the AMC through Investment Management Agreement (IMA). The contents of IMA are given in the Fourth Schedule to the MF Regulations. In terms of Regulation 24 of MF Regulations, no AMC can manage assets of more than one Mutual Fund and in case AMC decides to undertake any other activity then it has to satisfy SEBI that key personnel and infrastructure have been segregated activity-wise.

Fund Accountant (generally outsourced)

2.5 Fund Accountant is an entity handling the back office operations of the mutual fund for and on behalf of the AMC, *viz.*, services related to fund accounting, purchase processing, corporate actions accounting, valuation and Net Asset Value (NAV) calculation, reporting and other incidental services in respect of the Mutual Fund. An AMC, generally, enters into service level agreement with Fund Accountant, if outsourced, which will clearly bring out the expectations from the third party service providers. Periodically, these would be reviewed to reflect at all times the business requirements currently in practice.

Custodian

2.6 Custodian is an entity appointed to perform custodial service for the assets under management of its present and future schemes managed by AMC who is not affiliated to the sponsor and/or its associates. The custodian is responsible for settlement of trades and ensuring custodial services for the fund. AMC enters into service level agreement with custodian, which will clearly bring out the service delivery expectations from the custodian. Periodically, these would be reviewed to reflect at all times the business requirements currently in practice. The entity engaged for custodial services should be registered as custodian under the SEBI (Custodian of Securities) Regulation, 1996.

Registrar and Transfer Agent (RTA)

2.7 An entity appointed by the mutual fund to render services to its investors / unit holders *viz.*, receipt and processing of financial transactions (subscription, redemption, switch) from investors, dividend processing and payout, brokerage processing for distributors. Processing of non-financial transactions like, bank mandate, nominee, pledge, change of address, change of email address, transmission of units related request, name correction, etc. Additionally, the RTA also provides customer care support services through its wide-network of Investor Service Centers (ISCs), its call center and its web portal such as, requests for latest NAVs, requests for balances/ account statements, requests for fund literature. The RTA also manages the dividend distribution process and commission processing for the MF. An AMC, generally, enters into service level agreement (SLA) with RTA, which will clearly bring out the expectations from the third party service providers. Periodically, the SLA is reviewed and revisited in line with regulatory and business requirements currently in practice.

Distributors

2.8 Individuals, firms and corporate entities are engaged by the AMC for the purpose of distributing, marketing and procuring subscriptions of the Schemes of the mutual fund. All distributors appointed by the AMC are AMFI/NISM (Refer SEBI Circular dated June 24, 2010) Registered Mutual Fund Distributors (ARMFA).

Types of Mutual Fund Schemes

2.9 The following are various types of mutual fund schemes:

By Structure	By Investment Objective	Other Schemes Illustrated
• Open Ended • Close Ended • Interval	• Growth • Income • Balanced • Money Market • GILT	• Exchange Traded • Tax Saving • Capital Protection • Fund of Funds • Index Funds

(a) Open Ended Schemes - It is a fund which is available for subscription and redemptions all throughout the year. These do not have a fixed maturity. Investors can purchase and redeem units at prevalent Net Asset Value. The key feature is the liquidity factor.

(b) Close Ended Schemes - These schemes have pre-specified maturity periods. The funds offer exit options after the initial closing as per the offer documents. As mentioned in the scheme offer documents, these could be in form of repurchase at a certain pre-specified dates fixed by the mutual fund at prevalent NAV. Some close-ended funds are listed on the stock exchanges and provide an exit option.

(c) Interval Funds - These Schemes have the features of both open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined exit windows at intervals defined in the offer documents at the prevalent NAV.

(d) Growth Schemes – The objective is to provide long-term capital appreciations and invests predominantly in equity and equity related instruments.

(e) Income Schemes – The objective is to provide regular income. These schemes normally invest in fixed income securities, thus, providing a stable income.

(f) Balanced Schemes – The aim is to combine the benefits of both growth and income funds by investing in a mix of equity and debt securities thereby diversifying risks.

(g) Money Market Fund - Investment objectives are to provide a highly liquid portfolio of money market instruments to provide reasonable returns and high liquidity to the unit holders. These schemes invest in money market instruments with, normally, short durations as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

(h) Gilt Funds – Investments are predominantly in securities issued by the Government, thus, having very low risks.

(i) Exchange traded funds – An Investment fund traded on the stock exchange. ETF's hold asset such as stock, commodities, bonds, etc. and trade close to its NAV over the course of the trading day. Most ETF track an Index e.g., Nifty 50 or the price of the commodity e.g., gold and the NAV is close to these benchmarks subject to tracking errors.

(j) Tax Saving Funds (Equity Linked Saving Schemes) – It is an open ended fund with lock in periods and offers rebates to investors under section 80 C of the Income tax Act. It aims to invest predominantly in equity and equity related instruments across sectors. The tax laws are based on the contributions made to any (ELSS).

(k) Capital Protection Funds – Normally, they are close close-ended scheme with 3 to 5 years maturity and aim at endeavoring by investing in fixed income securities as primary objective and generate capital appreciations by investing in equity and equity related instruments. The protection of capital is not guaranteed.

(l) Fund of Funds – It a fund, which invests in other mutual funds. This allows investors to achieve a broad diversification and an appropriate asset allocation with investments in a variety of fund categories that are all part of one fund. Return is dependent on the return of the underlying funds.

(m) Index Funds - They are mutual funds that intend to track the returns of a market index. Index funds hold securities almost in the same proportion as its respective index. The returns from such schemes would be equivalent to those of the index, subject to tracking errors.

Departments within an AMC

2.10 Various departments within an AMC are as follows:

(a) **Sales and Marketing -** The department is headed by Chief Marketing Officer (CMO) who floats the schemes and pools together the savings of the investors. The supportive functions are rendered by Registrar and Transfer Agents and Distributors.

(b) Investment Department - The department is headed by Chief Investment Officer (CIO) who invests the money collected in capital market instruments such as, shares, debentures and other securities and money market instruments. The supportive functions are rendered by the brokers and custodians

(c) Fund Accounting - The department is headed by the Chief Finance Officer (CFO) who maintains scheme-wise accounting resources raised, amount invested, payment of divided, redemption, etc. The supportive functions are rendered by banks for maintaining scheme-wise bank account, Registrar & Transfer Agent and Fund Accountant

(d) Risk and Compliance - The department is headed by Compliance Officer (CO) who is responsible for monitoring of the risk management and compliance related functions within the AMC including those outsourced. The Chief Executive officer (CEO) in terms of regulation 24 (6A) shall ensure that the MF complies with all the SEBI MF regulations and that investments made by the Fund Manager are in interest of unit holders. The CEO shall be responsible for the overall risk management function of the mutual fund.

(e) Investor Services - The department deals with operational matters and the investor grievances and resolution thereof along with the Registrar & Transfer Agent Certain business processes are outsourced by mutual funds to third parties with a view to have lean organization structure and in turn be cost effective.

Chapter 3
Need and Objectives of Internal Audit of Mutual Fund

3.1 Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. It is an independent appraisal function established by the management of an organization for the review of the internal control system as a service to the organization. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic and effective use of resources of the organization.

3.2 A dedicated, independent and effective internal audit activity assists both the management and the oversight body (e.g., the board, audit committee) in fulfilling their responsibilities by bringing a systematic disciplined approach to assessing the effectiveness of the design and execution of the system of internal controls and risk management processes. The objective assessment of internal controls and risk management processes by the internal audit activity provides management, the oversight body, and external stakeholders with an independent assurance that the organization's risks have been appropriately managed. Internal auditors are experts in understanding organizational risks and internal controls available to mitigate these risks; thereby they assist management in understanding the subject matter and provide recommendations for improvements.

3.3 A well functioning, adequately resourced internal audit activity that works collaboratively with the management and the board is a key resource in identifying risks and recommending improvements to an organization's governance, risk management, internal controls, and operations. Internal auditors' unique perspective of independence and objectivity, knowledge of the organization, and understanding and application of sound consulting and audit principles by virtue of their exposure to other organizations makes them ideal for this role.

3.4 A primary lesson to be learnt from the financial failure and collapse of numerous organizations is that good governance, risk management and internal controls are essential to corporate success and sustainability. It is because of its unique and objective perspective, in-depth organizational knowledge, and application of sound audit and consulting principles, that a well functioning, fully resourced and independent internal audit activity is well positioned to provide valuable support and assurance to an organization and its oversight bodies.

3.5 Expectations from internal auditors are expanding. As a result, the traditional role of internal auditor is transforming to include activities that go beyond verification of compliance with policy norms and operating procedures to taking primary responsibility in assessing the effectiveness of the risk management processes in a business. The emerging role of the internal auditor requires that there is clear participation by the internal audit team in the process of improving an organization's operations through a combination of assurance and consulting work.

3.6 The real value derived from the efforts of the internal auditor can only be measured when the internal audit efforts are aligned to the strategic direction of the organization and operate at a level that improves organizational performance and ultimately delivers better returns to shareholders. This is possible when the internal auditor develops skills and competencies that are sector specific. This technical guide is an attempt to disseminate knowledge on the subject of internal audit of mutual funds and provides relevant guidance on developing mutual fund sector specific knowledge to internal audit professionals.

Auditor - Mutual Fund

Statutory Auditor

3.7. The statutory auditor of the mutual fund is a chartered accountant Firm appointed by the Trustee. These auditors are independent of the auditors appointed by the AMC to verify its own books of accounts. The scope of the statutory auditor is verification of the reports on the accuracy of accounting records maintained for the Fund, the AMC and the Trustee Company/ board of trustees. SEBI vide circular SEBI/IMD/CIR No. 8/132968/2008 dated July 24, 2008, prescribes new format of Abridged Scheme wise Accounting Disclosures, which are certified by statutory auditors. Under the SEBI Mutual Fund regulations, the statutory auditors of the AMC and Mutual fund schemes are to be different entities.

Internal Auditor

3.8 Internal auditor is an audit firm appointed by the Trustee Company, to enable them discharge their responsibilities effectively. The scope of the internal auditors broadly envisages periodic verification of control framework for the operations of the AMC and the service providers' vis-à-vis the provisions of the MF Regulations/ Trust Deed and the Guidelines issued by the SEBI from time to time.

Concurrent Auditor

3.9 It is an audit firm appointed by the Trustee Company, to enable them discharge their responsibilities effectively. The scope of the concurrent auditors broadly covers day-to-day key operations of AMC service providers, such as, deals entered into with the brokers, calculation of daily NAV, money market operations, etc.

Information System Auditor

3.10 SEBI has mandated system audit for mutual funds once in two years by SEBI/ IMD/ CIR No. 9/176988/2009 dated September 16, 2009. Under the circular, an independent CISA/CISM/DISA qualified or equivalent auditor is appointed for audit of systems and processes inter alia related to examination of integration of front office system with the back office system, fund accounting system for calculation of net asset values, financial accounting and reporting system for the AMC, unit-holder administration and servicing systems for customer service, funds flow process, system processes for meeting regulatory requirements, prudential investment limits and access rights to systems interface.

Chapter 4
Professional Opportunities - Mutual Fund

4.1 The current asset management business and the regulatory environment substantially require AMCs to develop a more systematic approach to their governance practices. As they do so, the role of internal audit is also changing with requirements for a strategic participation in its goals. AMCs are expanding the role of internal auditors, which include the following functions:

(i) **Concurrent Audit -** Review and verify NAV and various regulatory and internal limits on day-to-day operations and report to management on T + zero basis.

(ii) **Risk Based Internal Audit -** Review the mutual fund operations, SOPs, controls systems, role of outsourced agencies, etc., based on the level and nature of risk. Identify and report high-risk areas relating to key process gaps and/ or lapses, control failures and suggest mitigating measures to the management and its oversight bodies.

(iii) **Third Party Compliance -** With the increased outsourcing of activities and reliance on third party processes, AMCs require internal auditors to examine the controls that business partners deploy. This covers internal/ concurrent audit for:

- **RTA Audit -** To review and verify the critical R&T operations such as, processing of financial/ non-financial transactions on T+1 basis and report to the management.
- **Fund Accountant -** To review the accounting processes and systems, NAV calculation systems, assessing correctness of various MIS reports, daily cash flow statements, etc.
- **Custodian Audit -** Periodic review of controls, processes and practices put in place at custodian for safe custody of the securities.
- **SAS 70 -** To review controls, processes and practices for outsourced/ shared operations.
- **New Business Initiatives –** Review at the time of product launch and business expansions, which include audit of adherence to disclosures

made in Statement of Additional Information (SAI) and Scheme Information Document (SID), process setups at time of scheme launches, etc.

- SEBI Mandated System Audits – Every mutual fund and its service providers are required to conduct systems audit at least once in two years by an independent CISA/ CISM qualified or equivalent auditor. (SEBI/IMD/CIR No. 8/176988/2009 dated September 16, 2009)
- Certifications – Issue of various certificates to AMCs/ Trustees based on specific requirements raised by SEBI/ AMFI from time to time.
- Branch Audits – Review of the processes of collection of customer applications and other investor servicing methodologies.
- Corporate Governance Audits – Review various governance practices including those that are specified in SEBI under clause 49 as followed by the AMC and include board constitution, related party transactions, risk management practices and integration of various activities.
- Statutory Audit - Review the operations, controls systems within the organizations and at outsourced entities, verify accounts and accuracy of record maintained in line with regulatory requirements, certify the financial statements of various schemes of mutual fund prepared in the format prescribed by SEBI, and present the same to the Board of AMC and Trustee Company.

Chapter 5
Business Risk Factors in Mutual Fund Operations

Strategic Risks

5.1 The following are types of strategic risks involved in mutual fund operations:

(i) **Credit Risk -** This is the risk associated with the issuer of a debenture/ bond or a money market instrument defaulting on coupon payments or in paying back the principal amount on maturity. Even when there is no default, the price of a security may change with expected changes in the credit rating of the issuer.

(ii) **Liquidity Risk –** These are market events that cause excessive strain on the treasury of the fund house resulting in mismatch of cash flow. They lead to unexpected high value redemptions causing liquidity crunch.

Operational Risks

5.2 The following are various types of operational risks involved in mutual fund operations:

(i) **Front Office Risks -** Front Running by dealer may result into reputational risk and financial loss to AMC. It may also include leakage of sensitive information to insiders or breach of investment restrictions/ norms.

(ii) **Market Risk -** As the share prices, valuations and/ or interest rates of securities in which the scheme invests fluctuate, the value of investments in the scheme may appreciate/ depreciate.

(iii) **Third Party Failure -** The impact of failure of a third party to adequately perform the activity on the financial, reputational and operational performance of the AMCs and on the customers and their counterparts. Data protection, security and other risks may be adversely affected by the geographical location of the third party.

(iv) **Settlement Risk -** Fixed income securities run the risk of settlement, which can adversely affect the ability of the fund house to swiftly execute trading strategies, which can lead to adverse movements in NAV.

(v) **Third Party Agent -** Misuse of investor information resulting in sharing investor information with competitors, disruption to operations and financial loss to AMC.

(vi) **IT Risks -** Unauthorized access, absence of DRP/ BCP, limited audit trails, etc are various types of IT risks involved.

(vii) **Other Risks –** Computation of incorrect NAV, management override, employee frauds including collusion and conflicting functions, insider trading, fraudulent financial reporting, misfeasance by brokers, etc.

Reporting Risk

5.3 It may include publishing of wrong NAV by mutual fund.

Compliance Risk

5.4 It includes non-adherences with regulatory requirements leading to a loss of reputation and loss of investor confidence.

Chapter 6

Framework of Internal Audit for Mutual Fund

6.1 Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. In addition to the classical aspects to be covered in an internal audit, the internal auditor of a mutual fund has to include various circulars, regulatory requirements and directives issued by the SEBI.

6.2 SEBI (Mutual Funds) Regulations, 1996 states that the Board may appoint one or more persons as inspecting officer to undertake the inspection of the books of account, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and AMC for any of the following purposes, namely:

(a) to ensure that the books of account are being maintained by the mutual fund, the trustees and AMC in the manner specified in these regulations;

(b) to ascertain whether the provisions of the Act and these regulations are being complied with by the mutual fund, the trustees and AMC;

(c) to ascertain whether the systems, procedures and safeguards followed by the mutual fund are adequate ;

(d) to ascertain whether the provisions of the Act or any rules or regulations made there under have been violated ;

(e) to investigate into the complaints received from the investors or any other person on any matter having a bearing on the activities of the mutual funds, trustees and AMC;

(f) to suo motu ensure that the affairs of the mutual fund, trustees or AMC are being conducted in a manner, which is in the interest of the investors or the securities market.

The Board or the Chairman shall after consideration of inspection or investigation report take such action as the Board or Chairman may deem fit and appropriate including action under the Securities and Exchange Board of

India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002. The Board shall have the power to appoint an auditor to inspect or investigate, as the case may be, into the books of account or the affairs of the mutual fund, trustee or AMC, provided that the auditor so appointed shall have the same powers of the inspecting officer as stated in regulation.

6.3 The Board of Trustees appoints independent internal audit firm to conduct internal audit of AMC/ mutual fund operations. The internal audit delivery model in India is largely a fully outsourced model; however, at some place co-sourcing model is also prevalent. The prime reason for a fully outsourced model is on account of the lean organization structure of the AMCs in India and more so to improve independence of the internal audit function. (AMCs follow an outsourcing model for several business processes such as, Fund accounting, Custody and Registrar and Transfer operations.) The Internal Audit reports to the Audit Committee of the Asset Management Company at quarterly intervals and to the Board of Trustees at bi-monthly intervals.

Risk Management Guidelines Implementations

6.4 SEBI vide circular No MFD/CIR/15/19133/2002 dated 30th September 2002 has also advised the Mutual Funds to implement the Risk Management System, progress of which is to be reviewed by the Board of AMC and Trustees. Further, the review of Risk Management Systems shall be a part of internal audit and a report on which shall be placed before the Board of AMC and Trustees who shall make comments on the adequacy of systems in the quarterly and half-yearly compliance reports filed with SEBI.

Chapter 7

Major Focus Areas of Internal Audit of Mutual Fund

7.1 Major focus areas of internal audit of mutual fund shall include the following:

(a) Dealing Operations and Fund Management

(b) Net Asset Value (NAV) Calculations

(c) Fund Accounting and Treasury

(d) Custodian Operations

(e) Compliances and Risk Management

(f) Registrar and Transfer Agent and Investor Services

(g) AMC Branch Operations

(h) Distribution

(i) Information Technology

(j) Role of Trustees

Dealing Operations and Fund Management

7.2 Internal audit of dealing room and fund management activities includes the following:

(i) Process flow of dealing room and fund management activities with regards to internal policies, guidelines, and MF regulations.

(ii) Reporting structure of the dealing and fund management team in accordance with SEBI "Operating Manual for Risk Management for Indian Mutual Funds" for segregation.

(SEBI Cir – MFD/CIR/15/19133/ 2002 dated September 30, 2002).

(iii) Dealing room activities, i.e., ordering systems that includes order placement IT systems, deal slips, order books, counter party confirmation, price verification and documentation, authorization and its compliance with prescribed procedures and MF Regulations.

(iv) Recording of investment reasons by fund manager in compliance with MF regulations, internal policy, etc.

(v) Voice recording of the telephone lines connected to dealing room and restriction on usage of mobile phones for dealings in accordance with SEBI directives.

(vi) Compliance to investment activities with regard to internal policies and investment restrictions as imposed by SEBI MF Regulations.

(vii) Adherence to overseas investment norms and limits and appropriate disclosures in offer documents.

(viii) Delegation of power for investment in primary/ secondary markets-equity and debt.

(ix) Primary market transactions with laid down procedures including, authorization and allocation between schemes.

(x) Inter-scheme transfer of securities - Compliance with internal policy, clause 3 of the Seventh Schedule of the MF Regulations and its documentation for approval of compliance, Risk Management and respective fund managers.

(xi) Investment limits monitoring for schemes/ Fund, position monitoring for derivative transactions as per MF Regulations/ SEBI circulars.

(xii) Underwriting transactions entered into as per MF regulations.

(xiii) Investments conducted as per Scheme objectives as mentioned in the SID.

(xiv) Investment in Unrated papers to be pre-approved in accordance with MF Regulations.

(xv) Norms for empanelment of brokers as specified by the AMC [Reg. 18(4)(g)].

(xvi) Compliance by the AMC of the restrictions on transactions done through brokers other than those specified under regulations 25(7)(a) [Reg. 25(7)(b)].

(xvii) Distribution of business to empanelled brokers to avoid undue concentration of business with any broker [Reg. 18(5)].

(xviii) Identifications and recovery of Non Performing Assets.

(xix) Review of scheme/ fund performance with benchmarks stated in the scheme related documents, if any or with comparative benchmarks.

(xx) Documentation of debt/ equity primary market transactions.

Net Asset Value (NAV) Calculations

7.3 Various steps in internal audit of Net Asset Value Calculations are as follows:

(i) Valuation of Securities includes verification of valuation policy and its adherence. Compliance of valuation policies of the Fund vis-a-vis SEBI regulations and various circulars issued from time to time. Checking of valuation process for all types of securities including, equity shares, debts securities, money market instruments, unlisted and thinly traded securities, etc. (Valuation policies of the Fund are in line with the Eight Schedule to MF Regulations read with SEBI circular no. CIR/ IMD/ DF/ 4/ 2010 dated 21st June 2010.)

(ii) Valuation of gold, units of other mutual funds and other assets need to be in compliance with SEBI regulations.

(iii) Monitoring and updating of credit ratings of debt securities.

(iv) Review of recurring expenses charged by the AMC. [Reg. 52(4)] its authorization and supporting, recording and segregation. Expenses accrued needs to be within the limits specified under MF Regulation and approved by the trustees.

(v) Verification of the investment management and other fees charged by the AMC and regulatory limits.

(vi) Allocation of common expenses among participating schemes in accordance with the internal guidelines.

(vii) Timely tracking/ timely accounting/ accrual of corporate benefits on securities held in scheme.

(viii) Review of Unit Capital/ Switch Reconciliation.

(ix) Funding and accounting of dividend declarations within scheme.

(x) Review of accounting of exit load and reversal of excess over 1% in accordance with MF regulations.

(xi) Verification of timely upload of NAV on AMFI website by 9 p.m. of the same day for all schemes and 10 a.m. of the following business day in case of fund schemes.

(xii) Verification of timely upload of NAV to press.

(xiii) Applying correct NAV at time of switch/ repurchase, etc.

(xiv) Review of trial balance and balances of various accounts to identify discrepancies, if any, and suggest necessary corrections. This should include ledger scrutiny at periodic intervals.

(xv) Verification of dividend declared by the schemes.

Calculations of NAV

7.4 Based on the NAV declared, investors subscribe to the units in the schemes at the 'bid rate' or redeem units already held of the schemes at the 'ask rate'. Below is an illustrative table showing the calculation of NAV and NAV per unit:

No.	Particulars		Amount	Amount
A	<u>Unit Capital</u>			
	Opening		xxxx	
	Net Sold		(xxxx)	
	Net Purchased		xxxx	
	Closing			xxxx
B	<u>Reserve</u>			
	Opening		xxxx	
	On units Sold		(xxxx)	
	On units Purchased		xxxx	
	Closing			xxxx
C	Appreciation / Depreciation in Value of Securities			xxxx
D	<u>Income</u>			
	Dividend Income		xxxx	
	Interest Income		xxxx	
	Profit & Loss on sale of Equity / Debt/ G-Secs		xxxx	
	Other Income		xxxx	
	Total Income		Xxxx	Xxxx
E	<u>Recurring Expenses</u>			
	Opening recurring expenses		xxxx	
	Management fees		xxxx	
	Other scheme expenses		xxxx	
	Closing Expenses			Xxxx
F	Total	(A+B+C +D-E)		Xxxx

G	Income Distribution considering applicable taxes thereon, if any			(Xxxx)
H	Total NAV	(F - G)		Xxxx
I	Total outstanding units as on the day end			Xxxx
J	NAV per Unit	(H ÷ I)		Xx

Fund Accounting and Treasury

7.5 It includes review of following:

(i) Proper books and records are maintained by each scheme in terms of Regulation 50 and preserved for a period of eight years.

(ii) Process for updating Security masters in Fund Accounting application and Crisil Bond Valuer.

(iii) Contract notes with DIP/ DIS statements, STP, Broker's transaction file and custodians confirmation.

(iv) Primary market transaction with deal slips and DIP/ DIS statement and custodian's confirmation.

(v) Method followed for computing distributable surplus and its adherence to SEBI Circular No. SEBI/IMD/CIR No.18/198647/2010 dated 15th March 2010.

(vi) Accounting of Income Equalization Reserve and, particularly, dividend equalization reserve and accounting of dividend distributed by the schemes.

(vii) Investible surplus calculation reporting and utilization.

(viii) Load balance/ payable – receivable from AMC confirmation (spill over of expenses) every quarter.

(ix) Investment made by Gold Exchange Traded Fund in accordance with Sub Regulation 5 of Regulation 44.

(x) Corporate actions - dividend, interest, bonus, rights, etc. Process and control mechanism at Fund's end with regard to accounting of corporate actual benefits and monitoring of receipt thereof.

(xi) Daily settlement obligation, MTM and matching of the same with custodian.

(xii) Charges levied by Custodian and Registrar with regard to SLA.

(xiii) Timely payments of all statutory dues, such as, STT, TDS, etc and filing of returns.

(xiv) Closure of scheme books for schemes matured including appropriation of left over provisions.

(xv) Identification and provisioning for Non-Performing Assets.

(xvi) Reconciliations which includes review of:

(a) Subscription and redemption reconciliation and to ensure that proper action is taken on the items identified in the reconciliation. Verifying correctness of following:

- Reconciliation of bank accounts. (collections, redemption, dividend, brokerage, etc.)
- Corpus Reconciliation
- SGL Reconciliation
- Other Bank accounts like, NFO accounts, Operation Account, etc.

(b) Collection process from origination of transaction till final utilization of funds with regard to Daily Reporting of High Value and inter-bank transfer cheques/ non-high value cheques and deposition of the same by AMC Branches and R & T branches.

(c) Identify and report errors or weakness in system emerged out of reconciliations and suggest corrective actions.

(d) Various reports from R & T end, branches co-ordination with the R & T Agent and the Head Office of the AMC regarding collection and redemption/ switch process.

Custodian Operations

7.6 Internal audit of custodian operations includes the following:

(i) Review of agreement with custodian.

(ii) Review of processes and controls at the custodian.

(iii) Verification of certificate to operate as custodian of securities.

(iv) Review of disaster recovery plan, contingency plan and safe keeping arrangement of documents at custodian with regard to fund’s activities.

(v) Review of purchases and sales, DIP/DIS and settlement of trades.

(vi) Review of holding reconciliation as per Fund house, Custody and NSDL records.

(vii) Review and reconciliation of logical and actual holding tallying with the physical and electronic balances.

(viii) Review storage facility for physical holdings and verification, procedures and controls.

(ix) Physical verification of securities lying with the custodian.

(x) Review Income booking process, Income received vs. receivable (Interest on debt securities, Dividend income etc.).

(xi) Review process of Corporate Actions booking and settlement.

(xii) Review accuracy, timeliness, adequacy and periodicity of reports sent by the custodian to the Fund.

(xiii) Review compliance with service standards prescribed for Custodial Services.

(xiv) Review Insurance cover obtained in accordance with SEBI directives.

Compliances and Risk Management

7.7 Following are steps involved in internal audit of compliances and risk management of mutual fund:

(i) Adherences to MF Regulations, circulars, AMFI guidelines and internal norms.

(ii) Monitoring of employee dealing guidelines; reporting to trustees any deviations as per MF Regulation 25 (9).

(iii) Adherence to Compliance and Risk Manuals and SOP's; Review of Service level agreement terms with various service providers.

(iv) Adherences to accounting policies prescribed in Eleventh Schedule of MF regulations.

(v) Review of Investment restrictions (Seventh Schedule of MF Regulations), decision-making, and recording of decisions.

(vi) Day to day fees and expenses charged to schemes as per the MF Regulations.

(vii) KYC Norms and applicability of Prevention of Anti Money Laundering Act 2002; submission of Cash Transaction Report (CTR) and Suspected Transaction Report (STR).

(viii) Approval of Manuals and Policies by appropriate authorities:

- Compliance Manual, Operation Manual, Advertisement Manual, IT System Manual, Customer Service Manual, Risk Management Manual, Investment Policy, Valuation Policy, Employee Dealing Policy, etc. should be approved by the appropriate authorities.
- Conduct yearly updates of SOPs and should be approved/ noted by appropriate authorities.

(ix) Investment Committee

- Members and Constitution
- Number of Meetings
- Recording of Minutes
- Recommendations.

(x) Delegation of authority to be approved by the Board of AMC.

(xi) Amendments, if any, as approved by Board or noted by Board or in any manner as authorized by the Board/ Audit Committee.

(xii) Front Office and Back Office segregation of duties (including deployment of requisite skilled manpower, investment system and infrastructure to Back Office commensurate with Front Office).

(xiii) Adherences to the Advertisement Code; AMC and all intermediaries of the fund abide by the Code of Conduct.

(xiv) Employees engaged in marketing and distribution have obtained appropriate certification from AMFI as required by SEBI.

(xv) Risk Management System as per SEBI circular MFD/CIR/ 15/ 19133/ 2002 dated 30th Sept 2002. It includes risk policy approvals by the AMC and Trustee Board e.g., risk procedures for investment, operational and business risks assessments, DR/BCP set ups; risk/ investment committee set ups and meetings; reporting to Board/ Audit committee; other compliance with risk management circular of SEBI and ongoing updations.

(xvi) Verifying whether the company is carrying out appropriate and adequate investor profiling.

(xvii) Verifying the maintenance and adequacy of data security system.

(xviii) Verifying whether source codes for software are maintained and updated.

(xix) Verifying whether the company has with itself data lying with RTA and Custodian.

(xx) Whether outstanding observations of previous audit reports are followed up and implemented.

(xxi) Empanelment of brokers (by back office)

- Procedures/ criteria (as stipulated in Investment Policy) for Broker appointment by Back Office, Dealing with Front Office and Review/ monitoring by Mid-Office.
- Business-wise spreads, ceiling per broker (as stipulated in MF Regulations).
- Executing of Legal Agreement with Brokers for empanelment covering terms and conditions of brokerage business (in a standard format).
- Suspension of brokers based on action taken by regulator and exchanges.

(xxii) Inter- scheme transfers:

- Recording Rates and Times of Inter-scheme transactions
- Approval and Authorization
- Reporting to Trustees.

(xxiii) Verification of periodic reports for accuracy, content, format and timeliness before submission to Trustees and Regulators.

(xxiv) Submission of information and reports sought by regulators from time to time which includes:

No.	Particulars	Reporting Frequency
1	MCR Report	Monthly
2	Bi-Monthly CTR	Bi- Monthly
3	SGL Reconciliation	Quarterly
4	Bi-Monthly AMC Investment Report	Bi-Monthly
5	Un-audited Half Yearly Portfolio	Half Yearly
6	Un-audited Half Yearly Financials	Half Yearly
7	Bi-Monthly AMC to Trustee Report	Bi-Monthly
8	Half Yearly AMC to Trustee Report	Half Yearly
9	Half Yearly Trustee Report to SEBI	Half Yearly
10	Portfolio of All Close Ended Schemes	Monthly
11	Total Resource Deployment	Monthly
12	Associate Report	Monthly

13	New Scheme Report	As & When
14	Quarterly Average AUM Report to AMFI	Quarterly
15	Investor Service Statistics	Annually
16	Annual Information Return (u/s 285 BA of Income-tax Act); Dividend Distribution tax return and Securities Transaction Tax returns under Income Tax Act	Annually

Registrar and Transfer Agent and Investor Services

7.8 Internal audit of Registrar and Transfer Agent and Investor Services includes the following:

(i) Verification of Certificate to Operate as Registrar under SEBI regulation.

(ii) Review of checkpoints for control on R & T activities, like, various reports sent by them, monthly exception report, status report, etc.

(iii) Verify adherence to time stamping norms for the application received from various sources, such as, AMC FO, channel feeds, web based transactions and so on.

(iv) Review of procedure and control for handling of subscription/ redemption application request received at AMC branches and R&T branches and its compliance with SEBI circular SEBI/ IMD/ CIRNo.11/ 78450/ 06 dated October 11, 2006 on "Uniform cut-off timings for applicability of Net Asset Value (NAV) of Mutual Fund scheme(s) plan(s)" and CIR/ IMD/ DF/ 19/ 2010 dated November 26, 2010 on "Allocation of Government debt and corporate debt investment limits to FIIs". Reference may also be made to SEBI/ IMD/ CIR No. 13/150975/09 dated January 19, 2009.

(v) Review of process for handling investor complaints, tracking of complaints and follow up mechanism. Investor complaints will include investor complaints receipt/ resolving framework, escalated complaints resolution framework, complaints received from SEBI, court/ consumer forum/ such other cases and their resolution; adequacy of Compliant Resolution Mechanism system; Board/ Audit Committee review of complaints and resolution; annual publication of MIS on investor complaints as per SEBI guidelines.

(vi) Reviewing the accuracy of classifying the customer complaints in light of SEBI circular on the same issued in May, 2010.

(vii) Brokerage processing review comprising of setting up of brokerage rate in R& TA system, computation of brokerage payable, payment controls, factoring KYD norms and KYC norms for channel partners.

(viii) Process controls with respect to effecting the change of broker.

(ix) Accuracy of special incentive working and tax calculations involved.

(x) Process for setting of masters for loads, brokerage structure and dividend declared.

(xi) Review of procedure and controls for brokerage processing by R & T Agent. Checking of brokerage processed with reference to brokerage rates, timely and accurate updation, special rate/ incentives calculation, service tax deduction and payment, etc.

(xii) Procedure and control for collection and handling of mandatory documents including, Self Declaration and Know Your Distributor code.

(xiii) Compliance with KYC norms, Prevention of Money Laundering Act, bank details and PAN related documents as mandated by regulators from time to time.

(xiv) Verification of adequacy of controls for payout files generated for redemptions, brokerage and dividend payouts.

(xv) Verification of working for special incentives to the distributors, if any, handled by R&TA.

(xvi) Procedure towards registering systematic transactions and coordination with banks and service providers for PDCs, ECS mandates and standing instructions towards Systematic purchase transactions.

(xvii) Review of procedures for delay in dispatch of redemption and dividend warrants including, computation and payment of compensation for redemption in accordance with SEBI directives.

(xviii) Review process for withholding taxes for remittance outside India of redemption proceeds

(xix) Review of procedure for treatment of undelivered account statements/ redemptions/ dividends and correspondences.

(xx) Verification of recovery made/ to be made from R & T Agents for various mistakes which caused financial losses to Fund/ AMC/ Investors.

(xxi) Verify adherence to TAT for processing the request vis-a-vis the time stamped request.

(xxii) Verify adherence to AMFI guidelines, AMC instructions on the documents to be obtained before processing the application.

(xxiii) Dispatch of communication and account statement confirming the status of transactions.

(xxiv) Disclosure of investor complaints received from all sources on the MF's website and on the AMFI website as well as in annual reports as required in terms of SEBI circular IMD/DF/2/2010 dated 13th May 2010.

AMC Branch Operations

7.9 Following are aspects to be covered in AMC branch operations:

(i) Time stamping of application (subscription, redemption, switch, etc.)

(ii) Display of NAV of various schemes.

(iii) Timelines for investor servicing.

(iv) Banking of instruments.

(v) Reporting to Head office.

(vi) Request and complaints handling.

Distribution

7.10 Internal audit of distribution should cover following aspects:

(i) Empanelment of distributors, activation and review.

(ii) Commercials and service agreements.

(iii) NFO and product promotion.

(iv) Marketing collaterals.

(v) Sales management.

(vi) Subscriptions and redemptions.

(vii) Distributor contact program.

Information Technology

7.11 Internal audit of information technology aspects in mutual fund should broadly cover the following areas:

(i) Data Security.

(ii) Risk Management System.

(iii) Business Continuity Planning.

(iv) Disaster Recovery Plan.

(v) Access Controls.

(vi) Information Security.

Role of Trustees

7.12 Internal audit of role of trustees should cover following areas:

(i) Number of meetings held of trustees.

(ii) Quality of supervision provided by trustees.

Chapter 8
Mutual Fund - Internal Audit Checklist

8.1 Details of key areas along with the detailed activities for internal audit of mutual fund are tabulated hereunder. It may be mentioned that the list given is illustrative in nature.

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
1.	APPROVAL OF MANUALS, SCHEME OFFER DOCUMENTS		
	1.1. Whether manuals like Compliance Manual, Operation Manual, Advertisement Manual, IT System Manual, Sales/ Customer Service Manual, Risk Management Manual, Investment Policy, Valuation Policy, Employee Dealing policy etc, including delegation of authority is in place and are approved by the Board of AMC and Trustee, and whether the same is periodically (preferably annually) updated/ approved by authority.		
	1.2. Verify that Scheme Information Document (SID), Statement of Additional Information (SAI) and Key Information Memorandum (KIM) are available on fund website as per SEBI circular dated 29th September, 2009 and same are in the prescribed formats.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	1.3. Whether soft copy of SID uploaded on AMFI website two working days prior to launch of the scheme.		
	1.4. Whether in case of any changes in fundamental attributes of the scheme, the SID/ KIM has been revised and updated immediately after completion of duration of the exit option.		
	1.5. Whether in case of any other changes in the scheme, the AMC display it on its website the addendum and issued the same to all distributor and Investor Service Centre.		
	1.6. Where a public notice given in respect of such changes in one english daily newspaper having nationwide circulation as well as in a newspaper published in the language of region where the Head Office of the Mutual Fund is situated.		
	1.7. Whether copy of all changes made to the scheme are filed with SEBI within 7 days of the change.		
2.	APPROVAL AND DELEGATION OF AUTHORITY		
	2.1 Verify the delegation of authority as prescribed by various manuals of the Board of AMC/ Trustees and its implementation.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	2.2 Verify the transactions executed to ensure that the same is approved by the appropriate authority and that they are within the limits of authorization.		
	2.3 Verify that limit-wise authorization matrix has been defined in the system.		
	2.4 Verify that all such approvals are logged in the system and reviewed.		
	2.5 Verify the amendments, if any, to the delegations and whether the same are approved by the Board of AMC.		
3.	SEGREGATION OF DUTIES – FRONT OFFICE/ MID OFFICE/ BACK OFFICE		
	3.1. Understanding of segregation of duties between the Front Office (FO)/ Mid-Office (MO)/ Back Office (BO) in Mutual Fund and authorization matrix for the same.		
	3.2. Verify whether the structure of FO/ MO/ BO represents the actual workflow or is designed just for regulatory compliance.		
	3.3. Verify whether the Fund have job rotation policy.		
4.	FUND ACCOUNTING AND BACK OFFICE FUNCTION		
	4.1. Audit Trail and Records (i) Is there a record of all deals that have been done?		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ii) Are all deal slips serially numbered and available? (iii) Is there a record of approvals and investment justifications for each deal? (iv) What is the frequency of backups?		
	4.2. Investment Deal Testing (i) Verify that each deal has a deal slip with appropriate details *viz.*, security name, quantity, amount, broker name, etc. (Ideally system should have all requisite fields as mandatory fields without which deal slip should not be generated). (ii) Verify whether intimation for the trades sent to custodian is with proper documentation (such as, amount, quantity, value, description, etc.). (iii) Verify whether investments made by fund manager are backed by research report and research report format is approved by the board. (iv) Verify whether deals entered by the front office are backed by a broker note or entry into STP dump. (v) Verify, if there are any error trades, whether deals are authorized and matched with the underlying documents		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	such as counter-party confirmation, etc. (vi) Verify whether calculation of profit/ loss is happening on trade upon deal entry. (vii) Verify that there is adequate segregation of duties between people booking, confirming and accounting the trade (system should not allow a single person to complete a transaction). (viii) Verify whether the deals placed can be traced in the Voice Recording Machine. (ix) Verify the guidelines for schemes making overseas investments which inter alia include permissible limits, securities, dedicated fund manager, disclosures in SID, etc. (x) Verify whether in case of overseas investments, the disclosures in Half Yearly portfolios has been made in the prescribed format under a separate heading "Foreign Securities and/or overseas ETF(s)". In addition, whether scheme-wise percentage of investments made in such securities is disclosed while publishing Half Yearly Results in prescribed formats.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(xi) Verify whether offer document limits (if any) are complied with.		
	4.3. Accounting and Settlement of Deals (i) Obtain the procedure for accounting and settlement of deals from Manuals/ Policies and verify that the same is being adhered to. (ii) Verify whether all investment are accounted on trade date. (iii) Verify whether the settlement date is tracked properly. (iv) Verify whether robust cash management process is in place. (v) Verify that the funds are transferred as per the settlement date and trace the same in the bank statement. (vi) Verify entry into demat statement received on a test check basis from the custodian. (vii) Verify that investment bank reconciliation statement is prepared on a daily basis and is signed by the maker and reviewer. (viii) Verify that custodian reconciliation is prepared on a daily weekly and is signed by the maker and reviewer.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ix) Verify custodian reconciling items and whether they are followed up on a timely basis. (x) Verify that there is a four-eye principle (maker checker concept) for the process. For example, person settling the trade and person preparing reconciliation are different people. (xi) Verify whether the amount received/ paid against security sold/ purchased is properly recorded. Verify with the logs for any modification of deals exception note that has been generated and approved by the Dealer and Fund Manager. (xii) Verify whether investments are made as per objectives defined in the offer documents.		
	4.4 NAV Process (i) Verify on test check basis whether NAV computed either by in-house or outsourced fund accounting is correct considering all aspect including, valuation of investments, Income and expense accrual, corporate actions, dealing room activities (buying and selling), primary market transactions and inter-scheme transfer, Registrar's controls with		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	regarding to purchase, sale, rejection of unit transactions. (ii) Verify whether MF has provided an option to the investors to receive allotment of Mutual Fund units in their demat account while subscribing to any scheme (open ended/ close ended/ Interval). (iii) Verify whether security master is created as per the term sheet and deal slip. (iv) Verify whether there is a four-eye principle of maker-checker for security master creation and updation. (v) Verify whether all dividend and interest income been accounted on accrual basis, (vi) Verify whether valuation of Debt instruments, Money Market Instruments, Mutual Fund Investments, Equity Investments, Derivatives Investments and gold investments are valued as per MF Regulations and Valuation Policy. (vii) Verify whether realized and unrealized incomes are correctly accounted at the time of generation of NAV. (viii) Verify whether corporate actions are accounted and recorded on ex-date.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ix) Verify investment valuation of various securities and check whether it is in accordance with MF regulations? (Investment criteria should be set-up in the system and the same should be reconciled with independent valuation). (x) Verify whether expenses are correctly charged to various schemes and are within the maximum permissible limit as per MF Regulations. (xi) Check whether the company uses appropriate sources for deriving market value/ fair value of the investment. (xii) Verify whether there is an internal process, existing to ensure that units are daily reconciled as per the NAV Report and Report of Registrar and Transfer Agent Report. (xiii) Verify whether the units created or redeemed bring in or take out correct money of the fund to ensure the interests of all the policyholders are protected. If there is any difference, the same shall be compensated. (xiv) Verify whether investments are allocated to the different portfolios at the inception. (xv) Verify whether inter scheme transfers are done as per		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	norms and approved framework. (xvi) Whether the investments of the schemes strictly follow the pattern of investment and the limits mentioned in the product feature? (Norms and limits should be setup in the scheme master). (xvii) Whether the NAVs declared are correct and tally with the system. (xviii) Whether NAV are timely uploaded on AMFI website. (xix) If there is change in NAV more than 1% due to the error, the same shall be compensated to the unit holders as per the MF Regulations. (xx) Whether reasons for error impacting NAV less than 1%, have been documented with action plan to restrict re-occurrence in future. (xxi) Whether statutory dues like, STT, TDS and Service Tax, etc are correctly deducted and timely deposited to central governments. (xxii) Whether statutory returns are timely submitted to appropriate authority. (xxiii) Verify whether mark up and down are signed by CEO.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(xxiv) Verify whether expenses are correctly allocated to the schemes. Verify whether the appropriate authority authorizes the same. (xxv) Whether the usage of load account is in terms of SEBI circular dated 9th March 2011.		
	4.5 Reconciliations (i) Verify whether following reconciliations are carried out on a day to day basis and the same is signed by maker and checker: • Scheme-wise Collection Bank Reconciliation • Scheme-wise Redemption Bank Reconciliation • Scheme-wise Investment Bank Reconciliation • Switch Reconciliation • Dividend Reconciliation • Brokerage Reconciliation • RBI-SGL Reconciliation. (ii) Verify whether there is any long outstanding items appearing in the reconciliation. (iii) Verify whether management follow-up to identify and rectify old balances appearing in reconciliation. (iv) Verify whether RBI-SGL reconciliation is timely submitted to RBI.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(v) Whether Disaster Recovery Plan (DRP) and Business Continuity Plan are in place and have been tested.		
	(vi) Whether unclaimed redemption and dividend amount are invested into short-term deposits in accordance with the SEBI Regulations.		
	4.6 Investible Surplus (i) Verify determination of the investible surplus. (ii) Verify the control are in place for accuracy and completeness. (iii) If there is idle cash, inquire into reasons for the same. (iv) Whether distributable surplus are correctly calculated as per SEBI circular dated 15th March, 2010 and correct dividend are distributed and paid to unit holder. (v) Whether appropriate public notice of dividend declared is communicated as per regulations (applicable to unlisted schemes other than liquid/ debt schemes with frequent dividend distribution and listed schemes which notice shall be as per listing agreements guidelines). (vi) Verify whether there has been any modification in dividend liability impacting the total		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	outflow based on back dated processing by R&T.		
5.	CUSTODIAN ACTIVITY		
	5.1. Custodian Appointment and Controls (i) Check the appointment of custodian, its approvals and whether the agreement is effective/ live. (ii) Review the custodian agreement to ensure that the custodian: a) Maintains confidentiality and protects data from intentional or inadvertent disclosure to unauthorized persons. b) Has a comprehensive and effective system for disaster recovery and periodic testing of backup facilities? c) Has an adequate system to address all operational risks arising out of technology, errors and frauds which have been put in place? d) Provides full access to all records and other material to SEBI or its authorized representatives to the same extent as if it were a department of the company.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(iii) The outsourcing agreement with custodian shall contain an exit clause providing for smooth transfer of records and functions to the company or its nominated contractor in the event of the outsourcing agreement being terminated, without imposing onerous penalties for termination. (iv) Check if there is a periodic audit of the custodian to ascertain that adequate process and systemic controls are in place.		
	5.2. Controls Over Physical Instruments (i) If any instruments are dealt with in physical form, check for controls with regard to name of scheme on physical certificate, storage and accounting of such instruments. (ii) Verify whether Reconciliation of holdings as per custodian books and fund accounting books are carried out on a weekly basis and maker and checker sign the same. (iii) Verify whether salable quantities are correctly reflecting in custodian holding statement.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(iv) Whether NSDL account of all matured schemes are closed. (v) Whether custodian is regularly following up with the issuer in case of non-receipt of any security in scheme books. (vi) Whether physical securities are properly kept in the safe deposit vault. (vii) Whether the authorized person signs Delivery Instruction for Purchase (DIP) and Delivery Instruction for Sale (DIS). (viii) Verify custodian is timely and correctly intimate all corporate actions to fund. (ix) Whether Business Continuity Plan (BCP) is in place and tested at regular interval? (x) Whether all the reports as agreed in SLA are sent by the Custodian.		
6.	COMPLIANCE FUNCTION		
	6.1. Verify whether all investments are within maximum permissible limits under Seventh Schedule of MF Regulations.		
	6.2. Verify whether all investment limits are set in the Front End System. If no, how the limits are monitored by compliance.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	6.3. Broker Appointment and Control		
	(i) Whether brokers are empanelled as per the norms approved by Investment committee.		
	(ii) Verify that transactions with Associated and Non-Associated Broker are within permissible limits as per MF Regulations. Further, in case of Non-Associate Broker if turnover exceeds permissible limits, justification for the same is available and given to the Board of AMC and Trustee.		
	(iii) Is brokerage paid to brokers are correct and are in line with rate agreed?		
	(iv) Verify whether that all dealing activities are done through recorded lines. Is there a designated person to review the same on regular interval (preferably quarterly) and whether the same is reported to Board of AMC and Trustees.		
	(v) Whether back up of recording line is maintained and the same is retrievable and tested on regular (preferably quarterly) interval.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	6.4. Employee Dealing Guidelines (i) Whether employee dealing policy, code of conduct, do's and don'ts are in place and approved by the Board of AMC and Trustee. (ii) Verify that employee dealing policy is adhered. (iii) Whether compliance maintaining records of all deals is done by employees. (iv) Whether deals are done through only designated broker appointed by AMC. (v) Whether there is any penalty imposed on employees during the period in case of insider trading. (vi) Verity that all reports like, Compliance Test Report, New Scheme Report HY and Quarterly Trustee to SEBI Report, etc. submitted/ published on AMC website/ AMFI/ SEBI website/ in Newspapers/ filed with SEBI within stipulated time limits? Contain correct data and in correct format. (vii) Verify whether the employee dealing policy contains Chinese wall procedures. (viii) Match yearly declaration of		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	investments by an employee has all transactions made during the year.		
	6.5. Inter-Scheme Transactions (i) Verify whether Inter-Schemes are done as per MF regulations and approved framework. (ii) Verify that inter-schemes are done at spot price or previous day market price as per MF Regulations. (iii) Verify that inter-scheme deal slips are signed by fund manager or dealer of both the schemes. (iv) Whether Inter-schemes are done to enrich one portfolio at the cost of the other. (v) If both schemes are handled by same fund manager then whether CIO has signed the deal slip. (vi) Check if the transferor scheme and transferee scheme has same investment objectives. (vii) Verify whether inter scheme deals are approved by Compliance officer. (viii) Verify whether Net-Worth of AMC for Mutual Fund is more than 10 Crores? In addition, it is in addition to the net worth requirement for other business e.g., PMS. Compliance with reg 24(2).		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ix) Asset allocation pattern of schemes: a) Verify whether asset allocation pattern of schemes portfolio are maintained in line with Scheme Information Documents (SID) on selective dates. b) Verify whether fund fact-sheets of relevant schemes certify the same. c) Verify whether SEBI Regulations are complied w.r.t. declaration of dividend i.e., rate of dividend, record date, trustee approval.		
	6.6. Borrowing (i) Whether Schemes have borrowed money? (ii) Whether money has been borrowed either for redemption or for dividend payment? (iii) Whether borrowings are within prescribed limits? (iv) Whether period of borrowing is more than 6 months? (v) Whether interests on such borrowings are borne by the AMC or charged to schemes? (vi) If interest charged to scheme (net of income earned due to		

No.	Particulars	Observation, Associated Risk & Recommend ation	Management Comments
	non liquidation of assets) is within limits stated under SEBI Regulations. (vii) Whether the scheme-wise balance sheet discloses the details of borrowings by the scheme with amount, rate of borrowings, rate of interest, source and other terms shown separately, source-wise. (viii) Whether mutual fund has borrowed only to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit-holders. (ix) Whether mutual fund has borrowed more than 20 per cent of the net assets of the scheme and the duration. (x) Whether borrowings above 10 per cent of the net assets of any scheme of the mutual fund has been disclosed in the notes to accounts.		
	6.7. Voting Rights (i) Is there a procedure for exercise of voting rights and seeking representation on board of companies? (ii) Are these procedures and decisions taken by the		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	company adhered to during the period under review?		
	6.8. Advertisement Policy (i) Whether Advertisement Policy is in place and the same is approved/ noted by appropriate authority? (ii) Whether the Advertisement Policy is adhered to in all the cases. (iii) Verify whether the standards of communications are followed (i.e, same is fair and in good faith, no material fact omitted, declaring source of information when statistics published, standard risk disclosures published, no usage of unwarranted claims, etc.) (iv) Verify whether adequate controls exist to ensure that marketing collateral released complied with the regulatory norms.		
	6.9. Verify whether portfolios as on the last day of the month are uploaded on fund website on or before 3rd working day of succeeding month.		
	6.10. Verify that a close-ended debt scheme has invested in a security, which matures on or before the date of the maturity of the scheme.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	6.11. Verify that changes in expense ratios are updated on mutual fund website within two working days from the effective date of the change.		
	6.12. Verify whether observations of SEBI inspection report are addressed.		
	6.13. Verify the report filed with SEBI/ RBI/ Trustees/ AMFI is in correct format with correct data and files within time.		
	6.14. Verify whether composition of Board of Trustee and AMC is in compliance of SEBI Regulations.		
	6.15. Verify whether the Compliance officer of the Mutual Funds while forwarding the MCR data to SEBI confirmed that “the data forwarded is correct and does not require any revision”.		
	6.16. Derivative Transactions (i) Verify that the funds of scheme are not used to carry forward transactions subject to Derivative transactions on stock exchange and regulatory framework (Refer SEBI circular dated 18th August, 2010 for prudential limits for derivative investments by mutual funds)		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	6.17. Underwriting Transactions (i) Verify whether mutual fund has entered into Underwriting after obtaining registration certificate from SEBI to conduct said activity. (ii) Verify whether underwriting obligations have not exceeded the NAV of the scheme.		
7.	DEALING ROOM ACTIVITY		
	7.1 Verify whether Dealing Room policy is in place and is approved by Board of AMC and Trustees.		
	7.2 Verify whether the policy is adhered regularly.		
	7.3 Verify whether systems are in place to check on adverse dealing practices (e.g., front running, circular trading).		
	7.4 Verify that deals are done by authorized person.		
	7.5 Verify whether all deals are done through voice recorded lines and whether there exists procedure for maintaining the recorded conversation and their disposal.		
	7.6 Whether the voice recordings are reviewed on a periodic basis by Compliance/ Mid Office and whether an auditable log is maintained of the same.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	7.7 Verify whether adequate infrastructure is in place to avoid dissemination of information to unauthorized personnels.		
	7.8 Verify whether the dealer is not a common person for other business activities of AMC (e.g., PMS).		
8.	PREVENTION OF ANTI MONEY LAUNDERING AND KYC NORMS		
	8.1. Whether Policy for Prevention of Anti Money Laundering (PAML) and KYC Norms is in place and is approved by Board of AMC and Trustees? Is it in line with the SEBI Regulations.		
	8.2. Whether the same is adhered to.		
	8.3. Whether the company maintains a record of all the transactions as specified by PAML.		
	8.4. Whether the PAML policy issued by the company is being reviewed regularly.		
	8.5. Whether the reviewing function and framing function are carried out by two different persons.		
	8.6. Whether Customer Due Diligence (CDD) has been undertaken.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	8.7. Whether policy framed by the company covers the following aspects: (i) Communication of group policies relating to prevention of money laundering and terrorist financing to all management and relevant staff that handle account information, securities transactions, money and customer records, etc. whether in branches, departments or subsidiaries; (ii) Customer acceptance policy and customer due diligence measures including requirements for proper identification; (iii) Maintenance of records; (iv) Compliance with relevant statutory and regulatory requirements; (v) Co-operation with the relevant law enforcement authorities including the timely disclosure of information; (vi) Role of internal audit or compliance function to ensure compliance with policies, procedures and controls relating to prevention of money laundering and terrorist financing, including the testing of the system for detecting		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	suspicious money laundering transactions, evaluations and checking the adequacy of exception reports generated on large and/ or irregular transactions, quality of reporting of suspicious transactions and the level of awareness of front line staff of their responsibilities in this regard.		
	8.8. Whether the Client Due Diligence Process covers the following: (i) Policy for acceptance of clients (ii) Procedure for identifying the clients.		
	8.9. Transaction monitoring and reporting especially Suspicious Transaction Reporting (STR).		
9.	INVESTOR SERVICES AND RISK MANAGEMENT ACTIVITIES		
	9.1. Whether Policy for Risk Management Activities as per SEBI circular MFD/CIR/15/ 19133/ 2002 dated 30th September, 2002 is in place and is approved by Board of AMC and Trustees.		
	9.2. Whether the same is adhered regularly.		
	9.3. Whether the committee or the Risk officer reviews its compliance periodically.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	9.4. Verify that the scheme-wise Annual Report of the fund or an abridged summary thereof has been mailed to all unit holders (containing details as specified in the Eleventh Schedule) not later than four months from the date of closure of the relevant financial year. [Reg. 56(1)&(2)]		
	9.5. Verify that the mutual fund has forwarded a copy of the annual report and scheme-wise portfolio within four months from the closure of the financial year. [Reg. 57]		
	9.6. Verify that the mutual fund and the AMC have published its unaudited financial results in newspapers in the format prescribed in Twelfth Schedule of the Regulations.		
	9.7. Verify that the mutual fund has sent a complete statement of Scheme Portfolio to the unit holders before the expiry of one month from the closure of each Half Year (i.e., March 31 and September 30), if such statement is not published by way of advertisement. [Reg. 59A & SEBI Circular No.MFD/CIR No.010/024/00 dated January 17, 2000]		
	9.8. Whether the internal auditors have checked the adequacy of		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	Risk Management Systems on a continuing basis.		
	9.9. Whether the report of internal auditors are placed before the Board of the AMC and Trustee(s) who shall comment on the adequacy of systems in the CTRs and Half Yearly Reports filed with the SEBI.		
	9.10. Whether in case of Dormant Account holders, Mutual Funds have provided Statement of Accounts to those unit holders who have not transacted during the last six months prior to the date of generation of the Statement of Accounts.		
	9.11. Whether in Dormant Account holders, Statement of Accounts is issued alongwith scheme's Portfolio Statement or Annual Report and same has reflected the last closing balance and value of the units prior to the date of generation of the Statement of Accounts. If mandated by unit holder, whether a soft copy of the Statement of Accounts has been emailed to the unit holders instead of a physical statement.		
	9.12. Whether in case of realisations of NPA investments or illiquid		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	investments within 2 years after the time of maturity/ winding up of the scheme, the amount is repaid to old investors if such amounts are substantial? The Trustees of mutual funds shall take the decision as to the determination of substantial amount.		
	9.13. Whether in case of realizations of NPA investments or illiquid investments after 2 years after the time of maturity/ winding up of the scheme, the same are transferred to the Investor Education Fund maintained by each Mutual Fund.		
10.	BOARD GOVERNANCE		
	10.1. Whether the AMC has constituted an in-house valuation committee consisting of senior executives including personnel from accounts, fund management and compliance departments.		
	10.2. Whether the Valuation committee on a regular basis reviews the systems and practices of valuation of securities.		
	10.3. Whether the Directors of the AMC have filed with the trustees on a quarterly basis their details of transactions in securities exceeding ₹ 1 lac.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	10.4. Whether the Trustee Directors have reported to Mutual Funds the transactions in securities exceeding ₹ 1 lac in value.		
	10.5. Whether the Trustees review all transactions of the Mutual Fund with the associates on a regular basis.		
	10.6. Whether on appointment of new directors of the AMC or Trustee, their bio-data is filed with SEBI for information or approval respectively.		
	10.7. Whether the Employee dealing guidelines compliances are placed before the AMC and Trustee Board and reviewed periodically.		
	10.8. Whether the Investment Management Agreement and Trust deed entered into are in line with the contents specified in the third and fourth schedule respectively of SEBI Mutual Fund regulations.		
	10.9. Whether there are Chinese firewalls between various business activities of the AMC (*viz.*, PMS, Asset Management, Advisory etc.).		
	10.10. Whether AMC has job rotation policy in place.		
11.	REGISTRAR & TRANSFER AGENT FUNCTION		
	11.1. Investor Service Centers (Front Office) (i) Whether the procedure of		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	receipt of application is carried out properly. (ii) Whether the data capturing aspect at the ISC is carried out properly. (iii) Whether KYC process is carried out by the ISC in an appropriate manner. (iv) Whether the process of formation of customer master and scheme master is verified. (v) Whether inward entry (affixing of bar code) is done on application received. (vi) Whether the information scrutiny of received applications is carried out. (vii) Whether the process of scanning of documents is understood and verified. (viii) Whether various reports generated are explored and verified. (ix) Whether reports of external auditors considered. (x) Whether the dispatching of applications process is understood and verified. (xi) Whether all the commercial transactions as subscription/ redemption/ switch/ are duly time stamped? (Time stamp field should be mandatory in the system).		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(xii) Whether time stamp affixed across the locations are correct and consistent and reviewed on periodical basis. (xiii) Whether the Trustees have approved policy on exception in case of breakdown of Date and Time Stamp Machine (DTSM). (xiv) Whether instances of break down/ servicing of the DTSM have been reported to Trustee. (xv) Whether a manual register has been kept in place to capture the time in case of breakdown of Date and Time Stamp Machine. (xvi) Whether all mandatory documents are collected at the time of accepting the subscription application? (A checklist for mandatory documents should be kept at centres collection subscription application.) (xvii) Whether all the applications received across AMC branches/ ISCs are scanned and uploaded into the system. (xviii) Whether all the original documents are dispatched to the R&T Head Office. (xix) Whether all the applications		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	reported during the day are reconciled with the number of applications scanned and sent at R&T head office. (xx) Whether all the investment related documents are available in physical form and tagged to the respective transactions in the system. (xxi) Whether distributors' self-declarations and KYD received is updated in the system before processing the brokerage for the period. (xxii) Whether Investor complaint/ service management system is in place. (xxiii) Whether all the investor complaints/ request received are received and processed through the investor complaint/ request management system and resolved correctly. (xxiv) Whether all the service Turn Around Time (TATs) are agreed with AMC and defined in the system. (xxv) Whether all the necessary documents are obtained before processing the Investor complaints/ request. (xxvi) Whether SIP/ STP/ SWP registered is based on the physical mandate received from the investor.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(xxvii) Whether all the new SIPs/ STPs/ SWPs reported by ISCs/ AMC branches/ channel partners/ web applications are tracked in terms of physical received/ registered/ yet to register/ rejected and reconciled with application entered in the system. (xxviii) Whether ECS SIP mandates are sent to third party for bank registration. (xxix) Whether DD SIP mandates are sent to bank for registration. (xxx) Whether DD SIP cancelation request is sent to bank for cancellation. (xxxi) Whether all SIP/ STP/ SWP debit instructions are sent as per the SIP/ STP/ SWP cycle selected by the investor. (xxxii) Whether all applications processed are verified, i.e., is there a maker-checker policy in place. (xxxiii) Are there any exception reports generated? (xxxiv) Does the review process include element of `surprise'?		
12.	BACK OFFICE		
	12.1. Whether NAV applied to the transactions is in line with the uniform time stamping		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	circular and credit of the funds is reflecting in the investment account (in case of liquid schemes and debt schemes for transactions or ₹ 1 crore and above).		
	12.2. Whether AMC switch matrix is uploaded in the system and NAV applied to switch transactions are in line with the switch matrix.		
	12.3. Whether all the redemption warrants are issued within 10 working days from the date of transaction.		
	12.4. Whether all the dividend warrants have been dispatched within 30 days from the record date.		
	12.5. Whether compensation has been paid for delay in dispatch of redemption and dividend warrants.		
	12.6. Whether Account Statements are dispatched within 5 days from the closure of the NFO.		
	12.7. Whether minimum investor clause has been verified in accordance with SEBI directives.		
	12.8. Whether 20/ 25 clause on minimum investor and maximum investment by each investor is verified on quarterly interval.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	12.9. Whether restrictions w.r.t. minimum subscription amount, minimum balance, default option, etc, are properly captured in the system.		
	12.10. Whether sample verification of the transactions has been done to understand the quality of data entry accuracy.		
	12.11. Review the Internal checks and controls put in place by the RTA.		
	12.12. Verify SAS 70 report where applicable.		
	12.13. Whether authorized brokerage master rate structure is received from AMC and the same is uploaded into the system with proper maker checker mechanism.		
	12.14. Whether brokerage is calculated as per the master rate structure and the same is cross validated before forwarding it to the AMC.		
	12.15. Whether all the updations in brokerage master rate structure are done as per the instructions from AMC and are documented appropriately.		
	12.16. Whether all the held up		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	parameters as defined in the AMFI circulars are defined in the system and working properly.		
	12.17. Whether excess brokerage paid and to be recovered has been tracked on continuous basis.		
	12.18. Whether the rate of service tax and education/ secondary education cess is correctly updated in the system.		
	12.19. Whether the month end reporting is done to AMC with number of investor complaints/ request received, resolved and pending for the period.		
	12.20. Whether all the pending corporate documents are tracked on periodic basis.		
13.	DISTRIBUTION		
	13.1. Empanelment, Activation & Review (i) How many distributors are empanelled for distribution of products of mutual fund? (ii) What is the process for empanelment? (iii) What is the backup documentation needed for empanelment?		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(iv) Who approves empanelment on behalf of AMC? (v) What is the delegation of authority for empanelment? (vi) Is there any categorization of distributors empanelled? What are the parameters for such categorization? How often are these reviewed? Whether any upgrade/ downgrade happens, on the same? (vii) In case of empanelment with large banks, etc, whether any due diligence documentation has been submitted. (viii) For the above, how has the due diligence data compilation been done. Who is responsible for the same? (ix) What is the involvement of compliance in the empanelment process? (x) Whether the AMC does any regular review of distributors empanelled? If yes, are minutes of the same maintained. (xi) Whether there is any weeding out of inactive distributors? How is active/ inactive defined. (xii) Whether any exercise is conducted to activate dormant distributors.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(xiii) What is the chain of authority that participates in these review processes?		
	13.2. Commercials (i) What is the process for negotiation of commercials with empanelled distributors? (ii) What are the records maintained for the same? (iii) Who decides on how much commercials is to be offered for each distributor? What is the process for delegation of authority and are Regional Heads offered budgets, if so details thereof? (iv) How are exceptions to the process carried out and are documentation kept for the same? (v) Record of communications have been sent out to the distributors on the same. (vi) How changes to the brokerages to be paid out are communicated to the R & T agent who ultimately pays it? Whether maker/ checker concept exists for the same. (vii) What is the process for approvals of brokerages on a regular basis?		
	13.3. NFO and product promotion (i) What is the process for		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	launch of NFO (New Fund Offer) or promotion of an existing product? (ii) Is there a product P & L and who is responsible for the same? (iii) Commercials for NFO/ product promotion. (iv) Whether any sales promotion/ contest has been launched for incentivising sales. (v) What is the process followed for internal approvals of contest? (vi) What is the chain of command for approvals/ exceptions? (vii) Whether contest brochures and other collateral has been pre approved by compliance? (viii) Whether contest costings have been approved internally and check back up papers for the same ?		
	13.4. Marketing Collaterals (i) What is the process for developing marketing collateral for products? (ii) Verify whether list of product presentation, one pagers, flyers, banners, posters, etc are available. (iii) Whether the marketing collateral is pre-cleared with		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	compliance for adherence to the SEBI Advertisement Code. (iv) What is the process for clearing the marketing material with compliance?		
	13.5. Sales Management (i) Verify distribution of sales force region-wise/ manager-wise. (ii) Whether all sales force have been AMFI certified as required by SEBI. (iii) Whether process followed to ensure compliance with the above. (iv) Whether process for roll out of annual targets and communication of annual goals has been followed. (v) Verify process for communication of annual budgets and details of delegation to Regional Heads. (vi) Verify incentives launched for internal sales force. (vii) Verify details of plan and approval process followed for the same. (viii) Verify details of MIS generated for sales numbers and the review/ monitoring mechanism for the same.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ix) Verify process for recording meetings - meeting tracker, call reports, usage of software like Talisma, Sales Force, etc. (x) What are the internal controls in place to ensure that no written or electronic communication is sent out to customers without prior approval from compliance? (xi) Verify frequency and quality of training of sales staff. (xii) How are KRAs of the sales team members, regional heads and sales head decided? (xiii) What is the methodology adopted for digging and prospecting of new leads/ distributors/ customers? (xiv) What are the internal control mechanisms for controlling mis-selling of products? Have there been any customer complaints; redressal mechanism for the same?		
	13.6. Subscriptions and Redemptions (i) How are sales and redemptions tracked? (ii) Is there a distributor/ customer contact program in case of large redemptions?		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(iii) What are the customer retention initiatives? (iv) What are the cross sell initiatives? (v) Documentation for applications/ redemptions - where does the role of sales end and that of customer service begin? Are roles and responsibilities clearly defined. (vi) Verify matrix for escalation in case of deficiency in customer documentation.		
	13.7. Distributor Contact Program (i) Is there a distributor contact program drawn up which specifics content and frequency of contact? (ii) What is the plan for joint events with distributors? (iii) Verify the details of distributor training programs carried out.		
14.	FUND		
	14.1. Fund of Funds Scheme (i) Whether Scheme Information Memorandum and all advertisements for such Schemes have been disclosed clearly that Investors will bear the recurring expenses of the scheme alongwith the		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	expenses of other schemes in which the Fund of Funds Scheme makes its Investments. (ii) Verify that AMC has not entered into any form of revenue sharing arrangement with the underlying funds. Where any commission or brokerage is received from these underlying funds, the said amounts are to be credited into the concerned scheme's account. (iii) Verify whether the Fund of funds mutual fund schemes adopt either of the total expense structures laid out in Regulations, which AMC shall clearly indicate in the SIDs.		
	14.2. Gold Exchange Traded Funds (i) Verify whether Investments in Gold related instruments are done only after such instruments are specified by SEBI. (ii) Verify whether recurring expenses limits applicable to equity schemes are applicable to GETF Schemes. (iii) Whether Gold is valued based on the methodology as		

No.	Particulars	Observation, Associated Risk & Recommend ation	Management Comments
	provided in Clause 3A of, Schedule Eight of the Mutual Funds Regulations? (iv) Verify whether GETF Schemes performances are benchmarked against the price of gold. (v) Whether physical verification of gold underlying the Gold ETF units is carried out (by Statutory Auditors of the Scheme) and reported to the Trustees every half year?		
	14.3. Capital Protection Oriented Scheme (i) Whether the SID, KIM and advertisements pertaining to the Capital Protection Oriented Scheme disclose that scheme is "oriented towards protection of capital" and not "with guaranteed returns" and indicate that the orientation towards protection of capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover, etc. (ii) Verify that the proposed portfolio structure indicated in the SID and KIM is rated by a SEBI registered Credit Rating Agency on a quarterly basis by the Mutual Fund.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	14.4. Real Estate Funds (i) Verify that the units of real estate mutual fund do not confer any right on the unit holders to use the real estate held by the scheme or any provisions of trust deed. (ii) Whether the title deeds pertaining to real estate mutual fund are kept in safe custody with the custodian. (iii) Verify that the scheme has not undertaken any lending or housing finance activity. (iv) Verify that the real estate fund invests in permissible investments defined under regulations 49E.		
15.	INFORMATION TECHNOLOGY		
	15.1. Approval of Information Security Policies and Procedures (i) Whether organizational level Information Security policies, guidelines and procedures are in place and are approved by Board of the AMC in order to safeguard the organization's information resources such as, business applications, computer resources, network against unauthorized access, disclosure and misuse.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ii) Whether the same is periodically updated according to the latest security trends and are approved by the competent authority of the company.		
	15.2. Application Access Control (i) Whether the organization has implemented application access controls (especially for all the core and critical applications) in order to ensure completeness, accuracy, validity, authorization, segregation of duties to process information relating to business and to meet the business objectives. (ii) Whether the applications have the provision or capability to enforce maker-checker controls for critical functions such as user administration, master creation/ updation, critical transactions, etc. (iii) Verify whether unused user ids of the applications are disabled immediately and deleted, if not required. (iv) Verify whether user ids granted to the application users have correct privileges and access rights and whether user access rights		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	are reviewed periodically. (v) Verify whether minimum password controls (such as, minimum password length, password complexity, locking of password after certain number of unsuccessful attempts, forcing the user to change password on first logon, etc.) are implemented in the critical applications. (vi) Verify whether logical controls in the applications such as, session time out, disabling inactive users, login banner in application providing legal notice to users, notify the user with last log-in/ log-out information, etc., have been implemented in the critical applications. (vii) Verify whether the organization has defined process for periodic review of application audit logs of the users. (viii) Verify whether automated "interface controls" are in place to facilitate business data flow as an independent scheduled activity free from manual intervention. (ix) Verify whether application development is done by		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	following a systematic Systems Development Lifecycle Methodology.		
	15.3. Data Centre Controls (i) Verify whether temperature and humidity levels at the data center are monitored and documented on a daily basis. (ii) Verify whether power backup solutions like UPS/ power generator utilization is monitored and documented on a daily basis. (iii) Verify whether fire sensors and fire extinguishers are available to handle emergencies at the data centre. (iv) Verify whether all network and electrical cables are laid down separately with a minimum distance of one foot between them and appropriately labeled. (v) Verify whether the organization has developed policies and procedures with respect to physical security of the data centre and these are adhered. Critical areas like, process of granting access to authorized users, visitors, vendors, etc., to the data centre are defined in the policy.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(vi) Verify whether CCTVs were deployed in the data centre to monitor physical activity. (vii) Verify whether all asset movements within and out of the data centre are recorded and maintained.		
	15.4. Desktop Controls (i) Verify whether all the Desktop controls and hardening like, renaming the local administrator, disabling CD/USB is performed according to the organization Desktop Hardening policy. (ii) Whether all the desktop and laptops are patched with the latest windows patches.		
	15.5. Operation Systems Controls (i) Verify whether all the Server Access Controls and Server hardening like, renaming the local administrator, disabling CD/USB, disabling unwanted services are performed according to the Organization Server Hardening policy.		
	15.6. Database Controls (i) Whether the organization has formal documentation guidelines defining the process of inducting databases and appropriately hardened with IT controls.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	(ii) Whether password and logical access control are implemented as a part of database controls. (iii) Whether audit trails are implemented on the databases for performing audit trails for tracking the changes/ modifications in database.		
	15.7. Backup Management (i) Whether the organization has documented policies, procedures and schedules that define the entire backup management process being followed in the organization, Also, check whether these documents clearly define the scope, frequency, types and schedule for backup. (ii) Whether backup tapes are sent to off-site location and are stored in a fireproof cabinet. (iii) Whether the backup tapes are adequately labeled. (iv) Verify whether the backup tapes are stored in a secure infrastructure for 8 years as per the SEBI regulations. (v) Verify whether the backup administration team performs the backup restoration drill to		

No.	Particulars		Observation, Associated Risk & Recommendation	Management Comments
		test and document backup results.		
	15.8.	Incident Response Management		
	(i)	Whether a formal defined policy and procedure for Incident Response is followed in the organization.		
	15.9.	Source Code and Escrow Arrangements		
	(i)	Verify whether critical applications running the mutual fund business have active Source Code Escrow Agreements with the vendors.		
	15.10.	Network Security		
	(i)	Verify whether the organization maintains Secure Configuration Document (SCD) for hardening of Network Routers and Switches.		
	(ii)	Verify whether the firewall is configured to restrict access to network addresses and services only from those hosts, which require access.		
	(iii)	Verify whether Antivirus software is installed and updated in all servers and desktops and are patched against all known viruses and prospective malicious codes.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	15.11. Disaster Recovery and Business Continuity Plan (i) Whether the organization has defined, documented and tested Disaster Recovery Plan. (ii) Whether periodic DR drills are performed. (iii) Whether Business Continuity Plan (BCP) is in place and tested at regular intervals.		
	15.12. Outsourcing and Vendor Management (i) Whether the organization has communicated its generic information security guidelines to the vendors/ outsourced partners while operating in its premises. (ii) Whether the organization has signed service level agreements with outsourced vendors for all critical service contracts. (iii) Whether the organization is doing evaluation of the vendors on a periodic basis.		
16.	ROLE OF TRUSTEES		
	16.1. No of Meetings held of Trustees. (i) Obtain the minutes of all the meetings of trustees held during the year.		

No.	Particulars	Observation, Associated Risk & Recommendation	Management Comments
	16.2. Quality of Supervision provided by Trustees. (i) Whether the internal audit reports, concurrent audit reports, system audit report and any other report on controls effectiveness has been put to trustees for their review. (ii) Whether the accounts and report of statutory auditors were put to trustees review.		

Gist of Important Recent SEBI Circulars/ AMFI Guidelines

Circular Reference	Particulars
IMD/MC 2/ 836/2011 dated 7th January 2011	Master Circular for Mutual Funds – Compilation of all circulars issued by SEBI which are operational as on 7th January, 2011.
IMD/DF/4/ 2011 dated March 9, 2011 *(This circular supersedes all instructions regarding use of load accounts issued subsequent to the circular dated 30-6-2009).*	Usage of Load Account With a view to bring about uniformity in usage of load balances, the following have been decided: (a) The load balance shall be segregated into two accounts in the books of accounts of the scheme – one to reflect the balance as on 31-7-2009 and the other to reflect accretions since 1-8-2009. (b) Load balances can be used for marketing and selling expenses including distributor's / agent's commissions. (c) Not more than one-third of load balance as on 31-7-2009 shall be used in any financial year including the current financial year 2010-11. It is clarified though the unutilized balances can be carried forward, yet in no financial year the total spending can be more than one-third of the load balances on 31-7-2009. (d) The accretions after 31-7-2009 can be used by mutual funds for marketing and selling expenses including distributor's/agent's commissions without any restrictions mentioned in para (c) above.
CIR/IMD/DF/9/2011 dated May 19, 2011	Option to Hold Units in Demat Form a) Mutual Funds should provide an option to the investors to receive allotment of Mutual Fund units in their demat account

<table>
<tr><th>Circular Reference</th><th>Particulars</th></tr>
<tr><td></td><td>while subscribing to any scheme (open ended/close ended/Interval).
b) Mutual Funds/AMCs shall ensure that above mentioned option is provided to the investors in all their schemes (existing and new) from October 01, 2011 onwards.</td></tr>
<tr><td>CIR/ IMD /DF / 14 /2011 dated August 9, 2011</td><td>Investment by Foreign Investors in Mutual Fund Schemes
Foreign investors (termed as Qualified Foreign Investors/ QFIs) who meet KYC requirement may invest in equity and debt schemes of Mutual Funds (MF) through the following two routes:
• Direct route - Holding MF units in demat account through a SEBI registered depository participant (DP).
• Indirect route- Holding MF units via Unit Confirmation Receipt (UCR).</td></tr>
<tr><td>CIR/ IMD/ DF/13/ 2011 of August 22, 2011</td><td>A. Transaction Charges
• A transaction charge per subscription of ₹ 10,000/- and above be allowed to be paid to the distributors of the Mutual Fund Products.
B. Distributors of Mutual Fund Products
• Need for regulating distributors through AMCs.
• Due diligence process for distributors to satisfy ‘Fit and Proper criteria’.
C. Transparency of Information.
• Advertisement of scheme performance.
• Disclosure on bifurcation of the AUM into debt/equity/ balanced etc, and percentage of AUM by geography.
• Disclosure on websites for total commission and expenses paid to distributors.</td></tr>
</table>

Circular Reference	Particulars
Mutual Funds (Amendment) Regulations, 2011	A. Restrictions on Business Activities of the Asset Management Company • AMC to not to act as a trustee of any mutual fund. • AMC to not undertake any business activities other than in the nature of management and advisory services provided to pooled assets including offshore funds, insurance funds, pension funds, provident funds, if any of such activities are not in conflict with the activities of the mutual fund. B. The AMC shall not invest in any of its scheme, unless full disclosure of its intention to invest has been made in the offer documents. C. The AMC shall not carry out its operations including trading desk, unit holder servicing and investment operations outside the territory of India. D. The AMC shall ensure that consolidated account statement for each calendar month is issued, on or before tenth day of succeeding month. E. Introduction of Infrastructure Debt Fund Schemes.
MIRSD/SE/Cir-21/2011 dated October 5, 2011	Uniform Know Your Client (KYC) Requirements for the Securities Markets.
CIR / IMD / DF / 19 / 2011 dated November 11, 2011	Participation of Mutual Funds in Repo in Corporate Debt Securities The gross exposure of any mutual fund scheme to repo transactions in corporate debt securities shall not be more than10 % of the net assets of the concerned scheme.

References

1. SEBI (www.sebi.gov.in) – Please refer Mutual Funds Section.
2. AMFI (www.amfiindia.com)
3. BSE (www.bseindia.com)
4. NSE (www.nseindia.com)
5. Credence Analytics (www.credenceanalytics.com)
6. CRISIL (www.crisil.com)
7. Lipper (www.lipperweb.com)
8. Mutual Fund India (www.mutualfundsindia.com)
9. Morning Star (www.morningstar.com)
10. RBI (www.rbi.org.in)
11. Value Research (www.valueresearchonline.com)

I-11

TECHNICAL GUIDE ON INTERNAL AUDIT OF INFRASTRUCTURE INDUSTRY

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 nowledge 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.

Contents

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 utilization 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.

I-12

TECHNICAL GUIDE ON STOCK AND RECEIVABLES AUDIT

Foreword

In any business or organization, all functions are interlinked and connected to each other and are often overlapping. Some key aspects like, supply chain management, logistics and inventory form the backbone of the business delivery function. Inventory management is a very important function that determines the health of the supply chain as well as it impacts the financial health of the balance sheet. Finance against such inventories by banks is generally granted in the shape of cash credit facility where drawings will be permitted against stocks of goods. It is a running account facility where deposits and withdrawals are permitted. Stock audit acts as a warning signal to those accounts which are likely to turn into NPA. Stock audit also helps in prevention and early detection of frauds.

I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and other members of the Board for bringing out this "*Technical Guide on Stock and Receivables Audit*" on a timely basis. This Technical Guide will help the members to take care that the requirements of the banks or any other organization are met with and an early detection of the lapses and inconsistencies is done.

I am sure that this Technical Guide would be used by the members as a one stop practical guide for performing an effective stock and receivable audit and ensuring the quantity, quality, composition and actual value of the stock and the debtors.

February 6, 2012 CA. G. Ramaswamy
New Delhi *President, ICAI*

Preface

In the era of ever changing global business environment, a healthy as well as well balanced banking system is considered to be quite essential for any economy striving for growth and prosperity in the world of modern finance. The Indian banking system has witnesses numerous reforms and changes over the past two decades. Indian banks have enlarged their business portfolios not only in the domestic market but also in global competitive market.

The auditor of the bank today, be it at branch level or the head office level, is faced with challenges of the growing complexities in the operating environment of banks, attributable to not only the transactional, customer, regional spread of the activities of the bank, frequent regulatory directions issued by the banking regulator coupled with increasing use of sophisticated technology not only for providing services but also for accounting.

In the above scenario, for the internal auditors of banks to be able to provide quality in the audit services, requires proper understanding of the bank and its environment and application of that knowledge is indispensable. Considering this, the Internal Audit Standards Board of the ICAI is issuing this publication "*Technical Guide on Stock and Receivables Audit*" to provide extensive knowledge to the members restricted not only to circulars issued by the Reserve Bank of India but extends to knowledge of the industry, regulatory and other external factors, including financial reporting framework, nature of the client, *viz.*, its operations, ownership and governance structure, sources of its finances, selection and application of accounting policies, its objectives, including those related to its business risk, etc. This publication is a comprehensive, self contained in itself, touching upon almost all critical aspects in stock and receivable audit of banks. For easy understanding and practical implementation, the publication contains a variety of checklists and is written in a very lucid and logically flowing manner.

At this juncture, I wish to express my sincere gratitude to CA. Pankaj Kumar Adukia and his study group members for sparing time out of their professional and personal occupation and sharing wealth of their experience in the area of stock audit in the form of this publication.

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

February 5, 2012
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

Executive Summary

1. One of the primary objectives of the banks is to lend money against security. The banks and financial institutions lend money against hypothecation and pledge of stocks, book debts and securities. It is in the interest of the banks to monitor the activities of the borrower so as to ensure that the money has been applied for the purpose it was borrowed for and the public funds are not been squandered. It also has to ensure that the money is safe and there is adequate margin for the recovery of the loan.

2. Stocks and Debtors are two very important areas requiring attention because they are the essence of every business activity and they provide the true indication of strength and vitality of a business. The primary objective of verification, from any point of view, is to ascertain whether they are realizable in cash for the value stated. The best symptom for this is a good, healthy, regular movement of both. The thrust of any stock verification process is to verify the system followed or the procedure adopted to compile the quantities of stocks as on a given date and the rate applied for evaluation. The audit objectives remain the same though the accounting procedures vary from business to business, country to country, and product to product.

This book endeavors to provide the readers with a practical guidance on the various aspects of an audit of inventory and book debts.

Glossary

Cash Credit	A credit facility under which a customer draws up to the preset limit, subject to availability of sufficient security with the bank. The difference between an overdraft and cash credit account is that while the former is extended more to individuals, and less for business, the latter is extended only to business bodies. The cash credit facility is unique to India, as in most of the countries it is called overdraft. Further the cash credit facility is more or less on a permanent basis so long as the business is going on. Internationally, at the end of specific period the overdraft facility is withdrawn and the customer is required to pay back the amount lent by the bank. The purpose of cash credit is for working capital. The operations are similar to overdraft. Cash credit facility is of two types (depending upon the type of charge on goods taken as security by bank.) (i) *Cash Credit - Pledge*: when the possession of the goods is with the bank and drawings in the account are linked with actual movement of goods from/to the possession of the bank. The physical control of the goods is exercised by the bank. (ii) *Cash Credit*:- *Hypothecation*: when the possession of the goods remains with the borrower and a floating charge over the stocks is created in favour of the bank. The borrower has complete control over the goods and the drawings in the account are permitted on the basis of stock statements submitted by the borrower.
Causes of NPA	NPA arises due to a number of factors or causes like:- (i) *Speculation*: Investing in high risk assets to earn high income. (ii) *Default*: Willful default by the borrowers.

(iii) *Fraudulent Practices*: Fraudulent Practices like advancing loans to ineligible persons, advances without security or references, etc.

(iv) *Diversion of Funds*: Most of the funds are diverted for unnecessary expansion and diversion of business.

(v) *Internal Reasons*: Many internal reasons like inefficient management, inappropriate technology, labour problems, marketing failure, etc. resulting in poor performance of the companies.

(vi) *External Reasons*: External reasons like a recession in the economy, infrastructural problems, price rise, delay in release of sanctioned limits by banks, delays in settlements of payments by government, natural calamities, etc.

Charge on Assets of a Company

A charge means an interest or right which a lender or creditor obtains in the property of the company by way of security that the company will pay back the debt. Charges are of following two types:

(i) *Fixed charge*: Such a charge is against a specific clearly identifiable and defined property. The property under charge is identified at the time of creation of charge. The nature and identity of the property does not change during the existence of the charge. The company can transfer the property charged only subject to that charge so that the charge holder or mortgage must be paid first whatever is due to him before disposing off that property.

(ii) *Floating charge*: Such a charge is available only to companies as borrower. A Floating charge is attached to any definite property but covers the property of a fluctuating nature such as, stock-in-trade, debtors, etc. It attaches to the property charged in the varying conditions in which happens to be from time to time. Such a charge remains dormant until the undertaking charge ceases to be a going concern or until the person in whose favor charge created takes steps to crystallize the floating charge. A floating charge on crystallization becomes a fixed charge.

Consortium Lending	This approach to lending was introduced by the RBI in 1974. Accordingly, more than one bank finances, a single borrower requiring large credit limit. It (a) enables banks to spread risk of lending, (b) broke the monopoly of big banks to have large accounts, (c) enables banks to share experience and expertise, (d) introduces uniformity in approaches to lending, (e) enables banks to pool resources, and (f) checks multiple financing of the same account. Each consortium has a lead bank, which has the largest share in the loan, which processes the loans low rates proposal, which calls the meetings of the consortium for sanction of limits and review of accounts, which obtains RBI permission for credit limits, and which conducts joint inspection of the borrowers activities. The borrower executes a single set of documents with the lead bank. It obtains the letter of authority from member banks and releases the initial requirements of the borrower. Thereafter it obtains reimbursements from the member banks to the extent of their shares in advance. If the member banks delays the reimbursement beyond a week, the lead bank was entitled to charge a penal interest for the period of delay. This arrangement was also called a Single Window Lending.
Creditors	An entity (person or institution) that extends credit by giving another entity permission to borrow money with a stipulation for repayment at a later date.
Debtors/ Receivables	A person or entity that owes an amount of money or favor to.
Drawing Power	It is the limit up to which the borrower can utilize the cash credit. Drawing power is required to be arrived at based on the stock statement which is current. If

	the outstanding exceeds the drawing power, it will attract penal interest .The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. While calculating drawing power based on stock and debtors statements, care must be taken to exclude old, obsolete and non-moving stock and long outstanding debtors.
Inventories	Inventories denotes tangible property held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or services for sale, including maintenance supplies and consumables stores and spare parts meant for replacement in the normal course. Paid inventories refers to the inventories which is fully paid, i.e., excluding Sundry creditors.
Limit Sanctioned	This refers to the extent of facility granted to the borrower based on his working capital requirements and securities offered. In the case of cash credit, it is the limit up to which the borrower can withdraw from his borrowal account. The extent to which the borrower draws up to his pre set limit depicts the utilized amount.
Margin Money	Margin money is like a security deposit retained by the bank till the loan is fully settled. The credit limit is sanctioned by the banks after retaining a margin on the value of the security offered. The percentage of margin requirements varies as per RBI guidelines.
Memorandum of Satisfaction	A company must make a report to the Registrar of payment of satisfying in full of any charge registered under this act. The satisfaction of charges must be filed with the Registrar within 30 days from the date of such a payment of charge. On receipt of intimation to the company, the Registrar gives notice to the charge-holder calling upon him to show cause within

	time not exceeding 14 days as why the payment of satisfaction should not be registered. If no cause is shown within the time stipulated above the Registrar must enter the satisfaction of the payment of charge. If some cause is shown, the Registrar must record note to that effect in the register and inform the company accordingly.
Mortgage	A mortgage is the transfer of an interest is specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability. The transferor is called a mortgagor, the transferee a mortgagee; the principal money and interest of which payment is secured for the time being are called the mortgage-money and the instrument (if any) by which the transfer is effected is called a mortgage-deed.
Non Performing Asset	A debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time. The non performing asset is, therefore, not yielding any income to the lender in the form of principal and interest payments. If the customers do not repay principal amount and interest for a certain period of time then such loans become non-performing assets (NPA). Thus non-performing assets are basically non-performing loans. In India, the time frame given for classifying the asset as NPA is 180 days as compared to 45 days to 90 days of international norms.
Out of Order/ Irregular Account	An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases, where the outstanding balance in the principal operating account is less than the sanctioned limit/ drawing power, but there are no credits continuously for six months as on the date of Balance Sheet or

	credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.
Overdue Account	Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
Pledge	It is a bailment of property as a security for debt/ amount borrowed.
RBI's Non-performing Asset Projections for March' 12	RBI projected banks' balance sheets for 2011-12 and finds that at end-March 2012, the level of gross non-performing assets (NPAs) will rise to 2.92% of advances, assuming the tighter provisioning requirements made by the central bank and 30% of standard restructured assets turning into NPAs.
Stock Statements	It is a statement (normally in a prescribed format of the lending bank) showing the details of the various items of stock. It should clearly indicate the movement of the stock during the period. Stock which has not been paid for has to be excluded. Stock statements are to be signed by an authorized signatory and submitted to the banks at intervals stipulated in the sanction letter. Non- submission of stock statements on time will attract penal interest.
Types of NPA	NPA have been divided or classified into following four types: (i) *Standard Assets*: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPA in the real sense. So, no special provisions are required for Standard Assets. (ii) *Sub-Standard Assets*: All those assets (loans and advances) which are considered as non-performing for a period of 18 months are called as Sub-Standard assets.

(iii) *Doubtful Assets*: All those assets which are considered as non-performing for period of more than 18 months are called as Doubtful Assets.

(iv) *Loss Assets*: All those assets which cannot be recovered are called as Loss Assets.

Working Capital

There are two measures of working capital: gross working capital and net working capital. *Gross working capital* is the total of the current assets. *Net working capital* is the difference between the total of current assets and the total of current liabilities.

Contents

Chapter 1
Introduction

1.1 The most essential components, which form a significant portion of the total assets of an entity, in general, and current assets, in particular are Inventories and Debtors. They are considered as the lifeblood of every business activity since they are the indicators of good health of the company. The basic objective of verification of the assets is to indicate their physical existence and safety aspects.

In view of such magnitude entities obtain loans from banks in the form of cash credit against hypothecation of inventories and debtors. Consequently, the importance of the physical verification of inventories, their valuation and security aspects is not overemphasized, but rightly stated. The banks would like to get an assurance that the loans that have been made are backed by security that have a proper repaying capacity. Audit in banks is useful not only from the point of view of the management, who is the appointing authority but also from the point of other equally interested parties , who are interested for their different objectives, *viz.*, the Government, Public, RBI, Investors, Depositors and Analysts.

1.2 In order to get an assurance that the norms stated in the loan sanction form have not been disregarded, the bank appoints an external auditor, who is an independent person. The auditor undertaking such responsibility should take care that the requirements of the banks are met with and an early detection of the lapses and inconsistencies is done.

1.3 The main purpose of conducting the inventories audit in banks is to get an assurance that the security against which the loan is sanctioned represents the quality and quantity it claims to possess. With this assurance, the purpose of the inventories audit as required by the bank is served. The examination of the securities against which the loan has been sanctioned consists of not only physical verification of the securities but also includes verification of aspects, such as Ownership, valuation and proper storage. The auditor's role assumes great significance, in this regard as his report is considered as veritable and neutral. He is, therefore, expected to be objective and unbiased while undertaking the inventories audit.

1.4 Inventory and debtors, usually, account for a major part of the assets of an entity. Not only that, more than any other asset they indicate the financial health of the company. Hence, it becomes essential that a proper management control and accounting exists for these items.

1.5 Audit of inventory is undertaken for two major purposes:

(i) Audit of stocks of entity for financial reporting -Verification as part of existence of assets and maintenance of records.

(ii) Stock audit from the view point of the lender/ banks.

The difference in objective of the audit makes the process of audit different for both purposes hence they are discussed separately below.

Stock Audit

1.6 Working capital investment is the lifeblood of a company. Without it, a company cannot stay in business. The most critical use of working capital is providing the ongoing investment in short-term assets that a company needs to operate. A business requires a minimum cash balance to meet basic day-to-day expenses and to provide a reserve for unexpected costs. It also needs working capital for prepaid business costs, such as, licenses, insurance policies, or security deposits. Furthermore, all businesses from a professional firm's stock of office supply to the large inventories needed by manufacturers, retail and wholesalers invest some amount in inventory. Without some amount of working capital finance, businesses could not open and operate.

1.7 A second purpose of working capital is addressing seasonal or cyclical financing needs. Here, working capital finance supports the build-up of short-term assets needed to generate revenue, but which come before the receipt of cash. Since most businesses do not receive prepayment for goods and services, they need to finance these purchase, production, sales, and collection costs prior to receiving payment from customers.

1.8 The major forms of debt used to finance working capital are as follow:

Overdraft

This is an open-ended loan with a borrowing limit that the business can draw against or repay at any time during the loan period. This arrangement allows a company flexibility to borrow funds when the need arises for the exact amount required. Interest is paid only on the amount borrowed, typically, on a monthly basis. This can be either unsecured, if no specific collateral is pledged for repayment, or secured by specific assets such as accounts receivable or inventory. The standard term is 1 year with renewal subject to the lender's annual review and approval.

Factoring

It is a financial transaction where an entity sells its accounts receivable to a third party, collector (factor at a discount) in exchange for immediate money. Factoring differs from a bank loan in three main ways. First, the emphasis is on the value of the receivables, not the firm's credit worthiness. Secondly, factoring is not a loan – it is the purchase of a financial asset (the receivable). Finally, a bank loan involves two parties whereas factoring involves three. Factor bears collection risk. Company is made payment based on average collection period less a collection fee. Collection amount can be paid in advance with an interest charge.

Term Loan

Principal repaid over several years based on a fixed schedule. Loan amount tied to collateral value. Can be fully amortized or a balloon loan. Typical term is three to seven years.

Inventory Loan

Loan secured by inventory. The loan amount is based on a percentage of inventory value. Lender receives security interest in inventory and may take physical control. The inventory is released on loan repayment.

This is a common form of working capital finance. It is in the form of cash credit against the security of hypothecation of stock and debtors. Also, borrowers have to submit the details of stock and debtors every month on the basis of which Drawing Power after reducing the prescribed margin is calculated by the banks. Stock and debtors being the primary security, bankers need to ascertain the genuineness & correctness of such statements. The auditor has to conduct stock audit at specified intervals specifically, where the exposure exceeds the predetermined threshold limit.

Appointment of Stock Auditors and Periodicity of Audit

1.9 The appointment of stock auditors is generally, made by the regional or zonal offices, in case of nationalized banks, while in case of co-op banks sometimes concurrent auditors only are asked to conduct stock audit of select borrowers of the branch. Terms of appointment are prescribed by such offices which sometimes involves conducting of stock audit as one time exercise only while in others it may be a contract for two half yearly visits during a particular financial year, of which first visit to be conducted before September and second visit before March. The stock audit involves audit of latest stock and debtors information of the borrower and the report should give the position of stock and debtors ideally on the date of visit. Further it will also make examination of past data submitted by the borrower to the bank and appearing in the books of accounts of the borrower, to check reliability of information submitted by the borrower.

Steps Involved in Stock Audit

1.10 Stock audit is necessarily required to be conducted at the borrowers place for obvious reasons. But before visiting the borrower, understanding the entity, its banking operations and financial affairs is must.

Therefore, it is advisable to visit the respective branch where the borrower is having the account so as to gather the information relating to sanction, account operations, nature of business, performance of the borrower and other fundamental information along with the comments/ observations noted by other auditors (like Internal Inspectors, Concurrent Auditors, etc.) to have a brief understanding about the borrower and its financial affairs.

(i) Visit to Borrower's Branch

- o Banks, generally, has the system of maintaining two folders (in few cases only one folder) for each borrower of which one is used for keeping original documents executed by the borrower (*viz.* Demand Promissory Note, Hypothecation Deed, Guarantee Bond, etc.) while other folder contains Application Form, Project Report, Sanction Letter, Audited Financial Statements, Previous Stock Audit Report, etc. Stock statements submitted each month by the borrower are filed with the correspondence file or may be kept in a single file meant for keeping stock statements of all the borrowers. Scrutiny of both the files along with the account operations and DP Register with reference to terms of Sanction helps stock auditor to gain insight about the borrower' affairs and conduct of the account.

(ii) Visit to borrower and verification of stock

- o Once the basic information is collected from the bank branch, it is time to visit the borrower. It is advisable to carry audit questionnaire at the time of visit so that no important point / area is missed out. Visit to borrower involves verification of stock and debtors, inquiry about MIS and internal control, future projections and financial plans of the borrower and analysis of past results and bank operations.

- o Although audit is related to stock and debtors only, understanding of overall financial scenario and inquiry as to sister concerns & their businesses may also help the stock auditor to finalize the report in a better manner.

(iii) Preparation of Audit Report and discussion about audit findings

- o After conclusion of visits, stock audit report in the prescribed format, if available is to be prepared. In the absence of format, questionnaire prepared can itself also act as a report format. However, at the end of the questionnaire or in the covering letter itself (where auditor has to report in bank specified format) summary of major adverse findings (or points for future action) must be submitted by the auditor. Before submission of audit report, discussion about audit findings with the monitoring branch as well as borrower may be a good practice which may bring further clarity in reporting. But, it should be done depending upon the circumstances of case in hand.

Format for Stock Audit

1.11 Format for stock audit report may vary from bank to bank. Some banks have customized stock audit report formats while others may hint only the important areas to be reported by stock auditors. Irrespective of the formats, it is good to have questionnaire to be prepared by stock auditor covering following important areas of stock audit:

(i) Compliance with terms and conditions of sanction.

(ii) Timely and adequate submission of stock statements & other important financial information.

(iii) Account operations – overdrawing, credit summation and cash withdrawals.

(iv) Drawing power calculations by banks and by the auditors & discrepancies, if any along with the reasons.

(v) Physical maintenance and storage of stock and adequacy of facilities at the borrowers place.

(vi) Systems/ procedures implemented by borrower to identify the slow and non-moving stock items.

(vii) Borrower’s Management information system, its adequacy and Internal controls to safeguard stock.

(viii) Method of valuation of stock, time interval for valuation and adequacy and sufficiency of procedures thereof.

(ix) Insurance of stock.

(x) Verification of Debtors.

The list of common irregularities/ observations given below will give the better idea about preparation of stock audit questionnaire on above stated areas.

Common Irregularities/ Observations in Stock Audit

1.12 The common irregularities that may be observed during stock audit can be summarized as follows:

Observations about Statement Submission & Scrutiny	Observations About Account Operations	Observations about Insurance Coverage
• Stock Book Debts statements not submitted / not submitted in time. • Inadequate details *viz.* rate, quantity and amount of different type of stock items not stated in the statement. • Scrutiny of stock statements not done. • DP Register not written up to date. • Age wise analysis of Debtors not given/ done. Debtors over 90	• Operations in the accounts not scrutinized with reference to projections, QIS statements, audited accounts, etc. • Defects pointed out by the Internal Auditors/ Inspectors/ Concurrent Auditors are not complied with. • No/ belated review/ renewal of A/C. • All sales as per financial statements not	• Under insurance of stock. • Insurance expired and not renewed. • Premium for renewal policy paid but policy not on record. • Insurance Policy without Bank Clause. • No coverage of all risks as per sanction. • Wrong items/ description of goods on insurance policy. • Location of goods

days (or as per sanction) considered for drawing power. • Drawing power not correctly calculated. • Latest visit report by branch official not on record.	routed through account. • Account not operated actively. • Cash withdrawal during current period is abnormal. • Frequent overdrawing in the account. • Balance over drawing power although within Sanctioned Limit.	wrongly stated. • All locations of stock not covered.
Observations about Verification of Stock and Creditors	Observations about Verification of Sundry Debtors	General Observations
• Stock book not maintained/ not updated. • Obsolete stock not excluded from stock figures submitted to bank. • Deteriorating stock turnover ratio. • Stock figures submitted at the year end and as per financial statement not matching. • Stock debtors as per statements submitted and as per books not	• Existence of long pending debtors. • Long pending debtors shown as below 90 days debts to bank. • Increase in the average collection period of debtors. • Dispute with debtors and pending court cases. • Amount receivable from Sister concern considered for calculation of	• Diversion of funds and inter account transfers are not properly monitored. • Borrower having operations with other bank for which permission of lender not obtained. • Bank name plate not displayed.

matching. • Confirmation for inventory with third party not obtained or physical verification of Inventory not done. • Material received from third parties for job work not excluded while calculating drawing power.	drawing power. • Advances received from debtors not reported resulting into lower DP than calculated by bank.	

Above list is illustrative only and not the exhaustive one. In actual practice, there may be other observations/ irregularities over and above stated in the list.

Findings of Stock Audit

1.13 Stock audit is one of the important tools of credit monitoring for the bank. Apart from ensuring safety of realizable security, it also helps the bank to discipline the borrower or may act as a warning signal against probable future NPA. It may aid the bank to take timely remedial measures to avoid substantial future losses. It also highlights the weaknesses, if any, in the existing monitoring system of the branch through comments about maintenance of DP register, scrutiny of statements, review of accounts and compliance of audit findings.

Over and above, stock audit also has the utility for the borrower. Comments about insurance inadequacies, wrong product description and locations stated in the policies, if rectified timely may save the borrower from avoidable future losses.

Therefore, Statutory Audit where there is thrust only on the compliance under respective statute, the Stock Audit is a knowledge value addition exercise for both – bankers as well as borrowers.

Chapter 2
Inventories and Receivable Audit

Meaning of Inventories

2.1 Inventories denotes tangible property held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or services for sale, including maintenance supplies and consumables stores and spare parts meant for replacement in the normal course.

Inventories, thus, normally comprises of:

(a) stores,

(b) spares parts,

(c) loose tools,

(d) Maintenance supplies,

(e) raw materials including components,

(f) work in process,

(g) finished goods including by-products,

(h) Waste or by-products, etc.

Meaning of Debtors

2.2 A debt represent the amount due to an entity for goods sold or a service rendered or in respect of other similar contractual obligations but amount includes such amounts which are in the nature of loans and advances. Debtors are represented only by documentary evidence in the form of invoices and they don’t have any physical existence.

Cash-credit Facility

2.3 A major part of working capital requirement of any unit would consist of maintenance of Inventories of raw materials, semi finished goods, finished goods, stores and spares, etc. In trading concern, the requirement of funds will be to maintain adequate inventories in trade. Finance against such inventories by banks is, generally, granted in the shape of cash credit facility where drawings will be permitted against Inventories of goods. It is a running account facility where deposits and withdrawals are permitted.

2.4 Cash credit facility is of two types (depending upon the type of charge on goods taken as security by bank.):

(i) **Pledge:** When the possession of the goods is with the bank and drawings in the account are linked with actual movement of goods from/to the possession of the bank. The physical control of the goods is exercised by the bank.

(ii) **Hypothecation:** when the possession of the goods remains with the borrower and a floating charge over the inventories is created in favour of the bank. The borrower has complete control over the goods and the drawings in the account are permitted on the basis of Inventories statements submitted by the borrower.

Inventories/ Receivables Audit

2.5 The term 'Inventories Audit' in the context of banks refers to verification and valuation of the entire amount of current assets, current liabilities, loans and advances, diversion of funds, application of funds, accuracy of Inventories statements, arriving at the revised drawing power and any other matter connected with the credit administration by the banks.

2.6 The main thrust in inventories audit, therefore, is towards authentication of the quantity, quality, composition and valuation of the inventories and debtors.

Chapter 3
Mortgage

Meaning of Mortgage

3.1 Mortgage is a transfer of interest in specific immovable property for the purpose securing payment of money advanced, or to be advanced by way of loan, an existing or future debt, or the performance of an engagement, which may give rise to a financial liability.

3.2 The transferor is called a Mortgagor and the transferee is a Mortgagee, the principal money and interest of which payment is secured for the time being are called mortgage money, and the instrument, if any, by which the transfer is effected is called a Mortgage Deed.

3.3 *Section 58* of the Transfer of Property Act, 1882 deals with mortgage. Accordingly, the necessary ingredients of a mortgage are as follows:

(i) Transfer of interest in specific immovable property

(ii) Transfer is for the purpose of securing the payment of money advanced or to be advanced by way of loan.

(iii) It may be existing and future debt.

(iv) It may be also for performance of an engagement, which may lead to financial liability.

Types of Mortgage

3.4 Mortgage are of following types:

(i) Simple Mortgage,

(ii) English Mortgage,

(iii) Equitable Mortgage or Mortgage by deposit of title deeds,

(iv) Usufructuary Mortgage,

(v) Mortgage by Conditional Sale,

(vi) Anomalous Mortgage

Simple Mortgage

Where, without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage-money, and agrees, expressly or impliedly, that in the event of his failing to pay according to his contract, the mortgages shall have a right to cause the mortgaged property to be sold and the proceeds of sale to be applied, so far as may be necessary, in payment of the mortgage-money, the transaction is called a simple mortgage and the mortgagee a simple mortgagee.

English Mortgage

Where the mortgagor binds himself to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgagee, but subject to a proviso that he will re-transfer it to the mortgagor upon payment of the mortgage-money as agreed, the transaction is called an English mortgage.

Equitable Mortgage or Mortgage by Deposit of the All Deeds

Where a person in any of the following towns, namely, the towns of Calcutta, Madras and Bombay, and in any other town which the State Government concerned may, by notification in the Official Gazette, specify in this behalf, delivers to a creditor or his agent documents of title to immovable property, with intent to create a security thereon, the transaction is called a mortgage by deposit of title-deeds.

Mortgage by Conditional Sale

Where the mortgagor ostensibly sells the mortgaged property:

- on condition that on default of payment of the mortgage-money on a certain date the sale shall become absolute, or
- on condition that on such payment being made the sale shall become void, or
- on condition that on such payment being made the buyer shall transfer the property to the seller,

The transaction is called a mortgage by conditional sale and the mortgagee a mortgagee by conditional sale.

Provided that no such transaction shall be deemed to be a mortgage, unless the condition is embodied in the document which effects or purports to effect the sale.

Usufructuary Mortgage

Where the mortgagor delivers possession or expressly or by implication binds himself to deliver possession of the mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage-money, and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage-money, or partly in lieu of interest or partly in payment of the mortgage-money, the transaction is called an usufructuary mortgage and the mortgagee an usufructuary mortgagee.

Anomalous Mortgage

A mortgage which is not a simple mortgage, a mortgage by conditional sale, a usufructuary mortgage, an English mortgage or a mortgage by deposit of title-deeds within the meaning of this section is called an anomalous mortgage.

Difference between Mortgage and Pledge

3.5 Mortgages are dealt as per Transfer of Property Act, 1882 whereas Indian Contract Act, 1872 deals with pledge.

Pledge is the bailment of goods, as security for payment of debt, performance of promise. The creditor holds the possession of goods as security, but has no right of foreclosure; as there is no transfer of ownership. The right of enjoyment of property is not given to the pledge.

While, transfer of possession is very important in case of pledge it is not necessarily so in case of mortgage (depending upon type of mortgage).

In mortgage there is transfer of interest, whereas in case of pledge, the pledgee has only special right of detaining the goods till repayment of loan.

Mortgagor has right of redemption and mortgagee has right of foreclosure, where as the pledgee does not have right of foreclosure.

Charge

3.6 The word Charge is not defined in the Companies Act. *Section 124* merely states the expression ‘charge’ includes mortgage. However, *Section 100* of the *Transfer of Property Act, 1882* defines “charge’. These two provisions give a fair idea that Charge is nothing but security of its property, etc. by the Company in favour of creditor with the intent of securing his debt.

Difference between Mortgage and Charge

3.7 In *Raja Sri Shiva Prasad v. Beni Madhab AIR 1922 Pat. 529, Das J.* stated that the broad distinction between a "mortgage" and "charge" is:

"Whereas a charge only gives a right to payment out of a particular fund or particular property without transferring that fund or property, a mortgage is in essence a transfer of an interest in specific immovable property."

In other words:

- A "mortgage" effectuates transfer of property or an interest therein but there is no such transfer in "charge".
- In every "mortgage" there is "charge" but in "charge" there is no "mortgage".

Chapter 4
Charge

Charge as Defined in Section 100 of Transfer of Property Act, 1882

4.1 *Where immovable property of one person is by act of parties or operation of law made security for the payment of money to another, and the transaction does not amount to a mortgage, the latter person is said to have a charge on the property; and all the provisions hereinbefore contained which apply to a simple mortgage shall, so far as may be, apply to such charge.*

Nothing in this section applies to the charge of a trustee on the trust-property for expenses properly incurred in the execution of his trust, and, save as otherwise expressly provided by any law for the time being in force, no charge shall be enforced against any property in the hands of a person to whom such property has been transferred for consideration and without notice of the charge.

Important Provisions contained in Section 125 of the Companies Act, 1956

4.2 Certain charges to be void against liquidator or creditors unless registered:

(1) Subject to the provisions of this Part, every charge created on or after the 1st day of April, 1914, by a company and being a charge to which this section applies shall, so far as any security on the company's property or undertaking is conferred thereby, be void against the liquidator and any creditor of the company, unless the prescribed particulars of the charge, together with the instrument, if any, by which the charge is created or evidenced, or a copy thereof verified in the prescribed manner, are filed with the Registrar for registration in the manner required by this Act within thirty days after the date of its creation.

Provided that the Registrar may allow the particulars and instrument or copy as aforesaid to be filed within thirty days next following the expiry of the said period of thirty days on payment of such additional fee not exceeding ten times the amount of fee specified in Schedule X as the Registrar may determine, if the company satisfies the Registrar that it had sufficient cause for not filing the particulars and instrument or copy within that period.

(2) Nothing in sub-section (1) shall prejudice any contract or obligation for the repayment of the money secured by the charge.

(3) When a charge becomes void under this section, the money secured thereby shall immediately become payable.

(4) This section applies to the following charges:

  (a) A charge for the purpose of securing any issue of debentures;

  (b) A charge on uncalled share capital of the company;

  (c) A charge on any immovable property, wherever situate, or any interest therein;

  (d) A charge on any book debts of the company;

  (e) A charge, not being a pledge, on any movable property of the company;

  (f) A floating charge on the undertaking or any property of the company including Stock-in-trade;

  (g) A charge on calls made but not paid;

  (h) A charge on a ship or any share in a ship;

  (i) A charge on goodwill, on a patent or a license under a patent, on a trade mark, or on a copyright or a license under a copyright.

(5) In the case of a charge created out of India and comprising solely property situated outside India, thirty days after the date on which the instrument creating or evidencing the charge or a copy thereof could, in due course of post and if dispatched with due diligence, have been received in India, shall be substituted for thirty days after the date of the creation of the charge, as the time within which the particulars and instrument or copy are to be filed with the Registrar.

(6) Where a charge is created in India but comprises property outside India, the instrument creating or purporting to create the charge under this section or a copy thereof verified in the prescribed manner, may be filed for registration, notwithstanding that further proceedings may be necessary to make the charge valid or effectual according to the law of the country in which the property is situated

(7) Where a negotiable instrument has been given to secure the payment of any book debts of a company, the deposit of the instrument for the purpose of securing an advance to the company shall not, for the purposes of this section, be treated as a charge on those book debts.

(8) The holding of debentures entitling the holder to a charge on immovable property shall not, for the purposes of this section, be deemed to be an interest in immovable property.

Registration of Charge

4.3 A transaction or an arrangement that amounts to a charge, requires registration under the Companies Act only if it satisfies the conditions laid down in *Section 125*.

Such charge should be one among the kinds enumerated in Sub-section (4) of *Section 125*. Needless to state, a mortgage of every kind is a charge that requires registration.

Objective of Registration

4.4 The objective of Registration of a charge is to give public notice which can be achieved:

(i) By requiring the companies to maintain record of charges and make it available for inspection to the members of the public.

(ii) By requiring the registrar of companies to maintain record of the Charges filed by the companies and make it available for public inspection.

The registration of a charge thus, is intended to give notice to people who may not otherwise be aware of it, particularly, to persons who may advance money to the company, and it may also serve the purpose of preventing a fraudulent and belated claim of a charge in the event of liquidation.

Charge Requiring Registration

4.5 Charges which require registration are as follows:

(i) *Section 125* enumerates the following charges which require registration.

(a) A charge for the purpose of securing any issue of debentures;

(b) A charge on uncalled share capital or the company;

(c) A charge on any immovable property, wherever situated, or any interest therein;

(d) A charge on any book debts of the company;

(e) A charge, not being a pledge, on any movable property of the Company;

(f) A floating charge on the undertaking or any property of the company including stock in trade;

(g) A charge on calls made but not paid;

(h) A charge on a ship or any share in a ship;

(i) A charge on goodwill, on a patent or license, on a trade mark, or on a copy right or a license under a copyright.

(ii) A charge created without executing any instrument also requires registration.

Execution of an instrument for creating a charge is not a condition precedent for the requirement of registration.

(iii) A resolution of the Board of Directors can be taken to be fact of creation of a Charge.

(iv) A charge created by operation of law or by an order of the court and not by a contract is not a charge created by the company. It therefore does not need registration as *Section 125* is applicable only to the charges created by the company itself.

(v) A charge on any movable property also requires registration (except a charge by way of pledge of movable property) *vide* Clause (e) of Sub-section (4). Thus, hypothecation of movable property is a charge that requires registration so long as it is not a pledge.

(vi) A charge on book debts requires registration vide clause (d).

(vii) Pledge of promissory notes by endorsement thereof by a company in favour of its creditor does not require registration. If a transaction satisfies all the requirements of a valid pledge, it would be eligible for exemption from registration under Clause (c) of Sub-section (4) of *Section 125*; even it is also in the nature of mortgage. The reason for exempting pledge from registration is that in pledge the debtor parts with the possession of the property and passes it on to the creditor which is a sufficient notice of creation of a charge and, therefore, no registration of such a charge is necessary

(viii) A pledge of fixed deposit receipts with a Bank for obtaining a loan does not require registration. The Department of Company Affairs is of the view that registration of pledge, though not mandatory, is permissible at the instance of the company or of any interested person

(ix) A charge on future debts will be void if it is not registered. However, absolute assignment of a future debt is not a charge and a document making such assignment does not require registration.

Consequences of Non-Filing

4.6 The consequences of non-filing are as follows:

(i) Charge requiring registration is void against the liquidator and any creditor of the Company if prescribed particulars are not filed with the Registrar of Companies (RoC) within thirty days of the date of creation of Charge.

(ii) The words “Filing” and “Registration” are not synonymous and interchangeable. Filing is the delivering of particulars of Charges to the ROC. The term Registration denotes the registration of the Charge by the ROC office in its records as per provisions of Companies Act, 1956.

(iii) It is only the omission to file the particulars of a charge within 30 days. Charge void or within next 30 days with the permission of ROC.

(iv) Charge is valid even if RoC does not register it or makes unreasonable delay in registering it, provided the particulars thereof have been filed duly within thirty days.

Filing Defective Particulars

4.7 *Regulation 17 of the Companies Regulations, 1956* provides that:

(i) RoC shall examine, or cause to be examined, every document received in his office.

(ii) If any such document is found to be defective or incomplete in any respect, the RoC shall direct the company to rectify the defect or complete and no such document shall be registered and recorded until the defect has been so rectified or the document has been completed as the case may be.

(iii) RoC is, thus under an obligation to inform the Company about the defects.

(iv) However, the document shall be treated as filed on the date on which it was initially filed and not on the date it was rectified.

Date of Creation of Charge

4.8 The date mentioned in the instrument being the date of execution thereof would be taken to be the date of creation of Charge. The period of 30 days would start from such date.

In the cases of mortgage of deposit of title deeds, it is the date on which the title deeds are actually deposited and not the date of the Memorandum of the deposit, even if the date of the memorandum is subsequent to the date of deposit of the title deeds.

Procedure for Filing of Particulars of Creation of Charge

4.9 *The Companies (Central Government's) General Rules and Forms, 1956 read with Sections 125, 127, 128, 130, 132, 135 and 138 of the Companies Act, 1956 provides the procedure to file the documents. The Ministry of Company Affairs vide its Notification No.GSR 56 (E) dated 12.2.2006 has issued the Companies (Central Government's) General Rules and Forms (Amendment) Rules, 2006.* Accordingly, in place of physical filing of documents, the e-filing has been made mandatory to all incorporated companies whether private or public, listed or unlisted without any sectoral preferences.

(i) The prescribed particulars together with copy of the instrument creating the charge or Modification thereof or satisfaction of charge the following Forms shall be filed with the ROC through electronic media or through any other computer readable media:

Form No. 8: Creation of original Charge and Modification of charges.

Form No.10: Particulars for registration of charges for debentures. (Both creation and modification covered).

Form No.13: Register of charges [merged with Form No.8 in the new system].

Form No. 17: Memorandum of complete satisfaction of charge.

(ii) A copy of every instrument evidencing any charge or modification of charge and required to be filed with the Registrar in pursuance of Section 125, 127, 128 or 135 shall be verified as follows:

(a) Where the instrument or deed relates solely to property situate outside India, a copy shall be verified by a certificate either under the seal of the company, or under the hand of a responsible officer of the company, or under the hand of some person interested in the mortgage or charge on behalf of any person other than the company, stating that it is a true copy.

(b) Where the instrument or deed relates, whether wholly or partly, to property situated in India, the copy shall be verified by a certificate of a responsible officer of the company stating that it is true copy or by a certificate of a public officer given under and in accordance with the provisions of *Section 76 of the Indian Evidence Act, 1872.*

(iii) *Form 8 or Form 10 or Form 17* as the case may be, shall be signed on behalf of the company and the charge-holder. The electronic-form shall be authenticated by authorized signatories using digital signatures, as defined in the Information Technology Act, 2000.

Certificate of Registration

4.10 As per *Section 132 of the Companies Act, 1956* The Registrar shall give a certificate under his hand of the registration of any charge registered in pursuance of this Part, stating the amounts thereby secured; and the certificate shall be conclusive evidence that the requirements of this Part as to registration have been complied with.

Penalties under Section 142 of Companies Act, 1956

4.11 If default is made in filing with the Registrar for registration the particulars:

(a) Of any charge created by the company;

(b) Of the payment or satisfaction of a debt in respect of which a charge has been registered under this Part; or

(c) Of the issues of debentures of a series.

Requiring registration with the Registrar under the provisions of the Act, then, unless the registration has been effected on the application of some other person, the company, and every officer of the company or other person who is in default, shall be punishable with fine which may extend to five thousand rupees for every day during which the default continues.

Subject as aforesaid, if any company makes default in complying with any of the other requirements of this Act as to the registration with the Registrar of any charge created by the company or of any fact connected therewith, the company, and every officer of the company who is in default, shall, without prejudice to any other liability, be punishable with fine which may extend to ten thousand rupees.

Significance of MCA 21 for Banks and Financial Institutions

4.12 The Charge Registration information is an invaluable input for credit evaluation. MCA 21 serves the interests of the Banks and Financial Institutions through the process of "Registration of Charges".

Steps already taken by the Ministry of Company Affairs

4.13 With an Endeavour to improve and refine the charge registration process and enhance the value that can be derived by the financial services industry, following measures have been implemented by the Ministry of Company Affairs:

(i) Digitization of more than 10 million pages related to all subsisting charges and established inter-linkage between the charge data within a given company (including creation of an Index of charges);

(ii) Simplification and unification of charge related forms including adapting the same for electronic filing. These have been duly notified and have come into force from 28th Feb, 2006;

(iii) Facility of authenticating these e-forms using digital signatures in accordance with the Information Technology Act, 2000;

(iv) Cross-referencing of charge creation document at the time of filing anew charge document involving subsequent modification or satisfaction;

(v) Introduction of concise, structured yet comprehensive Instrument of Charge containing/ evidencing basic information in place of diverse elaborate contracts.

Steps to be taken by the Banks and Financial Institutions

4.14 The following are the guidelines given by the Ministry of Company Affairs to the Banks and financial institutions:

(i) Ensure that newly notified e-forms are used henceforth. Copies of the new e-forms and procedures for e-filing can be obtained from MCA portal www.mca.gov.in.

(ii) Ensure that all e-forms that will henceforth be used for filing, are authenticated using a digital signature.

(iii) Ensure that the authorized officers of your Bank or institution obtain Digital Signature Certificates authenticating all relevant e-forms for the purposes of registration of a charge with the ROC.

(iv) Encourage the borrowers to register creation/modification/satisfaction of charges in a timely manner. In particular, encourage the charges to be satisfied as there are a number of cases which are probably closed and the same has not been done.

(v) While Ministry has taken due care to ensure completeness and accuracy of data; it is very likely that there could be errors of omission and commission in an exercise of this enormity. Please review the existing charge data and highlight any discrepancies/errors to the concerned ROC, so that the same can be corrected to ensure the reliability of data.

(vi) Proactively support the enhancement of the Instrument of Charge and enforce this as a standard across all charge transactions this will facilitate us not only collation of data, but also explore the possibility for use of sophisticated data mining technology/ tools (the current data is largely unstructured and unfit for analysis).

(vii) Disseminate this information widely within your enterprise and facilitate quick adoption.

Chapter 5
Need, Scope and Applicability of Stock Audit

This chapter throws light on the procedure of stock/ inventory audit, its objectives and utility.

Objectives of Stock Audit

5.1 The various purposes expected to be achieved through stock audit may be summarized as follows:

(i) To ensure proper preservation/ storage and handling of stock.

(ii) To identify whether there exist any obsolete stock and if yes, whether it has been segregated and written off.

(iii) To verify whether the stock is adequately insured against fire and other natural calamities (in appropriate cases against other risks like, theft, burglary, marine, riots, etc. as per sanction).

(iv) To ascertain whether physical stock tally with the stock statement submitted to the banker.

(v) To ascertain whether hypothecated stock is realizable.

(vi) To confirm that stock is owned by the borrower and finance is made against value of paid stock only.

(vii) To examine the age wise debtors outstanding as per books and as per statement submitted by the bank, steps taken for recovery of long pending debtors and likely instances of debtors turning bad, if any.

Like any other audit, the rationale for conducting inventories audit also lies in prevention and early detection of frauds and errors. Inventories audit acts as a safeguard against occurrence of both internal and external frauds.

Scope of Stock Audit

5.2 The scope of the audit covers all the aspects that have a direct impact on the working capital of the unit as well as the aspects relating to Inventories that have a bearing on the bank finance. In other words, it deals with the matters that have an effect on the security and liquidity in view of the banker.

It encompasses the following aspects:

(i) Physical verification of inventories.

(ii) Verification of condition of storage.

(iii) Valuation of inventories and pointing out variances.

(iv) Valuation of obsolete/ non-moving Inventories.

(v) Age-wise categorization of inventories.

(vi) Evaluation of the Inventories management by the company.

(vii) Reconciliation of Inventories statements submitted with the accounting records maintained by borrowers particularly, relating to quantity, rate, value of inventories, age, marketability, etc.

(viii) Verification and evaluation of sundry creditors indicating separately those relating to Inventories and their relationship with bank finance.

(ix) Commenting upon the sources of the raw materials, i.e., whether any credit is available for the material and which of the items are available against cash payments.

(x) Review of the Inventories valuation system.

(xi) Age-wise and value-wise qualification of debtors.

(xii) Determination of the drawing power.

(xiii) Determining adequacy of the insurance cover.

(xiv) Verification of documents/ securities.

(xv) Commenting upon the comparative Profitability and Inventories ratio.

(xvi) Ensuring that the compliance of the terms and conditions of limit sanctioned.

(xvii) Verification of transactions with sister concerns, unsecured Loans to Directors and others.

(xviii) Any other matters of interest to the bank.

Purpose of Stock Audit

5.3 Stock audit is essential for the following purposes:

(i) To give the bankers an assurance regarding the following:

(a) That a suitable environment for preservation of Inventories exists.

(b) That a responsible person for safeguarding the inventories is always present.

(c) That degraded inventories have been written off.

(d) That adequate safeguards exist against fire and natural calamities.

(e) That physical inventories tally with the inventories statements submitted to bank.

(f) That the pledged/ hypothecated inventories is realizable.

(g) That inventories is owned by the borrower.

(h) That all sanction terms have been adhered to.

(i) That inventories are not stagnating and becoming obsolete.

(ii) To investigate wherever the party is not submitting periodic Inventories statements regularly.

(iii) To investigate, where the accounts have been marked as substandard.

(iv) To find out reasons when there are many qualifying remarks about inventories and receivables in the Auditor's report of the borrower.

(v) To find out suspect dealing in lending procedure.

(vi) To make the banks aware of their right of enforcement of the security interest provided in the Securitization and Reconstruction of Financial Assets and enforcement of Security Interest Act, 2002.

(vii) To fulfill Head Office requirement.

Need of Stock Audit

5.4 Under the following circumstances, it is advisable for banks to get annual stock audit done by the independent agencies:

(i) Where there are over dues in term loans or other accounts, where the banks' stake is high.

(ii) Where there is evidence of pressure on the borrower from the creditors.

(iii) Where the inventories are stagnating.

(iv) Where party is not submitting inventories statements regularly.

(v) Where there are grounds to suspect that the position of chargeable current assets indicated may not be correct.

(vi) Where there are too many qualifying remarks about inventories and receivables in the Auditor's report of a borrower.

(vii) Where the accounts is marked as sub-standard.

(viii) Suspect dealings in lending procedure, jeopardizing advances given.

(ix) An errant borrower, where Inventories audit is needed to supplement actions of the branches for recovery.

(x) Any other valid reason, such as, mismanagement, heavy losses, lockout, strikes, etc.

(xi) Fulfilling the criteria fixed by the head office to get done stock audit.

Special Consideration while Conducting Stock Audit

5.5 Following should be considered while conducting stock audit:

(i) If the stock statement as shown in the hypothecation statement does not tally with the stocks as in the balance sheet , then appropriate action should be taken to find reasons for the differences.

(ii) It should be seen that the stocks have been properly valued.

(iii) It should be seen that Current Assets are not over-stated.

(iv) It should be seen that the Turnover is not over-stated.

(v) It should be seen that the stocks that are genuinely owned by the borrower are shown in the accounts.

Chapter 6
Responsibility of the Auditor

6.1 The responsibility of an auditor lies towards the employing authority and the authority, which regulates the profession. In case of stock audit, the bank or the financial institution employs the auditor. They place reliance on the audit report and acts accordingly, due to which the auditors are responsible. The reports issued by the auditor also cater to the needs of others including the investors, society, creditors, etc.

6.2 The importance of stock audit is not limited only to compliance and discharge of responsibility. Stock audits also acts as a warning signal to those accounts, which are expected to turn into Non-performing assets (NPA). It may be possible that certain advances are prospective NPAs and their timely detection may prevent them from turning into actual NPAs. The auditor should try to detect such inconsistencies and plug these loopholes so as to prevent the misuse of funds. Thus, the stock audit assists the bank in the process of early detection and prevention of NPAs, so that appropriate action can be taken and such instances avoided. Auditors can perform this function in view of their expertise in this area and help banks to make a judgment. The auditor, thus should see to it that the purposes for which the stock audit is undertaken are served satisfactorily.

Composition of NPAs of Public Sector Banks - 2002 To 2011

(Amount in ₹ crore)							
Bank Groups / Years	As on March 31						
	Priority Sector		Non-Priority Sector		Public Sector		Total
	Amount	Per cent share	Amount	Per cent share	Amount	Per cent share	Amount
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
A. Nationalised Banks							
2002	16173	45.78	18742	53.05	413	1.17	35328
2003	16886	47.10	18402	51.33	561	1.57	35849
2004	16705	47.74	17895	51.14	390	1.12	34990
2005	16381	49.81	16225	49.33	283	0.86	32888
2006	15124	53.66	12845	45.58	216	0.76	28185

2007	15779	60.58	9965	38.26	302	1.16	26046
2008	16385	66.80	7941	32.38	202	0.82	24528
2009	15871	60.65	10001	38.22	297	1.13	26169
2010	19908	56.13	15283	43.09	280	0.79	35470
2011	25678	59.84	16957	39.52	273	0.64	42907
B. State Bank of India & its Associates							
2002	8977	47.01	9628	50.42	490	2.56	19095
2003	8053	47.49	8379	49.41	526	3.10	16958
2004	7136	47.07	7803	51.48	220	1.45	15159
2005	7017	47.39	7624	51.48	168	1.13	14808
2006	7250	54.95	5819	44.10	125	0.95	13193
2007	7175	57.15	5193	41.36	188	1.50	12556
2008	8902	58.49	6222	40.88	97	0.63	15220
2009	8447	47.26	9250	51.75	177	0.99	17874
2010	10940	50.11	10646	48.77	244	1.12	21831
2011	15567	55.32	12567	44.66	6	0.02	28140
Public Sector Banks (A+B)							
2002	25150	46.21	28371	52.13	902	1.66	54423
2003	24938	47.23	26781	50.72	1087	2.06	52807
2004	23840	47.54	25698	51.24	610	1.22	50148
2005	23397	49.05	23849	50.00	450	0.94	47696
2006	22374	54.07	18664	45.11	341	0.82	41378
2007	22954	59.46	15158	39.27	490	1.27	38602
2008	25287	63.62	14163	35.63	299	0.75	39749
2009	24318	55.21	19251	43.71	474	1.08	44042
2010	30848	53.83	25929	45.25	524	0.91	57301
2011	41245	58.05	29524	41.56	278	0.39	71047
Source : Off-site returns (domestic) - Latest updated database, Division of banking Supervision, RBI.							

Chapter 7
ICAI Pronouncements

7.1 As there is no Guidance Note or Standards prescribed for Stock audit, the auditors should conduct the audit based on the generally accepted auditing practices and to the best of his judgment and ability.

Relevant Engagement Standards

7.2 The auditor should apply the relevant Engagement Standards that will facilitate him in the process of giving the assurance of repaying ability that the bank seeks. The auditor should approach the audit with a perspective, which enables him in the process of preventing and in the process, taking corrective measures, for the probable frauds and errors that exist.

7.3 The audit may be conducted in five stages keeping in mind the relevant Standard as Auditing (SAs).

The five stages in audit are:

1. Pre-commencement
2. Understanding the entity
3. Audit planning
4. Substantive procedures
5. Reporting

Pre-Commencement

SA 210 [earlier AAS 26]	Agreeing the Terms of Audit Engagement	The auditor and the client should agree on the terms of engagement.

Understanding the Entity

SA 315 and	Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its	The auditor should obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

SA 330 [earlier AAS 6, 20 and 29]	Environment The Auditor's Responses to Assessed Risks	
SA 250 [earlier *AAS 21]	Consideration of Laws and Regulations in an Audit of Financial Statements	When the auditor believes that there is a non-compliance, he should document the same and report it.
SA 550 [earlier AAS 23]	Related Parties	The auditor should obtain sufficient audit evidence regarding the transactions of related parties that are material to the financial statements.
SA 402 [earlier AAS 24]	Audit Considerations Relating to an Entity using a Service Organization	The auditor should consider how a service organization affects the accounting and internal control system of the borrower.

Audit Planning

SA 200 [earlier AAS 2]	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	The scope of an audit will be based on the terms of engagement, relevant laws and the pronouncements of the Institute.
SA 300 [earlier AAS 8]	Planning an Audit of Financial Statements	Auditor should plan his work based on the client's business to enable him to conduct an effective audit in an efficient and timely manner.
SA 299 [earlier AAS 12]	Responsibility of Joint Auditors	The division of work should be adequately documented and matters of relevance may be communicated to the joint auditors in writing.

SA 530 [earlier [AAS 15]	Audit Sampling	The auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.
SA 570 [earlier AAS 16]	Going Concern	The auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.
SA 220 [earlier AAS 17]	Quality Control for an Audit of Financial Statements	The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Standards on Auditing.

Substantive Procedures

SA 200 [earlier AAS 1]	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	Auditor should comply with certain basic principles whenever an audit is carried out.
SA 230 [earlier AAS 3]	Audit Documentation	Auditor should have proper working papers that will enable him to substantiate his results.
SA 240 [earlier AAS 4]	The Auditor's Responsibilities Relating to Fraud in Audit of Financial Statements	The auditor should approach the audit with a perspective, which enables him in the process of preventing and in the process, taking corrective measures, for the probable frauds and errors that exist.
SA 500 [earlier AAS 5]	Audit Evidence	The auditor should evaluate whether he has obtained sufficient appropriate evidence

		before he draws his conclusions.
SA 610 [earlier AAS 7]	Using the Work of Internal Auditors	The auditor should evaluate the internal audit function and accordingly adopt less extensive procedures than otherwise required.
SA 620 [earlier AAS 9]	Using the Work of an Auditor's Expert	Auditor should carefully direct, supervise and review work delegated to assistants and should obtain reasonable assurance that work done is adequate for his purpose.
SA 600 [earlier AAS 10]	Using the Work of Another Auditor	In the process of giving an assurance that the bank requires, the auditor may have to rely on the work of the other auditors like the Internal auditor, the Inspectors appointed by the RBI, etc. The principal auditor should discuss with the other auditor the audit procedures applied.
SA 580 [earlier AAS 11]	Written Representations	The auditor should use his professional judgment in determining matters on which he wishes to obtain representations by management.
SA 320 [earlier AAS 13]	Materiality in Planning and Performing an Audit	The auditor should consider materiality and its relationship with audit risk when conducting the audit.
SA 520 [earlier AAS 14]	Analytical Procedures	The auditor should apply analytical procedures at the planning and overall review stages of the audit.
SA 560 [earlier AAS 19]	Subsequent Events	The auditor should consider the effect of subsequent events on the audit report.
SA 505 [earlier	External	The auditor should determine

AAS 30]	Confirmations	whether the external confirmations are necessary to support certain assertions in financial statements.
SA 501 [earlier AAS 34]	Audit Evidence-Specific Considerations for Selected Items	The auditor should perform audit procedures designed to obtain appropriate audit evidence during his presence in physical checking.

Reporting

SA 260 [earlier AAS 27]	Communication with those Charged with Governance	The engagement letter should describe the form in which any communication on audit matters of governance interest will be made.
SA 700 [earlier AAS 28]	Forming an Opinion and Reporting on Financial Statements	The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

Chapter 8
Audit Process

8.1 The audit process can be discussed in detail under the following stages:

1 Pre-commencement

2 Understanding the entity

3 Audit planning

4 Substantive procedures

5 Reporting

Pre-commencement

8.2 Before commencement of any audit, the auditor should obtain the following documents/ details from the client:

(i) Engagement letter from the bank.

(ii) All relevant details of the borrower including:

- (a) Name of the unit and of the key persons.
- (b) Address of both the registered office and factory of the unit.
- (c) Nature of business.
- (d) Sanction terms and conditions.
- (e) Bank Account No, banking facilities enjoyed by the borrower.
- (f) If the advance is a consortium lending, names of lead bank and other banks and their participation.
- (g) Last three months bank statements.
- (h) Last three months Inventories statements.
- (i) Latest inspection report of the account, Annual report or any available audit reports.
- (j) Insurance particulars.

(iii) An appointment before visiting the borrower's office.

(iv) Wherever applicable, he should communicate with the previous stock auditor.

Understanding the Entity

8.3 The auditor should have the following information to understand the entity:

(i) The nature of business.

(ii) The nature of goods, especially, with regard to the storage:

- (a) whether stored at multiple locations,
- (b) whether they are of deteriorating nature, etc.

(iii) The processes involved in manufacturing, production and ascertaining whether any part of the work is to be sent out of the entity for further processing.

(iv) The key personnel involved in preparation and submission of Inventories statements and financial statements to the bank.

(v) The business of the entity in order to identify the events and risks that may have an impact on the audit report.

(vi) The transactions of related parties that are material to the financial statements. The auditor should obtain sufficient audit evidence in this regard.

(vii) Effect of a service organization on the accounting and internal control system of the borrower.

(viii) Effect of a CIS environment on the audit. The auditor should have sufficient knowledge of the CIS to proceed with the audit.

Audit Planning

8.4 In planning the inventories and receivables audit, the auditor should consider the following:

(i) The nature of the accounting and internal control systems used regarding Inventories.

(ii) Inherent, control and detection risks, and materiality related to Inventories.

(iii) Whether adequate procedures are established and proper instructions issued for physical Inventories counting.

(iv) The timing of the count.

(v) The locations at which Inventories is held and its nature.

(vi) Whether an expert's assistance is needed.

8.5 When inventories is situated at various locations, the auditor would decide, the location to be checked, taking into account the materiality of the inventories and the risk of material misstatement and the assessment of inherent and control risk at different locations.

Inventories are usually located at the following locations:

(i) Borrower's premises

(ii) At the borrower's plant.

(iii) In transit.

(iv) On Consignment.

(v) In a public warehouse.

(vi) For processing.

Substantive Procedures

8.6 The following steps are to be taken by the auditor for an effective stock audit:

Before making Visit to Party

The auditor may obtain the following information before making visit to party:

(i) Obtain the Name, Address, Telephone No., and Fax No of the party.

(ii) Obtain the bank account numbers and full banking details of the party.

(iii) List down the various kinds of facilities enjoyed by party and the limits thereof.

(iv) List down the date of sanction, sanction limit, drawing power & current balance in the account. Obtain a copy (Xerox) of the original sanction letter and the latest review note.

(v) Check whether the party is regularly submitting the statement of inventories and book debts

(vi) Check whether the insurance policy has been issued in the favour of bank or not.

(vii) Check the amount of insurance policy and date of expiry.

(viii) Go through previous visit record made by branch manager, advance officer or any other officer of the branch.

(ix) Check whether the interest on overdraft or cash credit facility has been regularly paid, same is the case of installment payments of term loan.

(x) Check whether the operation of account is satisfactory or not.

(xi) Get an appointment before visiting the party's office.

(xii) Check the due diligence certificate in the case of Lending under Consortium Arrangement/ Multiple Banking Arrangements. [Refer RBI/2008-2009/379 DBOD. No. BP.BC.110/08.12.001/2008-09 dated February 10, 2009]

At the Borrower's Office

The auditor may check the following at the borrower's office:

(i) Check whether the party has maintained the inventory register.

(ii) Check whether other books of account have been maintained by the party, i.e., cashbook, bank passbook, purchase book, sales book, debtors ledger and creditor ledger, etc.

(iii) Check all statutory dues have been paid.

(iv) Check whether prescribed particulars of charges as detailed in Section 125(4) of this Companies Act along with the instrument by which the charge is created has been filed with the Registrar for registration within 30 days after the date of its creation.

(v) Check the sales and purchase invoices.

(vi) Bank name plate stating "Hypothecated to Name of Bank/ Financial Institution" should be affixed on the wall of Inventories premise, e.g. "Hypothecated to Corporation Bank".

(vii) If there is damaged Inventories, then it should not be taken into account for calculation of drawing power.

(viii) Inventories must be in sufficient quantity to cover the advance given by the bank.

(ix) Inventories should be kept in proper condition

(x) Inventories must be kept in the premises, which should be free from water leakages, fire, and other hazards, etc., so that damage to inventories does not occur.

(xi) Fire-fighting equipment must be available in inventories premises and it should be regularly checked to preserve its utility.

(xii) Specify the name of the person who has attended the auditor.

Documents to be Obtained from the Borrower

The auditor may obtain the following documents from the borrowers:

(i) The auditor should obtain a written representation from management regarding.

(a) The completeness of information provided regarding the Inventories; and

(b) Assurance with regard to adherence to laid down procedures for physical Inventories count.

(ii) Insurance premium receipt with respect to the insurance policy.

(iii) Bank/ Financial Institutions original sanction letter and the latest review note.

(iv) Balance Sheet and Profit and Loss Account of the borrower for last 3 years.

(v) Inventories Statement & Book Debts Statement as on the last day of the quarter and for the year and preceding 3 months before the date of inspection.

(vi) Copy of Memorandum of Association, Articles of Association along with Form No. 32 and 18, partnerships deed, Trust deed and its byelaws as may be applicable.

(vii) Copy of audited financial statements.

Procedure for Verification of Pledged Inventories

The auditor may perform the following procedures to verify the pledged inventories:

(i) Ensure that a board is prominently displayed at the entrance and within the godown, clearly stating that the goods are hypothecated or pledged with the respective bank or financial institution.

(ii) Examine the lock to ensure that bank's/ financial institution's name is engraved there on.

(iii) Examine the layout of the godown where inventories are stored.

(iv) If the godown is rented, inspect the rent receipt and ensure that it is in the name of the borrower. Also ensure that the rent is not in arrears. If the godown is in ownership, verify the ownership agreement and ensure that it is in the name of the borrower.

(v) Ensure that there is no other gate or entrance to the godown and if it is there, it is properly locked from inside.

(vi) Ensure that the godown is located at the address given to the bank and as mentioned in the insurance policy and other documents.

(vii) Ensure that the ventilators are covered by grills.

(viii) Ensure that no hazardous material is stored nearby the godown. If so, it should be specifically mentioned in the insurance policy.

(ix) Ensure that no other Inventories other than those pledged to the bank are stored in the godown without the specific prior authority and if they are stored, then adequate insurance cover is taken.

(x) Ensure that the godown is in a good condition without and leakage or Seepage of water and dampness.

(xi) Ensure that the bin cards are signed by the godown keeper and by all inspecting officers.

(xii) Ensure that there is proper stacking of goods.

(xiii) Ensure that the deteriorated goods are not stored in the godown.

(xiv) Ensure that the goods are not re-pledged.

Procedure for Verification of Hypothecated Inventories

In the case of hypothecation accounts, there will always be some difference between the inventories shown in the Inventories Statements and the actual inventories on the date of inspection due to the time lag involved. Hence the figures appearing in the Inventories statement and the borrower's books should be reconciled by making necessary adjustments for sales, purchases, production and consumption since the date of Inventories Statement. The audit should be designed in such a manner that if the inventories is large, an extensive check should be made of the material control system.

The auditor may perform the following procedures to verify the hypothecated inventory:

(i) Verify the actual inventories in the godown physically with that declared in the Inventories Statement.

(ii) Verify that the record keeping is proper and that there are no indications of dishonest or inefficient management.

(iii) Verify that there are adequate internal control systems commensurate with the size of the concern.

(iv) The auditor should review management's instructions regarding:

(a) The application of control procedures, for example, collection of used stock-sheets, accounting for unused stock-sheets, tagging and count and re-count procedures;

(b) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, Inventories owned by a third party, for example, on consignment and Inventories in transit; and

(c) Appropriate arrangements made regarding the movement of Inventories between areas and the shipping and receipt of Inventories before and after the cut-off date.

(v) The auditor should also consider cut-off procedures including details of the movement of inventories just prior to, during and after the count to ensure that such movements are appropriately included and/ or excluded, as applicable from such inventories. For example:

(a) Goods purchased but not received are included in the inventories;

(b) Goods sold but not dispatched are excluded from the inventories.

(vi) Verify whether consistent and accepted accounting principles are adopted for valuation of Inventories.

(vii) Evaluation of the security measures for prevention of theft and pilferage.

(viii) Costing system in operation to ensure the value of the system in use

(ix) Go through the "Purchase register ", "Sales register ", "Goods received note", and "Goods returned note" and verify with the invoices. If these registers are not prepared, then examine the books, which serve as a record of the things made as in these registers.

(x) If there is any difference between the physical verification of the inventories and the records, the same should be jotted down.

(xi) In case the inventories are lying with processors, verify whether the branch has obtained a letter of no-lien from the processors.

(xii) Scrutinize at least 20 % of the total raw material and 85 % of the total finished goods and semi-finished goods lying in the godown.

(xiii) Prepare the age-wise list of the inventories in the following manner:

(a) more than 12 Months.

(b) more than 6 Months Old and Less than 12 Months Old.

(c) more than 3 Months Old and Less than 6 Months Old.

(d) more than 1 Month Old and Less than 3 Months Old.

(e) less than 1 Month Old

(xiv) Bifurcate the inventories into paid and unpaid and ensure that only paid inventories are taken for the purpose of calculation of drawing power.

(xv) In case of unpaid inventories, the bank/ financial institution should not provide any assistance or credit facility to the extent the insurance policies cover the following risks:

(a) Fire.

(b) Marine

(c) Other Natural Calamities

(xvi) The inventories hypothecated should be within the norms as suggested be the Tandon/ Chore committee. If the borrower is keeping excess inventories than the prescribed norms, the borrowers should give a time-bound program to reduce the level of inventories.

(xvii) A written declaration from the borrower about his existing credit facilities with other banks, if any, and an undertaking that the inventories will not be hypothecated to any other banks without the prior consent of the bank is taken on record.

(xviii) Also verification of register should be done.

(xix) Details of the inventories as regards to quantity, quality, life, date of purchase and price must be verified.

(xx) Check whether goods require any specialized preservation, and if so, then proper arrangement should be made for facilitating such storage.

(xxi) Check the method, which has been employed for ascertaining the final value of closing inventories.

(xxii) Check whether borrower follows the method consistently or not.

(xxiii) Verify the movement of inventories.

(xxiv) Check the work in progress and its basis of valuation and percentage of completion.

Procedure for Verification of Hypothecated Book Debts

The auditor has to ensure that the book debts charged to the bank have arisen out of genuine trade transactions. Hypothecation of books debts, to be precise, is more like clean advances. Their safety depends upon the quality of checks the branch exercises over the book debts statements, submitted from time to time. Following checks, however, should be done by the auditor:

(i) The debts shown as outstanding should be shown in the respective ledger account in the books of the borrower.

(ii) Few invoices/ excise gate passes should be checked to ensure actual movement of Inventories.

(iii) Sundry Debtors may be classified as sound, i.e., fully realizable or doubtful.

(iv) Prepare the age-wise list of the Book debts in the following manner:

   (a) more than 12 Months Old

   (b) more than 6 Months Old and Less than 12 Months Old

   (c) more than 3 Months Old and Less than 6 Months Old

   (d) more than 1 Month Old and Less than 3 Months Old

   (e) less than 1 Month Old

   The age of the book debts should not be more than stipulated in the sanction. The debts of over a period of 3 months (or as stipulated in sanction) should be excluded while estimating the drawing power.

(v) The debt should represent sales and service transactions only.

(vi) Ledger of sundry debtors and sales-register should be pursued.

(vii) Bad or doubtful debts should be excluded while calculating the drawing power.

(viii) The advances have been allowed to reputed corporate borrowers after a careful assessment of the creditworthiness of debtors, besides that of the borrowers.

(ix) Examine the statement of Debtors to ascertain whether there is undue concentration of debts involving large amount from a few parties. If so, examine whether limits for individual debtors have been fixed and whether the limits are adhered to.

(x) Compare the statement of book debts with the debtors ledger to ascertain the genuineness of the debt, aging of debt and cases of non-realization of long outstanding debts.

(xi) All realizations are duly deposited in the account and the borrower furnishes realization statement of book debts.

(xii) The drawing power is revised from time to time on the basis of statements and the required margin is maintained in the account.

While valuing debtors, it should be seen that the bad and doubtful debts have been written off so as to reflect their correct value.

The following are the indicators that the debts are doubtful and uncollectible:

(i) Terms of credit have been repeatedly ignored.

(ii) Stagnation or lack of healthy turnover.

(iii) Payments have been received but balances are increasing continuously.

(iv) Cheques are repeatedly dishonored.

(v) Debt under litigation, arbitration or dispute.

(vi) Collection becomes time barred.

(vii) Debtor is unable to repay the due amount due to insolvency or disowns the debt.

Confirmations

Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are entitled to hold the stocks of the entity. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. In the process of audit, external evidence is considered to be more reliable than internal evidence. Therefore, confirmation of Accounts Receivables, which are hypothecated for the purpose of loans from financial institutions or bank, is a generally practiced auditing procedure to obtain such evidence. This establishes reliably the existence and the value of the debts as is reflected in the accounts.

The entire process is as follows:

(i) Select the parties for obtaining confirmation.

(ii) Design the confirmation request.

(iii) Communicate the confirmation request to the third party.

(iv) Obtain response from the third party.

(v) Evaluate the information provided by the third party and scrutinize the same for reliability.

The date of request of confirmation is also very important.

The date may be as follows:

(i) Year end date

(ii) Date prior to year-end.

Generally, the confirmation request should be sent approximately a week before the date specified in the request, if the debtor is in a foreign country. The auditor should first obtain a schedule of accounts receivable. The auditor should also determine that there are no totaling errors. He should investigate the credit balances and compare all or a selected sample of account balances with the account balances in the ledgers.

The auditor may verify the following accounts:

(i) All accounts with a balance over a pre-determined amount. The predetermined amount is based on the auditor's assessment of materiality.

(ii) All accounts having zero balances.

(iii) Accounts with old unpaid balances especially when subsequent sales have been paid off.

(iv) Accounts written off during the year under review.

(v) Certain accounts that had appeared on the prior year's accounts receivable schedule but not on the current year's schedule.

(vi) All accounts with credit balances.

Drawing Power

The auditor may perform the following procedure regarding drawing power:

(i) Ensure margin requirements as per sanction terms are considered.

(ii) Check for arithmetical accuracy.

(iii) Check that old and obsolete inventories are excluded.

(iv) Check that debtors greater than 90 days are excluded.

(v) Check that unpaid stock [Sundry Creditors] has been excluded.

(vi) Check that the statement is submitted as per bank's format only.

(vii) Drawing power is required to be arrived at based on the Inventories statement which is current.

(viii) The outstanding in the account based on drawing power calculated from Inventories statements older than three months, would be deemed as irregular.

(ix) The account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

Verification of Insurance Coverage

The auditor may perform the following procedures to verify the insurance coverage:

(i) Check whether the Inventories hypothecated is adequately insured.

(ii) Check whether the policy is in force.

(iii) Check whether inventories with third parties are also covered.

(iv) Check whether bank clause is included in the policy.

(v) Check whether the Inventories is covered against all major perils.

(vi) Check whether the collateral security is also insured adequately.

Documents to be taken as Working Papers

The auditor should comply with the requirements of the SA 230 [Earlier AAS 3] regarding documentation and gather the following records as documentary evidence for the purpose of facilitating him in the process of audit:

(i) Auditor's report on Inventories for the previous three years.

(ii) Bank statements of the last 3 months.

(iii) A statement showing previous years Opening Inventories, Purchases, Sales, Work in progress and Finished Goods.

(iv) Details of Installed capacity, licensed capacity and Actual production with documentary evidence.

(v) Copies of sales invoices for last 12 months, taking on an average at least 3 entries per month and checking the process of collection.

(vi) Copies of purchase invoices for last 12 months, taking on an average at least 3 entries per month and checking the process of collection.

(vii) A certified copy of the constitution of entity represented by either the

Partnership Deed or the Memorandum and Articles of Association or the Trust deed for Trust, etc.

(viii) In case of a company, the following copies: (a) a copy of Form No.18 along with filing fees receipt for registered office address (b) A copy of Form No 32 along with filing fees receipt for directors. (c)A copy of Form No. 8 and 13 along with filing fees receipt and charge registration certificate (d) a copy of Form No.8 and 17 along with filing fees receipt & certificate for registration of charge and balance sheet.

(ix) The Profit and Loss Account for the last 3 years.

(x) Month-wise Inventories statement of the last one year.

(xi) Month-wise book debt statement of the last one year.

(xii) In case of a manufacturing concern, a brief summary of the manufacturing process.

(xiii) A list of books and records maintained for the purpose of Inventories, debtors and security.

(xiv) An organization chart giving an overview of the organizations' hierarchy, along with their respective responsibility.

(xv) A flowchart depicting the movement of raw materials, work in progress and finished goods.

(xvi) The credit policy as is employed by the company.

(xvii) A detailed statement of debtors showing the date of the bill and age-wise classification of debtors.

(xviii) An Inventories statement as on the date of physical verification along with date of purchase with the detailed breakup of its components.

(xix) A copy of agreement of ownership / Lease agreement / Rent agreement for office / Factory / Godown.

(xx) A list of sundry creditors with date of bill for goods purchased on date of physical verification.

(xxi) A certified copy of the Insurance policy in force.

(xxii) A certified copy of loan sanction letter.

(xxiii) Comprehensive management representation letter.

(xxiv) A certified copy of Excise Return (RT-12), Sales tax return and Income tax return of the previous year.

(xxv) Copy of registration certificate under Shops and Establishment Act, Register of Firms, Pollution control Board, Food and Drugs Approval Authority – other laws as applicable.

(xxvi) A note specifying the accounting policies that are employed.

(xxvii) A detailed note on accounting system for purchases, sales and inventories.

The auditor should verify the documents that are available with the bank branch and satisfy him about the adequacy of such documents. As far as possible the auditor should not call for these documents, if they are insufficient since the borrower may be hesitant to divulge his trade documents to a third party. Instead the banks should be asked to call for these documents.

Reporting

8.7 The auditor may consider the following while reporting:

(i) The report has to be submitted to the authority appointing the auditor.

(ii) It should be in the prescribed format and should be exhaustive and inclusive of all facts and summaries.

(iii) It should include the date, time, location of visit and the name of the officials conducting the audit and the official of the entity present at the entity at the time of conducting the audit.

(iv) Copies of confirmations, management representations, etc should be submitted along with the report.

(v) If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of Inventories or adequacy of procedures adopted by the management in respect of physical inventories count, the auditor should make a reference to a scope of limitation in his audit report.

(vi) If the inventories is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

Chapter 9

Significant Observations in Cash-Credit Accounts

9.1. The significant observations made by the auditor in cash-credit accounts are as follows:

(i) Inventories / Book Debts / QIS statements not furnished in time.

(ii) Inventories Statement received from borrower are filed without scrutiny. Non moving inventories and not identified.

(iii) Age wise analysis of debtors are not done. Debtors more than 90 days are considered for drawing power.

(iv) Drawing power not correctly calculated.

(v) Inadequate insurance or insurance is not available, Policy without Bank Clause/coverage of all risk.

(vi) Operations in the accounts are not scrutinized with reference to projections, QIS statements, audited accounts, etc.

(vii) In case of consortium advances and account is not monitored in close coordination with the member bank.

(viii) Physical verification of assets and inventories are not done as per stipulation. Defects pointed out by the Inspectors are neglected.

(ix) Valuation of inventories are not verified.

(x) Confirmation for Inventories with third party are not obtained or physical verification of inventories are not done.

(xi) Material received from third parties for job work is not excluded while calculating drawing power.

(xii) Diversion of funds and inter account transfers are not properly monitored.

(xiii) Accounts are not reviewed/renewed at regular interval.

(xiv) Monitoring of account where sub-limit is transferred to branches.

(xv) Borrower having operations with other bank.

(xvi) To cover the valuation of security, revaluation of assets may not be genuine.

Chapter 10
Inadequacy of Stock Audit

10.1 Conducting Stock Audit does not necessarily guarantee absolute veracity of the stock records or even the healthy financial position, for that matter. There are certain inherent deficiencies that are inevitably there. They take place in the following ways:

(i) The auditors appointed for the purpose of Stock Audit cannot be expected to be aware of the industry scenario precisely. If the risk assessment and demand analysis is done without taking into consideration the future industry prospects, then it will undoubtedly reveal a wrong picture and hence a futile report as a result.

(ii) The scope of the auditor's work is limited; in the sense that he is not allowed to delve deep in the technical aspects. Also it is not humanely possible for him to be conversant with the technical details and this prevents him from judging the concept of technological obsolesce, which is a critical aspect as far as stocks are concerned.

(iii) Since the system of allocation of stock audit is not based on a well-worked out methodology, it is sometimes allocated without considering the proper evaluation of the competence, manpower or experience. As a result, it fails to serve the purpose it was meant to serve.

(iv) Several banks resort to window dressing for the purpose of reflecting a healthy financial position than it actually is. This may be in the form of certain liabilities which are not reflected in the books. This is particularly true in cases where the borrower has various group companies.

Remedies

10.2 It is not possible to deal with all the inconsistencies in a fool-proof manner. However the following can be done:

(i) The appointment procedure of the Stock auditors can be more scientific and should be based on merit.

(ii) As required by SA 310 [Earlier AAS-20], the auditor should acquaint himself with the Knowledge of the business, before he starts the audit, both technical as well as financial aspects, to give him a better understanding.

10.3 Special considerations while conducting Stock Audit:

(i) If the stock statement as shown in the hypothecation statement does not tally with the stocks as in the balance sheet, then appropriate action should be taken to find reasons for the differences

(ii) It should be seen that the stocks have been properly valued, after considering the relevant accounting principles, Standards on Auditing.

(iii) It should be seen that current assets are not over-stated.

(iv) It should be seen that the turnover is not over-stated.

(v) It should be seen that the accounting policies with regard to stock and debtors is employed.

(vi) It should be seen that the stocks that are genuinely owned by the borrower are shown in the accounts.

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Chapter 11
Physical Verification of Inventories

11.1 The auditor should check the following regarding the inventories.

(i) Ensuring whether the entity is maintaining proper records of inventories.

(ii) Conduct of physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification.

(iii) whether any material discrepancies were noticed on physical verification.

(iv) if so, whether the same .have been properly dealt with in the books of accounts.

Maintenance of Records

11.2 What constitutes "proper records" is a big question. However, in general, records relating to inventories should contain*, inter alia,* the following:

(i) Particulars of the item like nomenclature, nature, etc.

(ii) Identification code of the item.

(iii) Details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner.

(iv) Relevant document number and department identification, if any.

(v) Location.

(vi) If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made.

(vii) The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents.

(viii) The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.

(ix) In cases where a company is maintaining stock records for work-in-progress, say, for compliance with the requirements of the section 209(1)(d) of the Companies Act, 1956, the auditor would normally be able to obtain relevant information in respect of work-in-progress from such records. However, in many cases, it might be impracticable to maintain stock records for work-in-progress. In such cases, the auditor should consider the fact whether the company, at any point of time, can arrive or calculate the quantity and amount involved in the work-in-progress. Some of the factors that might be used in arriving at the value of work in progress include the production cycle, input/ output ratio analysis, production and stock records for the immediately following period. If the company is able to do so, the auditor may form an opinion that proper records relating to the work-in-progress have been kept and, accordingly, no adverse comment of the auditor under this clause would be required. However, before adopting this as an audit procedure, the auditor should satisfy himself as to the impracticability of maintenance of stock registers of work-in-progress.

(x) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc.

Conducting Physical Verification

11.3 Physical verification of inventories would mean verification with regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.

There are two principal methods of physical verification of inventories: periodic and continuous.

Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.

Frequency of Counts

11.4 Count frequency should be calculated to meet your previously stated objectives. Factors such as the effects on customer service and manufacturing operations, and the potential for inaccuracy within the specific product group will affect the frequency of your counts. Even factors such as manufacturing and supplier lead times should be considered in prioritizing counts. Certain key raw materials critical to your operation that are highly prone to variances due to high scrap factors or variation in manufacturing processes may need to be counted every week (or day) while some very slow-moving finished goods may only need to be counted once a year. As your count program evolves, the frequency of counts will change based upon the accuracy levels achieved.

Process of Verification

11.5 Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor has to use his professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion.

(i) The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.

(ii) The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks.

(iii) Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:

(a) maintains adequate stock records that are kept up-to-date;

(b) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and

(c) investigates and corrects all material differences between the book records and the physical counts.

(iv) The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.

(v) The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The documents which can be examined by the auditor would include

(a) written instructions given by the management to the concerned staff engaged in the verification process;

(b) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;

(c) summary sheets/consolidation sheets duly authenticated by the responsible officials;

(d) internal memos etc., with respect to the issues arising out of physical verification of inventory;

(e) any other relevant documents evidencing physical verification of inventory.

(vi) In case where the inventories are material and the auditor is placing reliance on the records, documents, information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management, attends the physical verification. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories.

(vii) While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.

Discrepancies on Verification of Inventory

11.6 The auditor needs to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies.

Chapter 12
Valuation of Inventories

12.1 If the inventories are not valued properly then it projects a wrong picture of the financial statements of the company. The valuation of inventories therefore is an important area that needs to be addressed well by the auditors.

12.2 There cannot be a universal principle to be applied for the purpose of valuation. Different methods of valuation are adopted, depending upon the type of Inventories, in particular and the type of the business, in general. The auditor is, therefore, required to ascertain the method of valuation that best suits the requirement.

12.3 However, it should be borne in mind that he should adopt the principle of conservatism while valuing the inventories. The inventories should be valued at cost or market price, whichever is lower. The fundamental concept is that provision for losses should be made and unrealized profits should not be considered. This helps the accounts to project the true value in the real sense.

12.4 An auditor is, therefore, expected to do the following regarding the valuation of inventories:

(i) Find out the cost price of the inventories.

(ii) Determine the market value of the inventories.

(iii) Since different types of inventories require different methods of valuation, ascertaining the appropriate method of valuation and valuing it, accordingly.

(iv) Value the obsolete inventories/ non-moving/ scrap inventories

I Actual Cost of the Inventories

12.5 Two aspects need to be addressed while arriving at the cost price:

(a) The method of valuation and

(b) Compliance of the Section 145A of the Income Tax Act, 1961

Method of Valuation

12.6 The term, cost price is elusive since it is not well defined anywhere. The auditor has to use his discretion to decide which method of ascertaining the cost price best suits his requirement. There are various methods that can be adopted. However, the Institute of Chartered Accountants has prescribed the methods that are mandatory for the valuation of inventories, by means of the Accounting Standard 2, which deals with the valuation of inventories.

These methods are specific identification method, First-in-First-out method and Weighted Average Method. It is the duty of the auditor to verify that the inventories have been valued by either of the above methods. The auditor should report any variance from the same.

A brief idea of these methods is given as under:

1. Specific Identification Method: If the materials that have been purchased are utilized for a particular job, the actual purchase price can be charged as the cost of the Inventories. This method is appropriate when there are minimum fluctuations in the prices.
2. First in First out Method (FIFO): This is the most widely used method adopted for valuing the Inventories. Here the Inventories is valued on the basis of the principle that the Inventories is utilized in the order in which it is received. Hence the Inventories remaining is from the latest purchase.
3. Weighted Average Method (WAM): This is a relatively practical method of valuation .As per this method; the Inventories is valued at an average price which is arrived at every time a purchase is made. The simple principle of average should be applied .In other words the total value of the Inventories should be divided by the quantity to arrive at the weighted average price.

Any of the above methods can be employed for the purpose of valuation of inventories. If any other method is employed, the auditor should take note of it and report the discrepancy in the report that is submitted.

Compliance with the Section 145A of the Income Tax, 1961

12.7 The Income Tax Act, 1961 has inserted Section 145A from Accounting Year 1998-99. This section requires that while valuing Inventories the method employed should be:

- In accordance with the method regularly employed by the assessee.
- Further adjusted to include the amount of any cess, tax, fee (by whatever name called) actually paid or incurred or fee by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

While valuing the Inventories, it should be ensured that the above requirement of the statute is complied with. The auditor should obtain a satisfaction to the effect that the value of the Inventories is inclusive of any cess, tax or fee that has been either incurred or paid on such Inventories. The auditor should bring any lapse on this account to the notice in the report.

II Market Price of the Inventories

12.8 After having arrived at the cost price of the Inventories, on the basis of the aforementioned parameters, the auditor has to find out the market price of the inventories. As the inventories is to be valued at cost or market price whichever is lower, it is an important step in the process of valuation. The market price may seem to be a very simple term, in the sense that it is the price of the inventories that prevails in the market. However, in order to arrive at the market price, the purpose for which the inventories is held is to be found out. If it is held for use then the market value is the value arrived at net of selling expenses. Similarly, if the inventories is required to be replaced, then the cost of replacement as on the date of balance sheet should be taken as the market price.

Thus, after arriving at the market price on the above basis, the auditor can quantify the value of the inventories.

III Valuation of Different Types of Inventories

12.9 The Institute of Chartered Accountants of India defines Inventories to include, stores, spare parts, loose tools, raw materials, materials in process, finished products, waste or by products, etc. Each type of Inventories entails different methods of valuation depending on their unique characteristics. The following points should be kept in mind while arriving at their value:

(i) *Stores*: Stores have been defined as that component of Inventories that is not held for sale. They are in fact, consumed in the manufacturing process. Examples of stores would include, oil, tallow, grease, dyes, fuel, etc. Since they are not Inventories in the real sense of the term, they should be shown as a separate item in the balance sheet and the amount of stores consumed should be debited to the Manufacturing Account, so as to arrive at the true cost of manufacture. The stores should be shown at cost price only. However, any deterioration in the price should be incorporated to arrive at their true value.

(ii) *Spare Parts*: It refers to the parts that form part of any Plant and Machinery. If any such spare part is consumed, they should be capitalized as part of the asset they have been used for. Spare parts should be valued at the cost price only. It is the duty of the auditor to get a list of these spare parts from the Works Manager so that he can verify their existence.

(iii) *Raw Materials*: It consists of the Inventories that is consumed in the process of manufacture. Raw material is valued at the invoice price, i.e. the cost price plus a reasonable proportion of freight, duty, etc that has been paid with regard to the Inventories. Either the actual cost or the average price can be taken as a method of valuation of raw material, depending upon the availability of data. For any diminution in the value of the raw materials, sufficient provision of the fall in the value should be made.

(iv) The raw materials should be valued at a price, which is never higher than the market price. In case of the goods, whose value appreciates with the passage of time, they are valued at a price higher than the cost price. It is the auditor's duty to see to it that they are not valued at a price that is higher than the price of the similar goods.

(v) *Materials in Process*: The goods which are not completed on the date of the balance sheet, some process needs to be carried out thereon, are called materials in process or semi-manufactured goods. These should be valued at cost plus a proportionate amount of wages and other charges, on the basis of percentage of completion. The auditor should verify that the percentage of completion has been worked out properly and hence valuation is in order.

(vi) For this purposes, the auditor should or may examine the production / costing records (e.g. cost sheets), hold discussion with the personnel concerned, and obtain expert opinion, where necessary.

(vii) In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work–in–process may be impracticable. In such cases the auditor should lay greater emphasis on ascertaining whether the system from which the W- I- P is ascertained, is reliable.

(viii) *Finished Goods*: The Finished goods are valued at the cost price. The cost price is arrived at after adding all the expenses incurred in the process of manufacture. The auditor should verify that the expenses have been appropriately apportioned.

(ix) *Goods on Consignment*: It may happen sometimes that the goods are sent on a consignment basis and they do not arrive till the date of the balance sheet. In this case, the goods should be valued at the cost price plus proportionate expenses like, freight, dock dues, etc. the auditor should insist on the consignee to verify the quantity of Inventories lying with him. Any expenses incurred during the process of sale, it should be allocated only to the goods sold and not added to the unsold Inventories. Here again the principle of conservatism should be followed, a price higher than the market price should not be taken, while provision for losses should be done. If the Inventories is valued at selling price, when sent as a consignment, it should be ascertained that the Inventories should be valued after making the adjustments, or else the Inventories will be over-valued.

For computing accumulation of huge inventories, the number of days holding of Inventories etc, the following methods may be followed:

1) For Raw Material:

$$= \frac{\text{Holding of raw material stock}}{\text{Annual raw material consumed}} \text{ X } 365$$

2) For Inventories in Process:

$$= \frac{\text{Holding of inventories in process}}{\text{Annual cost of production}} \text{ X } 365$$

3) For Finished Goods:

$$= \frac{\text{Holding of finished goods}}{\text{Annual cost sales}} \text{ X } 365$$

4) For sundry debtors:

$$= \frac{\text{Holding of sundry debtor's}}{\text{Annual sales}} \text{ X } 365$$

5) For sundry creditors

$$= \frac{\text{Holding of sundry creditor's}}{\text{Annual purchases}} \text{ X } 365$$

IV Valuation of Obsolete/ Dormant/ Slow-Moving/ Excess Inventories

12.10 The term obsolete inventories refers to the inventories that has become unsalable due to following reasons:

(a) Discontinuation of the product in the market

(b) Physical Deterioration

(c) Change in the design of the product

(d) Substitution by a better material in lieu of the existing one.

The auditor should make an effort to find out the inventories that have become obsolete due to any of the above reasons. After preparing a list of them, they should be presented to the management who can decide whether they should be disposed off or kept. Obsolete inventories should be valued at net realizable value.

Dormant inventories mean the Inventories whose movement is temporarily hampered due to a variety of reasons, but they are expected to be consumed in the days to come. One such reason for their slow movement is that the Inventories is consumed in the manufacture of goods that are sold seasonally and hence their production is stopped during off-season. Slow moving Inventories means the Inventories with a low turnover rate. In other words, they move at a slow rate.

The dormant and slow moving Inventories should be valued at net realizable value, cost or replacement price, whichever is the lowest. The auditor should make a list of these items also and speed up their disposal, if necessitated by the management.

Excess Inventories, as the name suggests, is the excess of Inventories that has accumulated due to either unwarranted purchase of goods, lapse in the forecast of sales leading to excess Inventories than can be consumed, unhealthy practices in the Inventories management, etc. The question whether any Inventories is in excess is subjective and depends on the discretion of the company. In general any Inventories that is in excess of three years usage will be considered as excess Inventories. The auditor should see to it that the excess Inventories is sold and unless there is any possibility of its usage in the production process.

The auditor should bear in mind the fact that either of the above kind of Inventories necessitates additional blockage of funds, mis-utilisation of space, maintenance cost, Storage cost and fear of pilferage and further deterioration. This has an adverse impact on the bottom line of the company. He should therefore make an effort to see that proper controls are in force so as to ensure that such inventories are kept under check and as far as feasible avoided.

Controls

12.11 The controls that should be exercised by the auditor are as follow:

A) Controls with regard to the Scrap, Waste and Spoilage

The term scrap refers to that Inventories that arises due to the manufacturing process and has very small value. Waste, on the other hand means goods that have no recovery value. While, spoilage refers to those goods that do not meet the quality standards and hence have to dispose off at less than their actual value.

The auditor should bear the following points in mind while exercising control over the scrap, waste and spoilage:

(i) The management should establish normal rates of scrap at which scrap is generated after having taken into account the past records and experience.

(ii) Proper documentation of the scrap records should be done.

(iii) The actual scrap realized should be compared with the standard set and the variance should be reported.

(iv) The scrap should be considered as good units for the purpose of valuing the Inventories. Any sale proceeds derived from the sale of such scrap should be deducted from the cost of production.

(v) An important area for the auditor to keep a check is that of sale proceeds of the scrap. He should satisfy himself that the sale proceeds are properly accounted and they have not been misappropriated.

(vi) The scrap units should be properly stored in the stores department.

(vii) Top management should be aware of the scrap generated and hence a periodic report should be generated.

B) Controls with regard to Stores Maintenance

Raw material forms the most important component in the cost sheet and hence an effort should be made that optimum Inventories is maintained. An auditor should see that the following points have been considered and any deviation from these should be immediately reported:

(i) It should be seen that the Inventories requirement has been properly planned so as to avoid a problem of either excess Inventories or shortage of Inventories. If the Inventories is more than which is required, it will lead to excess blockage of funds, in the other scenario if the Inventories is short, it will hamper the production process.

(ii) The Inventories should be properly handled and stored so as to prevent deterioration in value.

(iii) The stores department should be well located so as to minimize the transportation cost.

(iv) There should be an effective system for recording the movement of Inventories. Any movement should be well documented.

(v) The system of First-in-First-out should be adopted so as to prevent obsolescence of old Inventories

(vi) Any non-moving item should be identified and written off, if necessitated.

(vii) The principle of re-order point should be followed so as to ensure continuous supply of goods at any point of time.

(viii) A system of Continuous Inventories-taking should be in force

Auditor's Duty with regard to the Valuation of Stock

12.12 The cost of Inventories includes:

(i) Cost of purchases.

(ii) Cost of conversion comprising of cost of direct labor and allocated Fixed and variable overheads.

While valuing the Inventories, the auditor has to consider the following:

(i) He should ascertain the accounting policy adopted for valuation of stocks and consider the appropriateness as per AS-2.

(ii) He should verify that the cost of Inventories does not include:

(a) Abnormal waste material, labor or other production costs.

(b) Storage cost unless necessary in the production and manufacturing process.

(c) Administrative overheads not contributing to bringing the Inventories to the present location.

(d) Selling and distribution expenses.

(e) Interest cost.

(iii) He should check the basis for Net realizable value determination.

(iv) He should ascertain that the cost of damaged and obsolete item is written off.

(v) He should check the arithmetic accuracy of stock valuation.

(vi) He should check the consistency of the basis of valuation.

(vii) He should review Inventories records for identifying slow moving and obsolete items.

(viii) He should review the system of overheads allocation.

Chapter 13
Verification of Securities

Securities - Definition

13.1 According to *Section 2 (h) of Securities Contracts (Regulation) Act, 1956*, the term 'Securities' include:

(i) shares, scrips, inventories, bonds, debentures, debenture Inventories or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ii) derivatives;

(iii) units or any other instrument issued by any collective investment scheme to the investors in such schemes;

(iv) government securities;

(v) such other instruments as may be declared by the Central Government to be securities; and

(vi) Rights or interests in securities.

13.2 The physical as well as demat securities shall be in the form of:

(i) Scrips or Certificates.

(ii) Safe Custody Receipts (SCR).

(iii) Letter of Allotment.

(iv) Either Scrips or Allotment Letter.

(v) Certificate of holding.

Scope of Audit

13.3 The scope of audit in this regard is as follows:

(i) To verify physically the certificates of the securities held by the branch.

(ii) To see that the registers for the securities held physically are maintained properly.

(iii) To verify that securities held by the branch are tallying with Security Holding Register.

(iv) To obtain the statement showing the securities sent for demat and cross tally with the records maintained in the register.

(v) To check vault and other registers with the Inventories Holding Register to see the reconciliation between physically verified scrips and total investments made by the bank. This scrutiny will reveal major queries relating to demat, redemption, withdrawals, re-deposits, call/put options.

(vi) To give the report on the following lines.

Reporting

13.4 Reporting should be done on the following:

1. Statement showing primary market holding.
2. Statement showing the securities in the secondary market.
3. Statement showing the securities held in physical form.
4. Statement showing the certificates withdrawn permanently from Vault for redemption or for the purpose of demats.
5. Statement showing the investments neither where allotment letters are received nor the certificates.
6. Statement showing certificates of the investments held by other branches of the bank and for which there is Safe Custody Receipts.
7. The statement showing investments held by the other branches of the bank where the Safe Custody Receipts are not received by the Bank's Investment Section.
8. Statement showing certificates withdrawn from the Vaults for the interest collection.
9. Statement showing the certificates of the investments by the R.B.I.
10. Statements showing demat secondary market holdings.
11. Statement showing half yearly interest bonds.
12. Statement showing details of letters of allotment.
13. Statement showing the investment done in Regional Rural Banks.
14. Statement showing the certificates which are torn or mutilated.
15. Statement showing scrips lodged with branches (e.g. Custody).
16. Statement showing scrips pending for demat.

Audit of Securities

13.5 The auditor has to physically verify securities and check the following points:

(A) When the Original Securities are in Custody of Client

(i) Whether the securities are in the name of the client. i.e. Ownership;

(ii) Whether the securities are kept properly and in safe custody. i.e. Custodian;

(iii) Whether the face value of the securities is properly mentioned. i.e. Valuation;

(iv) Whether any security is missing, if so, investigate the reason thereto.

(B) When the Original Securities are in Custody of Another Person, i.e., Bank/ Financial Institution

In this case, the auditor will have to obtain a certificate from the holder of the securities that they are holding them on behalf of the client and the same are kept in safe custody.

(C) When the Original Securities are Sent Back to the Company for Surrender/ Transfer/ Change in Name, etc.

In this case, the auditor will have to check up the correspondence with the Company and the acknowledgement of the company that it has received the original security.

Chapter 14
Analytical Review Procedures

14.1 In addition to the audit procedures discussed earlier, an auditor has to apply certain analytical procedures to review the financial soundness of the business of the borrower. The auditor should carry on the following procedures:

(i) Checking records of opening stock, purchases, production, sales and closing stock

(ii) Comparison of closing stock with those of previous year quantity

(iii) Comparison of composition of closing stock with the previous year

(iv) Compare the current year Gross Profit with that of last year

(v) Compare actual stock with budgeted figures

(vi) Compare Inventories ratios with those of the industry and firms

14.2 The most common analytical procedure is Ratio Analysis. Ratios are useful tools for review of performance and state of affairs of the organization. Ratios calculated over a period of time can reveal trends based on which meaningful conclusions can be drawn.

At planning stage, ratios give a sense of direction to the auditor for areas to be covered for audit, during field work. They help him draw inferences and identify the main points to be dealt in report while after completion of the audit ratios help the auditor to re-enforce/establish his inferences and conclusions in his report. Ratios may be classified on the basis of their sources as follows:

1. Balance sheet ratios.
2. Income statement ratios.
3. Mixed ratios-these ratios contain figures from more than one financial statement.

Some of the more common ratios, their classification, method of computation, and the attribute measured are shown in the following list:

Ratios	Formula	Purpose
Liquidity Ratios - Measures the entity's ability to meet its short-term obligations, and provide an indication of the Company's solvency.		
Current Ratio	Current Assets / Current Liablities	Indicates whether short-term creditors can be met with current assets
Quick Ratio or Acid Ratio	Current Assets-Inventory / Current Liabilities	Measures the entity's ability to pay off short-term creditors without relying on the sale of inventories
Leverage Ratios - Measure the extent to which the entity is financed by debt and provide a measure of the risk of the entity borne by the creditors.		
Debt Ratio	Total debt / Total Assets	indicates percentage of total funds provided by creditors; high ratios when economy is in downturn indicate more risk for creditors.
Times Interest Earned	Earnings before interest and taxes / Interest Charges	Measures extent to which earnings can decline and still provide entity with ability to meet annual interest costs, failure to meet this obligation may result in legal action by creditors, possibly resulting in bankruptcy
Long Term Debt to Equity	Long Term Debt / Shareholder's Equity	indicates the proportion of the entity financed through long-term debt Vs. owners' equity
Active Ratios - Measure how effectively an entity employs its resources.		
Inventory Turnover	Cost of goods sold / Average inventory	Estimates how many times a year inventory is sold.
Age of Inventory	360 days / Average Accounts receivable	Indicates number of days of inventory on hand at year-end,
Accounts Receivable	Net Credit sales / Average account receivable	Estimates how many times a year, account receivable are collected
Age of Accounts	360 days / Accounts receivable turnover	Indicates the age of accounts receivable or number of days sales not collected
Total Asset Turnover	Net sales / Total Assets	Estimates volume of sales based on total assets

Profitability Ratios – Measure how effectively the entity is being managed.		
Sales To Total Assets	Net sales Total assets	Indicates the ability of an Entity to use its assets to generate sales.
Gross Margin	Gross margin\ Net sales	Provide a percentage relationship based on sales
Profit Margin On Sales	Net income Net sales	Indicates the return a Company receives on sales.
Net Operating Margin	Operating income Net Sales	Indicates management's effectiveness at using Entity's assets to generate Operating income
Return On Total Assets	Net income + Interest income Total assets	Indicates the return a company receives for its assets
Return On Common Shareholders Equity	Net income – Preferred dividends Average stockholders equity	Indicates return on investment to common shareholders

Illustration 1:

Facts

A company has cost of sales for the year of ₹1, 08,000. Its Inventories amounted to ₹20, 000 at the beginning of the year and ₹16, 000 at the end of the year. Its Inventories turnover is determined as follows:

1. Average Inventories

Opening stock	₹20, 000
Closing Stock	₹16, 000
Average Inventories	$\frac{20000 \quad 16000}{2}$ = ₹18000

NOTE: A better indication of the average Inventories may be obtained by using month-end inventories, if available.

2. Cost of sales ₹108,000

3. Inventories Turnover Ratio = Cost of sales/ Average Inventories

$$= \frac{₹\ 108{,}000}{₹\ 18{,}000} = 6$$

In the previous year, the inventories turnover was 6.

Interpretation of the above ratio:

An increase in the Inventories turnover ratio may occur because of improved purchasing, production, and pricing policies. It may also be caused by one of the following:

1. Poor credit rating of client. If the client has a poor credit rating, it may not be getting the entire Inventories it requires. This will cause Inventories levels to decline, and if sales do not decline as rapidly, the Inventories turnover ratio will increase.
2. Unrecorded purchases.
3. Unusual Inventories shrinkage.
4. Extremely conservative Inventories valuation.
5. Error in computing the Inventories.

Audit Procedures:

The following audit procedures may be employed for taking corrective action.

There are no specific auditing procedures when the high turnover is caused by insufficient Inventories because of a poor credit rating. In that situation, however, the auditor might want to obtain a credit report on the client and should approach the audit with more skepticism than usual.

If the auditor believes that the high turnover of Inventories is caused by other than a poor credit rating, he may take the following additional procedures:

1. Review debit balances in the accounts payable schedule. A debit balance might indicate a payment without the accompanying entry for a purchase.
2. Review Inventories controls to determine the possibility of theft. Also, if the company is a manufacturer, review production records to determine spoilage and waste.
3. Compare Inventories costs with Inventories values.
4. Review Inventories computations.

Illustration 2:

Facts

Following is the trend statement of selected income and expense item:

Year	1st	2nd	3rd	4th	5th
Sales	100	116	133	151	168
Selling expenses	100	115	132	150	175

Analysis

Sales have increased at a steady rate over the 5-year period, and selling expenses matched this increase for the first 4 years. In the fifth year, however, the increase in selling expenses was disproportionate to previous years' increases and to the current year's increase in sales.

The increase may have been caused by one of the following:

1. Misclassification of expenses,
2. Classification of prepayments as expenses,
3. Recording of non-business expenses.

Auditing Procedures

The following audit procedures may be employed for taking corrective action:

If a trend statement indicates a disproportionate increase in an expense, the auditor should apply additional substantive tests to this expense. To determine the reason for the disproportionate increase in selling expenses in the preceding examples, the auditor may review invoices for major expense items in order to answer the following:

1. Were administrative or non-selling expenses classified as selling expenses?
2. At year-end, did the Company make advance payments for the subsequent year's selling program and classify these payments as an expense rather than as a prepayment?
3. Are expenses of executives, personal in nature, being charged to the company?

Thus, Ratio Analysis acts as a useful tool for the purposes of interpreting the figures and acts as a guiding light to the auditor for taking the required action.

Illustration 3:

Facts

A company had sales (all credit) for the year of ₹1, 20,000. Its accounts receivable at year-end amounted to ₹20, 000. Its day's sales in account receivable are computed as follows:

1.	Sales	₹ 120,000
2.	Accounts receivable	₹ 20,000
3.	Average daily sales (Sales ₹120,000/360 days	₹ 333

4. Days sales in accounts receivable

   [Accounts receivable / Average daily sales

   (₹20, 000 / ₹333)] 60

In the previous year, the day's sale in account receivable was 45.

Analysis

The company is not collecting its receivables as rapidly as it did in the previous year. This increase in the day's sales accounts receivable indicates a possible problem in the collectibility of the receivables.

Auditing Procedures

The following audit procedures may be employed for taking corrective action.

The auditor may consider doing some or all of the following:

1. Review cash receipts and remittance advices for the subsequent period.
2. Obtain credit reports on significant past due accounts.
3. Analyze year-end sales to determine any unusually large sales. Determine the nature of these and sales and ascertain that they were recorded in the proper accounting period.

Apart from the above ratios, the following ratios may act as a helping tool for the purposes of interpretation of the figures as stated in the books. The illustrative example of these ratios is as below:

Chapter 15
Planning of Physical Inventory

15.1 Planning a physical inventory is much like planning a fund-raising campaign. The logistics must be fully worked out in advance and every participant must be thoroughly briefed. The following checklist covers planning considerations which should be included in preparing for a physical count:

General Planning

1. Identify the company personnel responsible for the conduct of the count.
2. Make a preliminary tour of inventory locations.
3. Take steps to:
    - clean up the areas where inventory is located
    - accumulate like inventory items that are scattered about
    - stack, sort and clean inventory items
    - segregate defective and obsolete items
    - identify slow-moving items
    - identify consigned or other items on hand belonging to others
    - identify items that need not be counted
    - pre-count items (if practicable and controllable)order necessary recording materials and equipment to take counts, such as tags, extra tape measures, more scales, etc.
4. Consider the need to physically count inventory being held by others
5. In setting a date or period for taking the inventory, consider the timing of the count in relation to the balance sheet date, the low point in inventory quantities

Cut-Off Procedures

6. Establish the cut-off date and time. This requires procedures designed to stop the flow of inventory items to assure that transactions are recorded in the appropriate accounting period in which they occurred.

7. Make plans for:
   - closing down production or suspending or controlling operations
   - segregating incoming inventory expected to be received during the count and establishing prenumbered receiving reports (or other means) to identify "pre-physical" and "post-physical" shipments of inventory.
   - accounting for inventory that must be shipped out during the count
   - controlling the movement of inventory in process
   - controlling intracompany shipments (to avoid double counting)
   - Identify and listing undelivered goods held by vendors for later delivery
8. Identify the forms for entering the physical inventory counts.
9. Make provision to control all count records (issued, returned, unused, and spoiled or voided) and to reconcile them at the end of the inventory count.
10. Determine that the count listing provides for identification of:
    - classifications of inventory (raw material, in process, finished goods)
    - condition (defective, obsolete, slow-moving, excess quantities)
    - location (building, floor, department, off premises, in transit)
    - ownership(inventory on hand belonging to others)

Most of the procedures to be followed during the physical inventory taking should be put into writing so as to guide all concerned.

Chapter 16
Stocktaking

Stocktaking

16.1 Stocktaking is an act of a physical counting process leading to the preparation of a detailed list of property assets and sources of their origin as of a specified date.

Stocktaking consists of the establishment by means of actual physical counting of all property, plant and equipment (fixed assets) and monetary assets; it also provides an explanation of a difference between actual balance established during the inventory and the balance resulting from books of accounts.

Objectives of Stocktaking

16.2 The main objective of a stocktaking process is to establish the actual balance of assets and liabilities. In particular, it consists of:

(i) elating entries in books of accounts with actual state.

(ii) clearing accounts with people responsible for entrusted with them property items.

(iii) assessing business usefulness of property items undergoing the inventory.

(iv) counteracting irregularities having been stated during the inventory (surplus, useless items).

(v) establishing proper financial outcome.

16.3 Activities to be undertaken:

(i) Inventory through a physical counting of all the property items that remain at a business entity disposal.

(ii) Valuation of property items.

(iii) Obtaining written information from a business entity's on :

- o financial assets deposited in bank accounts..
- o granted loans.
- o receivables and liabilities.

- the company's own assets entrusted to contractors.

(iv) Comparing inventory records of some items (for instance land) with referential documents.

(v) Establishing and explaining the causes of losses and discrepancies in quantities.

(vi) Proposing and substantiating motions concerning methods of settlement of inventory differences.

(vii) Indicating ways of removing irregularities in the management of a given entity's property.

Types of Stocktaking

16.4 Stocktaking are of following types:

(i) Stocktaking through Physical Counting - performed by members of a stocktaking commission on the basis of direct observations and measurement of property items conducted in a given business entity. It comprises such accessible items as:

- Fixed assets
- Tangible current assets
- Cash at the entity's cash desk
- Securities

(ii) Coordinating Balance with contractors comprises mainly:

- State of financial assets deposited in bank accounts
- Loans and credits
- Receivables
- Liabilities

(iii) Verification of Records-concerns assets and liabilities the balance of which cannot be established through inventory or through the coordination of balance with contractors In particular it relates to:

- Arable lands
- State or local authorities' receivables and liabilities
- Other items impossible to access

Methods of Stocktaking

16.5 Following are the method of stock taking:

1. Perpetual Inventory System

A method of controlling physical stock level by ensuring the amount of stock level of every item could be accounted at all times. This normally involves detailed recording of all receipts, issues and running balances for each item of stock.

Due to the detailed recording of all in and out, management does not need to do a physical stocktaking/ count. The stock level can be ascertained at any moment of time.

To ensure that the aforesaid stock level is accurate, physical stocktaking needs to be conducted.

Basically, there are two types of physical stocktaking:

2. Continuous Stocktaking

As the word continuous means the continual physical count of the quantity of the stock.

This is done at a FEW TIMES a year. The physical quantities counted are then compared to the stock recorded under the perpetual inventory system.

Stock discrepancies between physically counted and recorded might be due to:

(i) Pilferage and falsification of documents;

(ii) Natural wastage like evaporation or breaking in bulk;

(iii) Warehouse's errors both physical and clerical;

(iv) Clerical errors in the books recorded under the perpetual inventory system

3. Periodic Stocktaking

Unlike continuous stocktaking, the stocks are physically counted only at the end of the accounting year.

Advantages of Continuous Physical Stocktaking Compared to Periodic Stocktaking

16.6 Though the greatest disadvantage is the time and manpower factor as it involves more frequent stocktaking, there are many advantages of continuous over periodic stocktaking:

(i) It improves the quality of the physical stocktaking as there are more frequent physical counting;

(ii) It allows stock discrepancies to be more fully investigated;

(iii) Maintain a higher work standards as the warehouse personnel know that they need to count the stock more frequently;

(iv) Unauthorized changes in procedures are detected and

(v) Production hold-ups, a common issue in periodic stocktaking is eliminated.

Purpose of Stocktaking

16.7 Physical stocking taking is the process of counting, weighing or otherwise measuring all items in stock and recording the results.

The reasons for doing this are as follows:

(i) To verify the accuracy of the stock records.

(ii) To support the value of stock shown in the balance sheet by physical verification.

(iii) To disclose the possibility of fraud, theft or loss.

(iv) To reveal any weakness in the system for the custody and control of stock.

The size and number of surpluses and deficiencies revealed by stocktaking is a good criterion of the efficiency of storekeeping, control and procedure generally.

Procedures for Stocktaking

16.8 For a satisfactory stock take, a good deal of preparation is necessary. First of all, a program should be drawn up and agreed with all concerned, including the customer's finance department, auditors, the customer's management and warehouse personnel. Secondly, proper cut off time, inventory report, stocktaking sheets or cards have to be prepared in advance. Thirdly, all personnel concerned must be instructed and briefed before-hand on their respective duties come the day of the stock take.

(i) Appoint one person to control the whole operation.

(ii) While stocktaking is in progress, do not have the warehouse open for normal business or operations.

(iii) After the end of the last working day before the stock take, no more issues (deliveries) should be made and no more receipts recorded into the Warehouse Management System until the stock take is complete. The number of the last receipt and issue should be noted, and all documents up to and including these numbers posted to the computer system or records. At this point, all the records can be ruled off and no further postings are made until the results of the stocktaking have been entered.

Ideally, the warehouse should be tidied and the number of items per pallet standardized to ease counting on the stock take day. For example, if there are 210 televisions to be counted and one pallet has twenty televisions then all pallets of the same model should have twenty televisions making ten pallets of twenty TV's each with one pallet of ten TV's. A common cause of wrong counts is random numbers of each item on separate pallets. Another common cause of errors is a mixture of items on pallets. Sometimes, TV Model A may be stacked at the front of the pallet and Model B at the back. If the stock taker is tired, they may not do a complete count of items on the pallet and assume the whole pallet only contains Model A and the Model B TV's will not be counted. This will lead to an excess of Model A in the count and a shortage of Model B.

Each row of racks in the warehouse should be numbered and the number marked in chalk on the floor. Each bay in the racking should be numbered to enable easy recounting if necessary. Count sheets should be issued to the staff doing the stock take. Count sheets should be carbonized with minimum three copies. One copy for the Client, one copy for the warehouse operator (ie Tamadam) and one copy for the Master File as backup. Have stocktaking sheets under the control of one person, consecutively numbered, and issued to the staff on duty as required. No duplicates should be allowed and at the end of the job, all stocktaking sheets must be accounted for.

(iv) There should be count teams assembled on the day of the stocktake. Each team should consist of a forklift driver, a representative from the client and a representative from Tamadam. The number of items in each bay should be counted. The count sheet for each bay should be countersigned by the client's representative and Tamadam's representative. The object is to make each person taking stock responsible for a particular section or clearly defined area of the warehouse and record everything that is found in the area.

(v) Count all normal stock including loose packages and items under inspection. Damaged stocks should be recorded separately.

(vi) After the teams have completed their counts and handed the count sheets to the verifiers, the results of the count sheets should be entered into a computer and verified on the spot. The number of total items in the count and in the system should be compared to see if there are any shortages. If the number of items counted matches but there is a difference in individual models, there may have been cross counting or cross delivery of stock.

If the number items does not match or there is a large discrepancy, then the items which show large discrepancy have to be recounted immediately. This is where the numbered bays and allocated count sheets will be very useful as this will enable the count team to zoom in on the area where the goods for which there is discrepancy are kept.

(vII) Normally it is only possible to match the total number of items in the system and that counted on the day of the count. A detailed item by item comparison will normally only be completed a few working days after the stocktake day in the case of counts with large numbers of items and many SKUs.

Conclusion

16.9 The carrying out of accurate stocktakes is of crucial importance both to the warehouse operator and for our clients. With the procedures outlined above, the stocktake should be fast and painless. In the case of discrepancy, the procedure should enable the physical location in the warehouse in which there is a discrepancy to be located as quickly as possible so that a recount can be done. Also, physical tally sheets are very important and these must be kept in their entirety in a safe location for future reference

Chapter 17
Relevant RBI Notifications

I. Master Circular - Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances (DBOD.No.BP.BC.12/21.04.048/2011-12 dated July 01, 2011)*

Para 4.2.4

The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

(i) Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

(ii) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and

* Refer Link :http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6530.

other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

II Lending under Consortium Arrangement/ Multiple Banking Arrangements

RBI/2008-2009/427**
UBD.PCB.No. 59 /13.05.000/2008-09
April 9, 2009

Chief Executive Officers of
All Primary Urban Co-operative Banks

Dear Sir /Madam,

Lending under Consortium Arrangement / Multiple Banking Arrangements

Please refer to our circular UBD.PCB.No.36/13.05.000/2008-09 dated January 21, 2009 on the captioned subject.

2. The formats for declaration of information by the borrower at the time of applying for a credit facility to a bank (Annex I) and the format for exchange of information among the banks in respect of borrowers enjoying credit facilities from more than one bank (Annex II), enclosed to the aforesaid circular have been revised to reflect information relating to the derivative transactions entered into by banks with the borrowers and the unhedged foreign currency exposures of the borrowers.

3. Banks are advised to use the revised formats with immediate effect.

Yours faithfully,

(A.K.Khound)
Chief General Manager-in-Charge

Encl : Revised Formats

** Refer Link: http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=4919.

Part - I

Diligence Report

To,

The Manager,

_________________________ (Name of the Bank)

I / We have examined the registers, records, books and papers of ____________ Limited (the Company) as required to be maintained under the Companies Act, 1956 (the Act) and the rules made thereunder, the provisions of various statutes, wherever applicable, the provisions contained in the Memorandum and Articles of Association of the Company as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s, as may be applicable for the half year ended on ____________ . In my / our opinion and to the best of my / our information and according to the examination carried out by me / us and explanations furnished to me / us by the Company, its officers and agents. I / We report that in respect of the aforesaid period:

1. (a) The management of the Company is carried out by the Board of Directors comprising the following persons :

   (b) During the period under review the following changes took place:

2. (a) The shareholding pattern of the company is as under :

   (b) During the period under review the following changes took place:

3. The company has altered the following provisions of

   (i) the Memorandum of Association during the period under review and has complied with the provisions of the Act.

   (ii) the following Articles of Association during the period under review and has complied with the provisions of the Act.

4. The company has during the period under review, entered into the following transactions with business entities in which directors are interested.

5. The company has during the period under review, advanced loans, given guarantees and provided securities amounting to ₹ ____________ to its directors and / or persons or firms or companies in which directors are interested.

6. The Company has during the period under review, made loans and investments; or given guarantees or provided securities to other business entities as under :

7. The amount borrowed by the Company from directors, members, public, financial institutions, banks and others during the period under review is / are within the borrowing limits of the Company. The break-up of the company's borrowings is as under:

8. The Company has during the period under review, not defaulted in the repayment of any public deposits or unsecured loans and the Company or its Directors are not under the Defaulter's list of Reserve Bank of India or in the Specific Approval List of ECGC.

9. The Company has during the period under review, created, modified or satisfied charges on the assets of the company as under :

10. The Forex Exposure and Overseas Borrowings of the company are as under

11. The Company has issued, offered and allotted all the securities to the persons entitled thereto and has also issued letters, coupons, warrants and certificates thereof to the concerned persons and also redeemed its preference shares / debentures and bought back its shares (wherever applicable) in compliance with the specified procedures and within the stipulated time.

12. The Company has insured all its assets including the secured assets.

13. The Company has complied with the terms and conditions, set forth by the lending institution at the time of availing the facility and also during the currency of the loan and has utilized the funds for the purposes for which these were borrowed.

14. The Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.

15. The Company has paid all its statutory dues and that there are no arrears.

16. The Company has complied with the provisions stipulated in Section 372 A of the Companies Act in respect of its Inter Corporate loans and Investments.

17. The Company has complied with the applicable and mandatory Accounting Standards issued by the Institute of Chartered Accountants of India.

18. The Company has credited and paid to the Investor Education and Protection Fund all the unpaid dividends and other amounts required to be so credited.

19. A list of prosecutions initiated against or show cause notices received by the Company for alleged offences under the Act and also the fines and penalties or any other punishment imposed on the Company in such cases is attached.

20. The Company has complied with the various clauses of the Listing Agreement, if applicable.

21. The Company has deposited both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note: The qualification, reservation or adverse remarks, if any, may be stated at the relevant place(s).

Signature :

Place :

Name of Company Secretary :

Date :

C.P. No.:

Part - II

Certification of Borrowal Companies by Chartered Accountants / Company Secretaries

(i) Terms of reference for stock audit are to be spelt out clearly by the Banks, so that the Chartered Accountants can give focused attention to such areas.

(ii) End-use verification of funds lent, if certified by Statutory Auditors, will be a good comfort to the Banks.

(iii) As Banks quite often deal with unlisted companies, disclosure requirements for such companies above a specific turnover may be made akin to those for listed companies, *viz.* consolidated balance sheet, segmental reporting etc. Information on large shareholding also will be useful

(iv) Further, the following additional certification either from Chartered Accountant or Company Secretary may also be thought of :-

- (a) Company Directors not figuring in defaulters list (RBI / ECGC) / willful defaulters list etc.)
- (b) Details of litigation above a specified cut off limit.
- (c) A specific certificate, probably from the Company Secretary, regarding compliance with Sec. 372 (a) of the Companies Act.
- (d) Details of creation / modification / satisfaction of charges on the assets of the company, position regarding insurance, show cause notices received, finds and penalties awarded.
- (e) As regards rotation of Auditors, for the sake of operational convenience, it is suggested they may be changed once every 5 years instead of every 3 years.

(v) In order to avoid concentration, group companies may have different Statutory / Internal Auditors in case group turnover exceeds ₹100 crores.

Annexure I

Format for Stock Audit Report

Index

S.No.	Particulars	Page no.
A.	Particulars of Limit	
B.	Operations in the Account	
C.	Submission of Statements	
D.	Insurance	
E.	Unit Visit	
F.	Verification of Stock	
G.	Verification of Book Debts	
H.	General	
I.	Stock Auditor's Certificate	
J.	Conclusion	

Particulars of Limits

1. With our Bank:
   - Sanctioning Authority
   - Date of Sanction
   - Reason for Overdue position, and
   - Position & Non Renewal (if any)
2. Nature of Limit

	Amount (₹ in lacs)	DPN Date	Balance O/s. as	Overdue	ROI
FUND BASED					
TOTAL EXPOSURE					
NON-FUND BASED					
TOTAL EXPOSURE					

3. Value of Collateral Securities:

   Agriculture Properties

   Non Agriculture Properties

   Others

   TOTAL VALUE

Date of Last Valuation (by the Panel Valuer / Manager)

4. Any transactions indicating diversions of funds noticed. (Random check 5% to 10% of the total debit)

5. Average daily balance (debit as well as credit) credit / debit summations in relative to utilization of the limit and the sales projections.

6. Whether the interest has been serviced within 7 days.

7. In case of Overdue Packing Credits:

   Furnish the Amount and Last date of shipment.

8. Whether PC is adjusted by application of local rupee funds.

9. Whether bills are being realized as per tenor / terms.

10. Details of overdue bills both inland / foreign.

11. Details of bills returned.

12. Comprehensive ECGC coverage obtained as per terms of sanction or not.

13. Is there any devolvement of LC.

14. if yes, number of LCs devolvement and amount.
15. Whether any guarantee invoked. (if yes, number and amount).
16. No of guarantees expired but still outstanding with amount.
17. In case of term loan, whether repayment of installment is regular.
18. Whether purchase commitment is met by issue of cheque/ DD on Cash Credit account.

Operations in the Account

1. Operation/ Performance of the account of the branch.

   (See the operation for full year)
2. Whether the account is being regularly/ actively operated.
3. Whether sales are being routed through the account.

   Random check of 10 credits with sales realization including bill.
4. Number of times the account remained overdrawn.

   Ascertain reasons for such overdrawals.
5. Whether cash withdrawals are regularly allowed.

   Reasons for allowing withdrawals.

   In your opinion such cash withdrawals are warranted or not.

6. (a) Whether returned and discounted cheques have been adjusted on the date of return itself or subsequently with how much delay, (if so, mention the number and value)

   (b) Whether, is there any instance of cheque return issued by the borrower or keeping cheque under the CCO, (If so, mention the number and value)

   (c) Whether any cheque submitted by the party for collection is returned. (if so, mention the number and value)

Submission of Statements

1. (a) Whether stock statements are being submitted regularly.

   Movement of Stock is found. Date of Last Stock Statement.

   (b) Present market rate.

   (c) Whether value is correctly given in the cost of price or the market price whichever is lower?

   (d) Quality and Marketability of good.

2. (a) Whether Book Debts statements are being submitted regularly.

   Date of Last Book Debts statement.

   (b) Whether Book Debts statements show age-wise list of debtors.

   (c) Particulars of Long Outstanding debts included in the statement of the Book Debt.

   (d) Whether Auditor certificate is obtained once in 3 months.

   (e) Comments / Remarks, if any, made by the Auditor.

3. Whether DP is being calculated. Check DP Register

   (if not, maintained give remarks)

4. Statements of QTS, MSOD, etc,

5. Whether QIS/ MSOD /other relevant statement. Details should be given for QIS-I, QIS-II, QIS-IU (for the last one year).

6. Whether operating limits are fixed as per QIS-I.

7. Whether penal interest @ 1% p.a. charged for delay / non submission of QIS statement.

8. Whether the information submitted in QIS is as per the books of account of the party.

Insurance

S.No.	Description	Value	Amount insured (₹ In lacs)	Date	Whether Adequate (Yes/ No)	Expiry
1.	Stocks					
2.	Machineries					
3.	Vehicles					
4.	Building					
5.	Whether the goods are fully insured for all the industry specific risks					
6.	Extent of insurance cover available					
7.	Whether the policies are in force					
8.	Whether "Bankers Clause" included in the policy					
9.	Location of goods property stated in the policy with Door No. / Survey No. Municipal No. etc.,					
10.	Goods sent to the processing uruts / sub-contractors / whether insured / transit insurance obtained					
11.	Whether any location / godown is not covered in the insurance.					
12.	Whether any risk is excluded (if so, specify the reasons)					

(a) Drawing Power (stocks)

(₹ in lacs)

	Cash Credit	Packing Credit	Key Loan
i) Value of the stock at the time of verification			
Less			
ii) Stock procured under			

	FLCALC / BG + other credit purchases
Add	
iii)	Stock in transit-Inward
	(to be covered under the Trust Loan)
Add	
iv)	Stock in transit-Outward but not yet Invoiced (mostly in the export business)
v)	Value of paid Stock
Less	Margin %
Drawing Power Outstanding as on the date of verification:	
i.	With our Bank
ii.	With other Bank
Total Borrowings Stock Deficit / Surplus	

b) Drawing Power for Cash Credit (Book Debts):

(₹ in lacs)

		Cash Credit	Packing Credit	Key Loan
(i)	Total Receivables within tenor period			
Less				
(ii)	Receivables emanated by sales of goods got under BG / ILC/PLC			
Net Receivables				
Less				
(iii)	Margin			

(iv) Drawing power /limit whichever is lower

Outstanding in Cash Credit (Book Debts):

i. With our Bank (₹ in lacs)

ii. With other Bank

Total Whether Deficit / Surplus

Unit Visit

1. Address of all godowns.
2. Storage place owned/ rented.
   if it is owned whether upto date tax paid.
   if it is rented whether no lien letter from owner is obtained
3. Whether storage places have direct access.
4. System of stock records.
5. Safety of stocks.
6. Condition of stocks
7. Movement of stock (comments on method of inventory control - FIFO/ LIFO).
8. Name of the person contacted at unit with designations.
9 Name of the official who had verified the stock periodically and the godown register is being maintained update.
   Date of the last verification and by whom and the remarks, if any, observed by the official.

   Is there any remark which persists for a few occasions and the borrower had not set it right.

Whether bank's name board has been prominently displayed.

Whether letter of free access is obtained.

S.No		Last Year	This Year
A	Production Capacity of the Unit		
	1. Licensed capacity		
	2. Installed capacity		
	3. Actual capacity		
B.	Method of valuation of Stock		
	1. Raw material		
	2. Stocks in process		
	3. Finished Goods		
	If not in order, give details		

Physical Inventory (Stocks)

S.No	Particulars	Value of stocks as shown in Stock statements as on (₹ in lacs)
Value of Stocks as shown in Stock Statements as on ……………		
1.	Raw material	
2.	Stock in-process	
3.	Stores & spares	
4.	Stores & spares	
	Total Value	

Total

Add Purchases (from the date of stocks statement till the date of inspection)

Less: Material consumed / reduction on account of sales {from the dale of stocks till the date of inspection)

Total Add Stocks given on job work

Total Less Stocks received on job work

Less Stocks belonging to sister concerns for which no payment has been made

Stock Auditor's Certificate

1. We have inspected (physically) the stocks of goods as per the enclosed Stock statements from the borrowers in the case of OD/CC as per particulars furnished in case of Key Loan, etc., as on …………and found them correct.
2. The balance of Stock shown in the borrowers Stock shown in the borrowers Stock statements are enclosed and agree with that shown in the Bank's Godown Inspection Register or {In the case of Hypothecation advances) Drawing Power Register.
3. The stocks are in good and marketable condition and do not show any signs of deterioration in quality and that the storages is in a satisfactory condition.
4. The stocks are not outstanding beyond the stipulated period of months as per terms of sanction (Details of old stocks, if any value thereof are enclosed).
5. The godowns belong to borrowers / third parties in which case latest rent receipt / no lien letter from processors are verified.
6. The stocks are valued at manufacturing cost or ruling market value or invoice value whichever is lower.
7. The stocks under hypothecation have not been hypothecated to other banks.
8. The advances of the bank are fully safe / secured / liquid.
9. We further certify that we have covered all the points indicated in terms of reference in the Assignment letter.

Signature of Auditor

Date: __________

Stock Audit Report

We have conducted the Stock Audit allotted by your Head Office and we furnish hereunder the above report:

Introduction

Name of the Branch

Name of the Region

Date of Commencement

Date of Completion

Date of Stock Verification

Status of Account as on date of visit

Date of Report

1. Name of the Borrower
2. Constitution
3. Address
   a. Registered Office
   b. Administrative Office
   c. Factory
   d. Godown
4. Name of the Partners/Directors and their net worth (Nature of relationship among partners/ directors)
5. Name of the Guarantors and their net worth (Nature of relationship with partners / directors)
6. Enjoying credit facilities Since
7. Name of the Branch Officials contacted / discussed
8. Nature of activity (Trading / Manufacturing / Exporting, etc.)
9. Description of Stock declared (commodity dealt with)

10. Nature of Banking arrangement (sole/multiple/consortium)

11. Banking with us Since

12. If advance if an Consortium basis or Sanctioned by more than one bank

    The position of each bank share is to be given

    a. Fund Based

    b Non Fund Based

13. Terms & Conditions

    Ascertain whether all terms & conditions of sanction are complied with (Yes / No)

    If no, the terms & conditions which are yet to be complied with

14. Steps proposed for rectification of shortcoming / irregularities

15. Comment on accounts - conduct with other consortium banks/ banks under multiple banking arrangements

16. With other Banks / Institution:

Name of the bank / institution	Nature of Limit	Amount (₹ In lacs)	Balance O/s. as on	Status of the Account

17. Comments on accounts with any other banks / any diversion of funds(if no, diversion specific observation, specific comment should be made)

Verification of Stock

1. Value of Stock:

As per latest statement	As on the date of verification	O/s. as on date of verification
on.	on.	on.
₹	₹	₹

2. Particulars of Stock as on date of verification (₹ in Lacs)

Description of goods	Quantity	Total Value	Stored at	Amount Insured	Due on

3 Stock Coverage - Drawing Power:

(For non-fund based facilities) (₹ in lacs)

Limit availed under with	Our Bank	Other Bank	Bill Liability
I. a) BG issued for suppliers credit			
b) ILC (DA) issued			
c) FLC (DA) issued			
TOTAL			

2. a) Details of goods procured under the above non-fund based limits and net value thereof (₹ in lacs)

Available as		Sale proceeds/ remitted kept in the account	Total	Goods procured under the above limits	Deficit/ Surplus
Stock	Receivable		(1+2+3)		

Verification of Book Debts

1. Collect age-wise an party wise break up of book debts and party wise receivables be checked with Invoices / sales register comments on any discrepancy observed.
2. Whether receivables are routed through the account?
3. Average time taken for realization of book debts to be compared with the past trend / industry trend / trade trend. Reasons for any deviation to be analysed and commented upon.
4. Overall observations as to the quality of book debts.
5. Verify excise records / sales tax returns / assessment orders of sales tax.
6. Composition of value of stocks and book debts as on the balance sheet date should be compared with value of stocks as on the date of inspection.
7. Whether level of Sundry Creditors is commensurate with pnst trends.
8. Whether arrangement of goods is properly done so as to verify the goods in easily.
9. Whether the borrower holds Stock received for processing (job work) and whether they are separately stored.

   If so, whether it is so declared and deducted from the total Stock.

10. Whether Stock turnover is satisfactory.
11. Whether maintenance of Stock and accounting records are satisfactory.
12. Whether random physical inspection now conducted represent a correct position of the entire Stock.
13. Whether purchased / sale invoices are verified. Whether valuation of purchase is correct? Whether over valuation of product is done.
14. Whether there are any purchases from allied / sister concerns.

    Whether all such transactions are genuine.
15. Whether there are cash purchases whether such cash purchases are proportionate.
16. Any other observation on
    - Verification of invoices
    - Physical verification of Stock
    - Stock held with processing / job work or outstation godowns
    - Old, obsolete, non moving Stock

General

1. a) The unrectified inspection/credit supervision / concurrent Audit comments made, if any, and latest progress report.

	b) Reason for non-rectification	
2.	Whether the borrower account is subject to credit rating	
3.	Statutory dues (workers & govt.)	
4.	Details of pending litigations and its Present Status	
5.	Problems faced by the company in general and the plans to overcome these problem vis-a-vis bank's assistance	
6.	Summary of Features	

Discussion with Branch Manager

It is hereby confirmed that we held discussions with Branch manager / Sub-Manager/ Assistant Manager on all the above observations before finalizing the report.

Signature of Auditor

Date:

Signature of Branch Manager

Conclusion

1. Any other matters in the Auditor's view.
2. Any features which contravenes the Bank's instructions which is likely to effect Bank's interest.
3. Any suggestions / comments to improve the system of cost audit by the borrowers.

Signature of Auditor

Date:

Annexure II

Checklist for Inventories and Receivables Audit

Bank: Branch: Zone:

Name of the account:

Address:

I) Office:

II) Factory & Go down:

Constitution:

Name of the Partners /directors:

Nature of business:

Latest Sanction : Authority: Date

Position of account:

Nature of Facility	Sanctioned Limit (₹)	Drawing Power (₹)	Outstanding as on (₹)	Overdue Excess, If any. (₹)
Term Loan Specify the assets a) Land & Building b) Plant & Machinery c) Others Cash Credit (Inventories & Book-Debts.)				

Remarks on the payment of interest and installments:

Inspected by:

Date of inspection:

Name and designation of Attendant:

A) Before going for Physical Verification:

<table>
<tr><th>S. No.</th><th>Particulars</th><th>Yes/ No/Not applicable</th></tr>
<tr><td>1</td><td>Have you sent an engagement letter?</td><td></td></tr>
<tr><td>2</td><td>Have you verified the borrower's file at the branch to ascertain the following details:</td><td></td></tr>
<tr><td></td><td>a) Name of the borrower</td><td></td></tr>
<tr><td></td><td>b) Location of
- Office
- Godown / Factory</td><td></td></tr>
<tr><td></td><td>c) Constitution (Sole proprietor, Partnership, Pvt. Ltd)</td><td></td></tr>
<tr><td></td><td>d) Nature of Business</td><td></td></tr>
<tr><td></td><td>e) Date of establishment and date of commercial production</td><td></td></tr>
<tr><td></td><td>f) Particulars of credit limits<table><tr><th>Loan A/c No</th><th>Facility</th><th>Sanction-ed Limits</th><th>D.P</th><th>Balance O/S</th><th>Overdue/excess</th></tr><tr><td></td><td></td><td></td><td></td><td></td><td></td></tr></table></td><td></td></tr>
<tr><td></td><td>g) Particulars of security:
A) Primary:
B) Secondary</td><td></td></tr>
<tr><td>3</td><td>What is the asset code: (Standard, Sub-standard, Doubtful or Loss Assets)?</td><td></td></tr>
<tr><td>4</td><td>Whether advance is sanctioned on Consortium Basis? If so, the position of each of the banks?<table><tr><th>Name of the Bank</th><th>Limit sanctioned</th><th>Value of security</th><th>Balance Outstanding as on ----------</th><th>Overdrawn amount</th></tr><tr><td></td><td></td><td></td><td></td><td></td></tr></table></td><td></td></tr>
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<table>
<tr><td>5</td><td>Insurance Particulars:
<table>
<tr><td>Policy No</td><td>Assets covered/ Location</td><td>Amount Insured</td><td>Date of expiry of Policy</td><td>Whether Bank clause exists in the policy</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td></tr>
</table>
</td><td></td></tr>
<tr><td>6</td><td>Whether additional risks like theft, earthquake, and machinery breakdown are included as per sanction terms and are complied with by the borrower?</td><td></td></tr>
<tr><td>7</td><td>Whether the address/ location of goods is properly stated and includes Door No./ Survey No. Municipal no etc?</td><td></td></tr>
<tr><td>8</td><td>Whether goods sent to the processing units, sub-contractors are insured/ transit insurance obtained?</td><td></td></tr>
<tr><td>9</td><td>Whether all locations/ all industry specific risks are covered?</td><td></td></tr>
<tr><td>10</td><td>Whether proper documents, including charging of primary and secondary securities have been obtained?</td><td></td></tr>
<tr><td>11</td><td>What is the date of documentation?</td><td></td></tr>
<tr><td>12</td><td>Whether documents are properly stamped?</td><td></td></tr>
<tr><td>13</td><td>Whether equitable/ registered mortgage of property created?</td><td></td></tr>
<tr><td>14</td><td>Whether search report has been got done up to the date of equitable/ registered mortgage?</td><td></td></tr>
<tr><td>15</td><td>Wherever required whether charge has been registered with ROC within prescribed time?</td><td></td></tr>
<tr><td>16</td><td>Have you verified the periodical stock statements submitted by the borrower with reference to any conditions stipulated in the sanction regarding:
a) Quantity of stocks,
b) Place of storage,
c) Value of stocks
d) Composition of stocks- Proportion of raw material, work – in- process and finished goods</td><td></td></tr>
<tr><td>17</td><td>Have you verified that the stock statements are?
a) signed by authorized persons only</td><td></td></tr>
</table>

	b) sent in bank's format c) sent within the stipulated time to the bank	
18	Have you verified the Godown stock register in case of pledged accounts to ascertain the nature and quantity of stock pledged in each godown, age and turnover in the stocks?	
19	Have you verified the operations in the account to ensure that the a) Operations and utilization of the funds and turnover are satisfactory b) Drawings are allowed within the drawing power and sanction stipulations are complied with c) Sale proceeds of hypothecated stocks are routed through the account only	
20	Have you verified the previous stock audit/ branch inspection reports to ascertain whether any steps have been taken to rectify irregularities pointed out?	
21	Have you obtained a representation letter from the borrower clearly indicating the places /branches where the goods are stored?	
22	Have you obtained the following documents to from the borrower? 1) A written representation from management concerning: (a) The completeness of information provided regarding the Inventories; and (b) Assurance with regard to adherence to laid down procedures for physical Inventories count. 2) Balance Sheet & Profit & Loss Account of the borrower for last 3 years 3) Inventories Statement & Book Debts Statement as on the last day of the quarter and for the year & preceding 3 months before the date of inspection 4) Copy of Memorandum of association, Articles of association along with form No. 32 & 18, partnerships deed, Trust deed & its byelaws as	

	may be applicable 5) Copy of Audited financial statements	
23	Have you inquired about the Associations of which borrower party is member?	
24	Have you done documentary checking of ownership or lease? Have you taken a copy of the same?	
25	Have you taken phone numbers of CA's – Statutory Auditor, Tax Auditor etc?	
26	Have you made a comparison of previous 2 to 3 years financial position of the borrower?	
27	Have you checked whether the account is a suit filed account?	

B) Physical Verification of Stocks

I. Verification of Hypothecated Stock

Sr No	Particulars	Yes/ No/ Not applicable
1	Is there any difference between the stocks as shown in the stock statement and the actual stock?	
2	Whether any reconciliation for the difference has been made?	
3	Whether the stocks represent those reflected in the stock statements sent to the Banks?	
4	Is the level of Inventories held found to be too high?	
5	Is the material control system employed by the borrower proper?	
6	Whether the borrower has maintained up to date records?	
7	Whether the borrower is having adequate internal control system commensurate with the size of the concern?	
8	Whether borrower is following consistent and accepted accounting principles for valuation of stocks?	
9	Whether the quality and sale ability of the stocks are good?	
10	Whether the following records of the borrower have	

	been checked? a) Excise records b) Raw materials consumption, Production register, Purchase and sales records c) Purchase and sales invoice d) Cost records and order books e) Sales, Purchase, Sundry creditors and Debtors ledgers	
12	Has the stock been stored properly?	
13	Is there a direct access to the godown?	
14	What is the value of a) Obsolete stock b) Slow- moving stock c) Damaged/ Rejected stocks d) Unpaid stock	
15	Whether Sundry creditors have been deducted as per policy of bank and as per sanction terms?	
16	Whether stipulated margin as per sanction terms has been deducted?	
17	Whether stocks received under usance L/C, co-acceptances and guarantees for purchase of raw materials have been reduced?	
18	Whether the Bank Hypothecation Board has been displayed?	
19	Whether stocks belonging to sister concerns, received for job- work etc are properly segregated?	
20	Whether the movement of stock in and out of the godown is properly accounted and monitored?	
21	What is the Work in progress and level of completion?	
22	Whether the goods which require any specialized preservation, are properly preserved?	
23	Whether rent/ property tax/ municipal tax receipts pertaining to godowns have been verified?	
24	Whether , in case of stocks which have expiry dates(such as drugs, food items) the same have been excluded for calculation of drawing power.	
25	Whether, stocks have been examined at	

	laboratories(in case of chemicals, dyes etc).	
26	Whether goods-in transit are included in the stock statements? Is the inclusion of such goods as per sanction terms? Whether the relative bills/ challans/ invoices have been verified?	
27	Whether goods sent to third parties for job work, finishing or machining, etc. have been inspected?	
28	Whether any written confirmation is on record for stock with third parties?	
29	Whether the sanction terms permit storage of goods with clearing agents?	
30	If so, whether the agents are in the approved list of the bank and within the limits fixed by the bank?	
31	Whether clearing agents charges and other dues have been paid?	
32	Whether any irregularities pointed out in the last Concurrent audit/ Inspection report have been rectified?	
33	Whether a written declaration has been obtained from the borrower that the stocks will not be hypothecated to other banks without the prior consent of the bank?	
34	Whether, in case of consortium advances, information is exchanged between the banks?	
35	Whether the hypothecated Plant & Machinery is maintained properly and found in working condition?	
36	Were there any instances of breakdown causing interruptions in the working of the unit in the recent past?	
37	Whether fire protection measures are satisfactory?	
38	Whether security arrangements at the godown/ Factory are satisfactory?	
39	Have you checked up the Sales Tax Provision?	
40	Have you checked Income Assessment Orders?	
41	Have you checked the provisions relating to ESIS Challans?	

42	Have you checked provisions relating to PF – Challans, assessment order?	
43	Has the factory license been renewed?	
44	Have you received the details of no. of skilled and unskilled employees, office staff? Have you checked up the Salary register?	
45	Have you considered the inherent control and detection risks, and materiality related to Inventories?	
46	Whether adequate procedures are established and proper instructions issued for physical Inventories counting?	
47	Whether persons involved in stock taking differ from those responsible for store-keeping?	
48	Whether store procedures provide for the use of pre-numbered forms	
49	Whether a system of cross-checking exists for checking data generated by different departments?	
50	Whether controls exist for receipts and issues of stores?	

II) Hypothecation of Book-Debts

Sr. No.	Particulars	Yes / No/ Not applicable
1.	Are standard price lists maintained?	
2.	Are prices that are not based on a standard price list, required to be approved by a senior executive outside the sales department?	
3.	Are written orders received from customers?	
4.	If oral/ telephonic orders are received from customers, whether the same are recorded immediately in the standard forms?	
5.	Is there a numerical control over all customers' orders?	
6.	Are credit limits fixed in respect of individual customers? Does an official independent of the sales department approve these limits?	
7.	Are credit limits reviewed periodically?	
8.	Are customers' credit limits checked before orders	

	are accepted? Is this done by a person independent of the sales department?	
9.	If sales to employees are made at concessional prices: a) Is there a limit to the value of such sales? b) Are the amounts recovered in accordance with the terms of sale? c) Is there an adequate procedure to see that the limits are not exceeded?	
10.	Are dispatches of goods authorized only by Dispatch Notes/Gate Passes or similar documents?	
11.	Do such Dispatch Notes/Gate Passes or similar documents bear pre-printed numbers?	
12.	Are they under numerical control?	
13.	Are they prepared by a person independent of: a) The Sales Department? b) The processing of invoices?	
14.	Except when all documents are prepared in one operation, are the Dispatch Notes/Gate Passes matched with: a) Excise Duty Records? b) Sales invoices? c) Freight payable to carriers (where applicable).	
15.	Are unmatched Dispatch Notes/ Gate Passes reviewed periodically?	
16.	Are the goods actually dispatched checked independently with the Dispatch Notes/ Gate Passes and customer's orders?	
17.	Are acknowledgements obtained from the customers for the goods delivered?	
18.	Are the customer's orders marked for goods delivered?	
19.	Are shortages in goods delivered to the customers investigated?	
20.	Are credits to customers for shortages, breakage & losses in transit match the claim lodged against carriers/ insurers?	
21.	Are sales invoices pre-numbered?	

22.	Are invoices checked for: a) Prices? b) Calculations (including excise duty and sales tax)? c) Terms of payment?	
23.	Are 'no charge' invoices authorized by a person independent of the custody of goods or cash?	
24.	Are invoices mailed direct to the customers promptly?	
25.	Are credits to customers for remittance posted only from the entries in the cash book (or equivalent record)?	
26.	Does cashier notify immediately: a) Sales Department, b) Debtors Ledger Section and c) Credit Controller; i) Of all dishonored cheques or other negotiable instruments? ii) Of all documents sent through bank but not returned by the customers?	
27.	Is immediate follow-up action taken on such notification?	
28.	Are the bills of exchange, etc. periodically verified with the bills on hand?	
29.	Is a record of customers claims maintained: a) Are such claims properly dealt with in the accounts?	
30.	Does the Receiving Department record them on sales Return Note?	
31.	Does the Receiving Department count, weigh or measure the goods returned?	
32.	Are copies of Sales Returns Notes sent to: a) Customer? b) Sales Department? c) Debtors' Ledger Section?	
33.	Are the returned goods taken into stock immediately?	
34.	Is a Credit Note issued to the customer for the	

	goods returned?	
35.	Are all Credit Notes pre-numbered?	
36.	Are Credit Notes numerically controlled?	
37.	Are Credit Notes authorized by a person independent of: a) Custody of goods? b) Cash receipts? c) Debtors' ledger?	
38.	Are Credit Notes: a) Compared with Sales Returns Notes or other substantiating evidence? b) Checked for prices? c) Checked for calculations?	
39.	Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers?	
40.	Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and stock on hand?	
41.	Is the Sales Ledger balanced periodically and tallied with the General Ledger Control account?	
42.	Are ageing schedules prepared periodically?	
43.	Does a responsible person review them?	
44.	Are statements of accounts regularly sent to all customers?	
45.	Are the statements checked with the Debtors' Ledger before they are issued?	
46.	Does a person independent of the ledger keeper mail the statements?	
47.	Are confirmations of balances obtained periodically?	
48.	Do a person independent of the ledger-keeper and the person preparing the statement verify the confirmations?	
49.	Is special approval required for: a) Payments of customers' credit balances? b) Writing of bad debts?	
50.	Is any accounting control kept for bad debts written off?	

51.	Is any follow-up action taken for recovering amounts written off?	
52.	In the case of export sales: a) Is a record maintained of import entitlements due? b) Does the record cover the utilization disposal of such entitlements? c) Is there a procedure to ensure that claims for incentives etc., receivable are made in time?	
53.	Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?	
54.	Is age wise classification of debtors done? Has care been taken to exclude long outstanding debtors from drawing power calculation?	
55	Whether the debt represents sales and service transactions only?	
56	Whether all realizations from debtors are routed through the borrower's account?	
57	Whether care is taken to ensure that receivables already advanced by way of bills purchased/ Bills discounted have been excluded?	
58	Whether reasons for non-realisation of overdue debts have been examined?	
59	Whether Power of Attorney in favour of the bank, wherever prescribed has been duly registered?	
60	Whether the statement of book debts submitted to the bank is as per Bank's format?	
61	Whether the drawing power is revised from time to time on the basis of the statements and the required margin is maintained in the account?	

III) Pledged Inventories

Sr. No.	Particulars	Yes / No/ Not applicable
1	Have you verified that a board is prominently displayed at the entrance and within the godown, clearly stating that the goods are hypothecated or pledged with the respective bank or financial institution?	

2	Have you examined the lock to ensure that Bank's / financial institution's name is engraved there on?	
3	Have you examined the layout of the godown where inventories are stored?	
4	If the godown is rented, have you inspected the rent receipt and ensured that it is in the name of the borrower? Have you ensured that the rent is not in arrears?	
5	If the godown is in ownership, have you verified the ownership agreement and ensured that it is in the name of the borrower?	
6	Have you ensured that there is no other gate or entrance to the godown and if it is there, it is properly locked from inside?	
7	Have you ensured that the godown is located at the address given to the bank and as mentioned in the insurance policy and other documents?	
8	Have you ensured that the ventilators are covered by grills?	
9	Have you ensured that no hazardous material is stored nearby the godown. (If so, it should be specifically mentioned in the insurance policy)	
10	Have you verified that no other inventories other than those pledged to the bank are stored in the godown without the specific prior authority and if they are stored, then adequate insurance cover is taken?	
11	Have you verified that the godown is in a good condition without and leakage or Seepage of water and dampness?	
12	Have you verified that the bin cards are signed by the godown keeper and by all inspecting officers?	
13	Have you verified that there is proper stacking of goods?	
14	Have you ensured that the deteriorated goods are not stored in the godown?	
15	Have you verified that the goods are not re-pledged?	

16	Have you verified that manufactured goods are stored in their original packing?	
17	Have you ensured that goods are delivered only in the presence of the Bank's representative?	
18	Have you ensured that the turnover of the stocks is satisfactory and that there is no old stock?	

Annexure III

Specimen Engagement Letter

The following letter is for use as a guide in conjunction with the considerations outlined in SA 210 [Earlier AAS 26] and will vary according to individual requirements and circumstances relevant to the engagement.

To the Board of Directors (or the appropriate representative of senior management)

You have requested that we audit the Inventories and receivables of (Name of the Company) as --------------, 2012. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective verification of the assets so as to indicate their physical existence, valuation and safety aspects.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Chartered Accountants

…………………………

(Signature)

Annexure IV

Specimen Management Representation Letter

[Client's Letterhead]

[Date]

To,

[Name]

Chartered Accountants

We are providing this letter in connection with the Inventories Audit for the period ___________________ for the purpose of expressing an opinion as to whether the stock records have been properly maintained or not and whether they are in conformity with the generally accepted accounting principles.

We confirm to the best of our knowledge and belief as under:

1) The financial statements referred to are in conformity with generally accepted accounting principles. (We have complied with all accounting standards issued by Institute of Chartered Accountants of India).

2) There have been no communications from regulatory agencies regarding non-compliance or differences, if any, in financial reporting practices.

3) There are no material transactions which have not been properly recorded in the accounting records underlying the financial statements.

4) There has been no:

   a) Fraud involving management or employees who have significant say in internal control.

   b) Fraud involving other than that would have a material effect on the financial statements.

5) The company has no plans or intentions that may materially affect the carrying value of assets and liabilities.

6) The following have been properly recorded or disclosed in the financial statements:

a) Related party transactions including sales, purchases, loans, transfers, and guarantees and amounts receivable from or payable to related parties.

b) Guarantees whether written or oral under which the company is contingently liable.

7) The company has satisfactory title to all owned assets and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

8) We further state as under:

Accounting Policies:

Method of Accounting:

The Financial statements are prepared on accrual method of accounting.

Inventories:

Raw material is valued at cost on FIFO.

Finished Goods is valued at lower of cost or net realizable value. Excise duties on goods manufactured by the company and remaining in Inventories are included as a part of values on of finished goods.

9) The Insurance for building and furniture is ₹ -------, Plant & Machinery ₹ -------- Stock in process ₹ ------ & for other items Rs -------, which will be expiring on --------.

10) a) The Installed capacity of the company is ---- millions pieces.

b) Actual production for the year ended 31.03.2011 on –-------- was -----pieces.

11) a) The total quantity produced during the month -----to ------- was ------ pieces.

b) Total quantity cleared during the month ---------- to ------- was ---------- pieces and the value for the same was ₹ ----- ----

c) Actual production for the year ended 31.03.2008 was ------ pieces.

The performance of the company for last 3 years was as follows:

Particulars	For the year ended 31.03.2010	For the year ended 31.03.2011	For the year ended 31.03.2012
a) Sales (including excise duty but exclude Sales tax)			
b) Purchases			
c) Net Profit			
d) Opening Stock			
e) Closing Stock			

13. Insurance Policy:

    a) Period of Insurance policy.

    b) Risks Covered.

    c) Place of Insurance

    d) Conditions of claim

    e) Name of insured

    f) Period of Validity of Policy & Time

14. Godown:

    a) Address along with Tele/Fax/E-mail.

    b) Ownership/Rented

    (If leased/ rented obtain lease/ rent agreement)

    c) Period of Rent/ Lease agreement

    d) Monthly Rent/ Lease

    e) Name & Address of Owner (when it is rented / leased)

15. Office:

    a) Address along with Tele/Fax/E-mail

    b) Ownership/Rented

    (Obtain copy of Rent/ Leased agreement if taken on Lease/ Rent)

c) Period of Rent/ Lease agreement

d) Monthly Rent/ Lease

e) Name & Address of Owner (when it is rented / leased)

Tele/Fax/E-mail

16. Factory:

a) Address along with Tele/Fax/E-mail

b) Ownership/Rented

(Obtain copy of Rent/ Leased agreement if taken on Lease/ Rent)

c) Period of Rent/ Lease agreement

d) Monthly Rent/ Lease

e) Name & Address of Owner (when it is rented / leased)

Tele/Fax/E-mail

17. The total value of book debts less than 90 days as on -------- was ---------- and receipted challans was ---------

18. The total value of the following items is as under:

I Raw Material

i. Average Stock as per project report for the year ended 31.03.2012

ii. Average stock of last 12 months.

iii. Value of stock on date of physical Verification.

iv. Comparison of last 12 months stock as per records and as per statement

(reason for discrepancies)

II Work in Progress

i.
ii.
iii.

III Finished Goods

i.
ii.
iii.

19. Ratios:

	For the year ended 31.03.2012	For the year ended 31.03.2011	For the year ended 31.03.2010
a) Current Ratio.			
b) Liquid Ratio.			
c) Gross Profit Ratio.			
d) Stock Turnover Ratio.			
e) Debtors Turnover Ratio.			

For [Borrower's Name]

(__________)

Director/ Partner/ Proprietor

Annexure V

Specimen Letter of Confirmation from Third Party

[Client's Letterhead]

To [Date]

[Name & Address of Customer]

Dear Sir,

Our auditors [name and address] are conducting an audit of our financial statements. Please examine the accompanying statement and either confirms its correctness or report any differences to our auditors.

Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

For XYZ Ltd.

(____________)

Director

Confirmation: The balance receivable from us of [amount] as on [date] is correct except as noted below:

Annexure VI

Specimen Letter of Confirmation of Inventories Held by Others

(Letterhead of entity)

Date: _______

(Name and address of holder of inventories)

Dear Sir /Madam,

For audit purposes, kindly furnish directly to our auditors (Name & Address of the auditors) details concerning our inventories held by you for (state the reasons/ purpose of holding of inventories by the third party) as on ___(date).

According to our records, you held the following inventories as on ___ (date).

Description	Quantity
---------------	-----------
---------------	-----------
---------------	-----------
---------------	-----------

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully

(Signature of responsible official of entity)

Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks.

Annexure VII

Specimen Letter of Confirmation of Inventories Held by the Entity on Behalf of Others

(Letterhead of entity)

Date: ______

(Name and Address of owner of inventories)

Dear Sir / Madam,

For audit purposes, kindly furnish directly to our auditors (name and address of auditors) details concerning your inventories held by us for (state here the purpose of holding of inventories by the entity) as on __(date).

According to our records, we held the following inventories as of that date.

Description	Quantity
---------------	-----------
---------------	-----------
---------------	-----------
---------------	-----------

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully

(Signature of responsible official of entity)

Annexure VIII

Specimen Inventories/ Receivables Audit Report

1) Bank: Branch: Zone:
2) Name of the account:
   Address:
3) Office:
   Ownership / Rented:
4) Factory & Go down:
   Ownership / Rented:
   Date of establishment:
5) Constitution:
6) Name of the Partners /directors:
7) Nature of business:
8) Inspected by:
9) Date of inspection:
10) Name and designation of Attendant:
11) Position of account:

Nature of Facility	Sanctioned Limit (₹)	Drawing Power (₹)	Outstanding as on (₹)	Overdue Excess, If any. (₹)
Term Loan Specify the assets a) Land & Building b) Plant & Machinery c) Others Cash Credit (Inventories & Book-Debts.)				

Remarks on the payment of interest and installments:

12) Latest Sanction: Authority: Date:

13) Particulars of the godown and factory premises:

(a) Address:

(b) Whether owned or rented:

(c) Total Area:

(d) Constructed Area:

(e) Condition of the godown:

(f) Whether rented in borrower's name:

(g) Whether rent is paid regularly.

14) Inventories (as on):

(Preferably on the last day of the previous month)

a)

Value of Inventories/ hypothecated Value of book – debts/ hypothecated (Less Than 90 days.)	
Total Less : Creditors	
Working Capital Gap Less :Margin 25%	
Drawing Power Outstanding (As on) Excess over drawing power, if any	

b) Age and quantity of Inventories for more than six months old / amounts of old Inventories:

c) Condition of inventories: (Whether properly stored / arranged.)

d) Whether the mode of valuation is satisfactory:

Whether trade discount, if any, allowed is deducted while arriving at the price of inventories as mentioned in the Inventories statement checked with purchase bills:

Comments on verification and reconciliation of Inventories (quantity and value) as per Inventories statement and as per actual record such as purchase register, etc.:

e) Value of entire book – debts:

- Less Than 90 Days :
- More Than 90 Days :
- Bad Debts (If Any) :

f) Whether book – debts of associate / sister concerns are included in statement:

g) Whether sales bills are accompanied by copy of lorry receipt/ receipt challans:

h) Whether bills discounted are included in book-debts statement:

i) Whether book debts are arising out of genuine trade transactions:

j) Whether accommodation bills are observed:

k) Whether party wise book – debt accounts / registers are maintained properly and kept up – to – date? :

l) Whether the outstanding book – debts are arisen out of normal business transaction, which Bank has financed:

m) Normal time limit taken for realisation of book – debts vis – a – vis past trend or the industry trend. Give comments in case of abnormal delay :

* Book – Debts outstanding for 60 days is ____________

* Outstation Customers are ________________

n) Are there any cases of diversion of funds for other than business needs? :

o) Whether production / sales achievements found in line with production. If not, offer comments

Year ended	Projected sales (₹)	Actual sales achieved (₹)
2010		
2011		
2012		

15) Insurance Cover:

16) Other conditions whether satisfied:

(a) Bank's name board whether displayed/ painted/ affixed/ engraved:

(b) Whether godown-keeper/ godown chowkidar is appointed?

(c) Whether the branch receives Inventories statements certified by borrower?

17) Books and records:

(a) Whether the following records have been verified and found in order:

- Sales register:
- Purchase register:
- Sales bill:
- Purchase bills:
- Inventories register:
- Debtors register:
- Cash book:

(b) Whether proper records are evidenced for goods in transit or sent to outsiders for processing or lying with sales depots branches is available:

(c) On physical verification whether the individual items of Inventories appearing in Inventories statement submitted to the bank found in agreement with the Inventories register or excise records? :

(d) Do Inventories registers tally with records provided to the bank?

(e) Turnover in the account during last twelve months:

(g) Sales during the last twelve months ending on :

(h) Sales tax paid up to:

(i) Sales tax assessment completed up to:

(j) Excise duty returns filed upto:

(k) Excise duty assessment completed upto:

(l) Advance income tax paid:

(m) Income tax assessment completed unto

(n) ESIS paid up to:

(o) Provident fund paid up to :

(p) Municipal taxes paid up to:

(q) Rent paid up to:

(r) Shop & establishment/factory license renewed up to:

- No of fire extinguishers:
- Date of expiry :
- No of sand buckets :

(xix) Watch and ward arrangement :

(xx) Service Tax returns filed up to:

(xxi) Service Tax assessment completed up to:

18) Movement of inventories:

a) Is turnover in Inventories satisfactory? :

b) Is turnover in account satisfactory? :

19) Particulars of machinery:

Name of machines (with full description on like, make other details, etc.)	Whether purchased new or second hand?	Date of Invoice	Purchased Value	Latest Value Basis of Valuation	Written down Value as per B/S as on (₹)

20) No of employees:

Skilled :

Unskilled :

Office staff :

21) Information about shifts:

No of shifts :

Working hours:

22) Comments on working and capacity utilization:

23) Are the machines working in full capacity?

Whether the plant and machine is maintained properly and found in working condition?

24) Value of fixed assets:

(As per latest balance sheet as on)

25) Value of current assets:

(As per latest balance sheet as on)

26) Was there any instance of breakdown of plant and machinery causing hindrance in progress of the unit during last six months?

27) Other remarks/ observations

28) Computation of Ratios.

I-13

TECHNICAL GUIDE ON INTERNAL AUDIT OF MINING AND EXTRACTIVE INDUSTRY

Foreword

The mining industry is a key segment of the Indian economy, with India being highly endowed with vast mineral resources. The country's accelerated growth rate warrants a rapid development of the mining industry, on which most of the basic industries in the manufacturing sector depend. Extraction and development of minerals are closely interlinked with other natural resources like land, water, air and forest. Hence, the management of this precious resource and its optimal and economical use are matters of national importance.

Globalization, competition of new mineral properties, and environmental regulations and concerns are some of the issues that introduce new layers of complexity for companies operating in mining industry. I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board, CA. Rajendra Kumar P., Vice Chairman, Internal Audit Standards Board and other members of the Board for bringing out this “Technical Guide on Internal Audit of Mining and Extractive Industry” as mining sector is one of the largest and capital intensive sector in the country. This comprehensive publication would surely help the members to understand entire spectrum of operational, conceptual and practical issues related to internal audit in mining sector.

I am sure that this Technical Guide would be an informative and useful publication for the members.

March 24, 2012	CA Jaydeep Narendra Shah
New Delhi	President, ICAI

Preface

Minerals constitute the backbone of economic growth of India. It provides the foundation for industries by providing raw material and energy for manufacturing and other activities. Accordingly, with progressive industrialisation, the demand of mineral is ever-growing. In the face of growing demand, operating an efficient and streamlined business, as well squeezing costs is most significant challenge for mining industry. The enterprise should adapt its ideal vision by analyzing its current business processes and core functions, such as production, maintenance and logistics. A strong, skilful and independent internal audit function is fundamental to achieve these objectives. Internal audit adds value to overall organizational performance by improving operational efficiencies and strengthening internal controls.

Keeping this in mind, the Internal Audit Standards Board is issuing the Technical Guide on Internal Audit of Mining and Extractive Industry, as a part of industry specific series of Technical Guides issued by the Board. 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 internal audit aspects relating to the same. The Technical Guide has been divided into various chapters. These chapters provide an overview of the mining industry. It deals with technical and operating aspects of the mining and extractive industry. It gives a brief overview on various aspects like industry structure, challenges faced by the industry, evaluation and assessment, mine planning, mine development, mineral processing, process monitoring. The Guide also covers the policies and regulation related to mining industry. It contains detailed checklist on internal audit that would help the readers in understanding the various technicalities arising during the internal audit of mining industry. List of applicable laws and statues and flow charts regarding various processes undertaken by the industry are also given in this Guide for providing valuable guidance to the readers. The Guide also contains list of abbreviations used in the mining industry for providing valuable guidance to the readers. In addition to this Guide, the Board has already issued “Technical Guide on Internal Audit in Oil & Gas Refining & Marketing (Downstream) Enterprises” and “Technical Guide on Internal Audit in Upstream Oil and Gas Companies” to help the members in understanding the basic concepts and peculiarities of the industry concerned.

At this juncture, I am grateful to CA. Vishal Ruia and his study group members, *viz.*, CA. Arup Sen, CA. Dharmendra Lodha, Shri Dilip Kumar Jena, CA. Puja Agarwal and CA. Anirban Dasgupta for sharing their experiences and knowledge with us and preparing the draft of the Guide.

I also wish to thank CA. Jaydeep N. Shah, President, ICAI and CA. Subodh Kumar Agrawal, Vice President, ICAI for their continuous support and encouragement to the initiatives of the Board. I must also thank our colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Rajendra Kumar P., CA. Amarjit Chopra, CA. Shiwaji B. Zaware, CA. Ravi Holani, CA. Anuj Goyal, CA. Nilesh S. Vikamsey, CA. Atul C. Bheda, CA. Charanjot Singh Nanda, CA. Pankaj Tyagee, CA. G. Ramaswamy, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. S. Santhanakrishnan, Shri Prithvi Haldea, Smt. Usha Sankar, Smt. Usha Narayanan, Shri Manoj Kumar and Shri Sidharth Kumar Birla for their vision and support. I also wish to express my thanks to CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers, CA. Gurpreet Singh, Assistant Secretary and CA. Arti Bansal, Sr. Executive Officer in giving final shape to the Technical Guide.

I am sure that this publication would prove to be a useful reference in making the process of internal audit in the mining sector comparable with the best in the world.

March 22, 2012
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

Abbreviations

AFC	Armored Flexible Conveyor
BOOT	Build Own Operate & Transfer
BWE	Bucket Wheel Excavator
CARO	The Companies (Auditor's Report) Order, 2003
CMMI	Council of Mining and Metallurgical Institutes
CSO	Central Statistical Organisation
DMS	Dense Medium Separation
DOA	Delegation of Authority
DRI	Directly Reduced Iron
ECOSOC	Economic and Social Council of United Nations
ECS	Electronic Clearing System
EFT	Electronic Fund Transfer
EHS	Environment, Health and Safety
ESI	Employee State Insurance
FEMA	Foreign Exchange Management Act
FY	Financial Year
GDP	Gross Domestic Product
GoI	Government of India
GRN	Goods Receipt Note
GW	Giga Watt
HMS	Heavy Medium Separation
HR	Human Resource
HSE	Health, Safety and Environment
IA	Internal Audit
IASB	Internal Audit Standards Board
JC	Job Card
LC	Letter of Credit
LHD	Load Haul and Dump

LoA	Letter of Allocation
LTIF	Loss Time Injury Frequency
MGR	Merry-go-round
MIS	Management Information System
MT	Million Tonnes
MTBF	Mean Time between Failures
MTTR	Mean Time to Repair
OEM	Original Equipment Manufacturer
OT	Over Time
PERT	Programme Evaluation and Review Technique
PF	Provident Fund
PO	Purchase Order
PPE	Personal Protective Equipments
PR	Purchase Requisition
RBI	Reserve Bank of India
ROI	Return on Investment
ROM	Run of Mine
SDL	Side Discharge Loader
SEBI	Securities and Exchange Board of India
SIA	Standards on Internal Audit
SOA	Schedule of Authority
SRN	Services Receipt Note
TDS	Tax Deducted at Source
UNECE	UN-Economic Commission for Europe
UNFC	United Nation Framework Classification
UOA	Utilisation of Available Hours
VCR	Vertical Crater Retreat

Contents

Chapter 1
Introduction

1.1 The concern for ensuring effective corporate governance has become more pronounced with increasing complexity, global inter-linkages and fierce competitiveness in the business world. The basic wisdom that effective corporate governance leads to enduring wealth creation is, unfortunately, overlooked by some organizations. However, good organizations and agencies always adhere to the fundamentals of corporate governance for ensuring sustainable success. The various systems of checks and balances, of which internal audit is a very important one, constitute the architecture of corporate governance.

1.2 India's mining infrastructure is among the largest in the world and the complexity and financial resources involved are enormous. Further, the mining sector in India is on an unprecedented growth trajectory. Mining sector being one of the most capital intensive sectors, the financial implications of the sector's business dynamics are huge. This 'Technical Guide on Internal Audit of Mining and Extractive Industry' Inducting deals with the entire spectrum of conceptual and practical issues concerning internal audit. This will prove to be a very useful reference in making the process of internal audit in the mining sector of India comparable with the best in the world.

Objective and Scope of Technical Guide

1.3 Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of the entity with a view suggest improvements thereto and add value to and strengthening the overall governance mechanism of the entity, including the entity's risk management and internal control system. Thus, through its appraisal of management processes, internal audit can be of great assistance on effective and efficient management of mining sector.

Today, the scope of internal audit has increased from mere verification of financial transactions to reviewing of proper, efficient and economical usage of resources by the entity. Therefore, it is imperative that an internal auditor familiarizes with various management aspects and technical aspects of the mining sector for performing internal audit in more efficient and effective manner.

1.4 The Technical Guide deals with operational areas of entities operating in mining sector. The scope of this Technical Guide is confined to discussing the role that the Internal Audit function can play in this regard. This Technical guide is intended to assist internal auditors in carrying out internal audit in entities operating in mining sector.

Chapter 2
Mining Sector - An Introduction

History of Mining

2.1 Mining of stone and metal has been done since pre-historic times. Since the beginning of civilization, people have used stone, ceramics and, later, metals found on or close to the Land. These were used by them to manufacture early tools and weapons, for example, high quality flint found in northern France and southern England was used to create flint tools. Flint mines have been found in chalk areas where seams of the stone were followed underground by shafts and galleries. The mines at Grimes Graves are especially famous, and like most other flint mines, are Neolithic in origin (ca 4000 BC-ca 3000 BC). Other hard rocks mined or collected for axes included the greenstone of the Langdale axe industry based in the English Lake District. Traditionally, mining focused on extracting minerals economically and with a degree of safety considered practical.

2.2 Ancient Egyptians mined malachite at Maadi. At first, Egyptians used the bright green malachite stones for ornamentations and pottery. Later, between 2613 and 2494 BC, large building projects required expeditions abroad to the area of Wadi Maghara in order "to secure minerals and other resources not available in Egypt itself." Quarries for turquoise and copper were also found at "Wadi Hamamat, Tura, Aswan and various other Nubian sites"on the Sinai Peninsula and at Timna.

2.3 Mining in Europe has a very long history, examples including the silver mines of Laurium, which helped support the Greek city state of Athens. However, it is the Romans who developed large scale mining methods, especially the use of large volumes of water brought to the minehead by numerous aqueducts. The water was used for a variety of purposes, including using it to remove overburden and rock debris, called hydraulic mining, as well as washing comminuted or crushed ores, and driving simple machinery.

Mining - International Scenario

2.4 The price boom in the past decade has also brought renewed attention to the sharing of energy and mineral related wealth between host counties and investors. A number of world class deposits are now either being developed or are in the detailed pre-feasibility explorations stage-minerals such as bauxite, iron ore and mineral sands in Africa, and copper and iron ore in Asia. Strong demand and high prices have prompted a rush by investors to obtain access to mineral resources, with BRIC-based companies joining both large multinational and smaller juniors in seeking new resources.

2.5 With the rush in activity, access to resources has shifted from a “buyers’ market” (with countries seeking to attract mineral exploration and investment) to a “sellers’ market,” especially in Africa and Asia, with companies competing strongly to obtain mineral rights. The exploration boom has resulted in prospective areas being contracted or licensed with a shift towards competitive bidding and away from open access for mineral license. However, some mineral-rich countries have found that their mineral tax revenues have not increased commensurate with the sharp rise in prices and the increased profits of private developers, and therefore have been seeking to improve their EI-related tax collection in recent years.

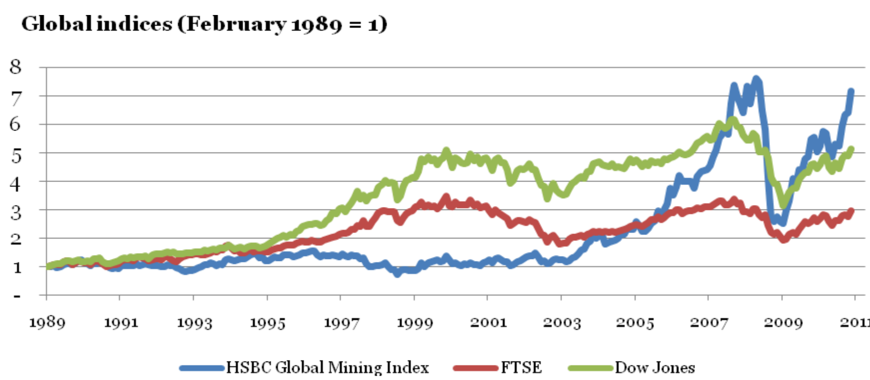
2.6 Against this background of increased competition of resources, higher profitability and in some cases government frustration over low tax revenues at a time when the sector is booming, there has been a change in government attitudes toward sharing the profits of their resource wealth. Mining contract reviews have taken place in several African Countries (DRC, Tanzania, Guinea, Zimbabwe, Sierra Leone, Madagascar, and Guinea) and regulation changes and adjustments to royalty and tax rates have been either proposed or adopted in many others (South Africa, Chile, Australia, Ghana, Quebec, India, Peru, Argentina and Nigeria).

2.7 In addition, governments seem to be increasingly conscious of social and environmental safeguards, and are more focused on deriving economic benefits, whether in the form of infrastructure development, local content requirements, or increasing employment opportunities and skills training for local communities. Private sector companies are being held to higher standards, whether with respect to their management of environmental and social concerns, or to the transparency of their interaction with host governments.

2.8 The World Bank forecasts that global metals demand will grow faster than global GDP through 2015, and energy demand is likely to rise by 55 percent until 2030. 80 percent of this increase will be in fast-growing developing countries like China and India. Accordingly to the US Energy Information Administrator(EIA) International Energy Outlook 2010, total global energy demand will increase by 53 percent by 2035, with the bulk of the increase occurring in non-OECD countries: total energy demand in non-OECD countries will grow by 85 percent by 2035, compared to 18 percent demand growth in OECD countries. The dominant drivers of energy demand, the industrial and (personal) transport sectors, are expected to grow significantly in emerging economies over the coming decades.

Global Mining Trends

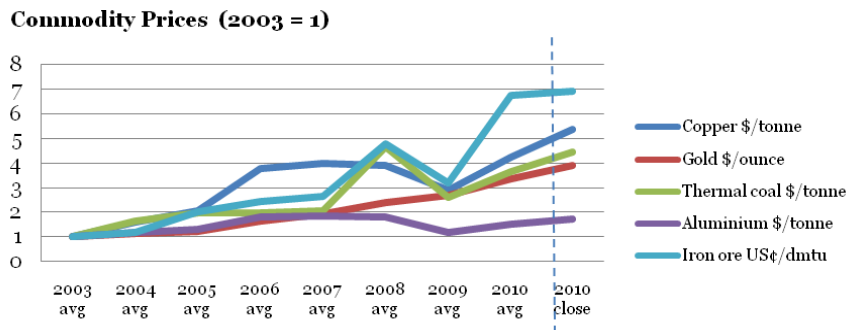
2.9 Globally, the mining industry continues to grow, led by the strong growth in emerging markets. In 2010, the total year end market capitalization of the top 40 mining companies (by market capitalization) increased by 26% to USD 1o billion, with larger gains generally achieved by the smaller companies. While the industry was hit hard by the global financial crisis, mining companies have led the return and gone beyond.



Source: Bloomberg

2.10 The analysis of top 40 mining companies shows that revenues crossed USD 400 billion mark for the first time in 2010 and the net profit rose to USD 110 billion. The highest revenue earning commodities were coal, copper, iron ore and gold. Emerging countries are leading the way as the demand for resources are driven by strong GDP growth. In 2010, the average Total Shareholder Return (TSR) of companies from emerging markets in the top 40 companies more than doubled the return from the traditional mining countries over the past four years.

The graph below depicts the trend of commodity prices over the past years:



Source: AME, PwC Analysis

2.11 The supply is becoming increasingly constrained, as development projects become more complex and are typically in more remote, unfamiliar territory. There is the challenge of declining extraction grades, more geographically remote and/ or politically challenging regions and the increasing scale of projects required to generate economic returns. Supplying sufficient resources to meet the growing demand is a key challenge for the industry. To keep up with rising demand, the top 40 mining companies announced more than USD 300 billion of capital programs with maximum capital expenses in iron ore, coal, copper and gold.

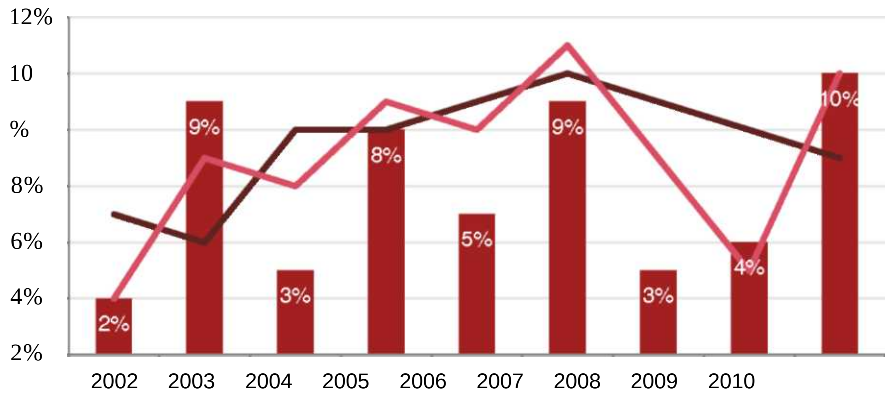
2.12 It has been observed that there has been a global shift in mining deals with the share of Asian acquirers on a rise. For example, in 2010 (upto Sept), 21% of all deals involved an Asian acquirer, up from 10% a decade earlier. Further, the 35% of all deal targets (2010 to Sep) were in Africa, Middle East and Asia, up from 14% a decade earlier.

Overview of Mining in India

Minerals and its Contribution to GDP

2.13 Mining in India has been known to have existed with a long history. The tradition of mining in the region is ancient and has undergone modernization alongside the rest of the world since India gained independence in 1947. The economic reforms of 1991 and the National Mining Policy of 1993 further helped in the growth of the mining sector. India produces 87 minerals, which include 4 fuel, 10 metallic, 47 non-metallic, 3 atomic and 23 minor minerals (including, building and other materials). The mining sector in the country comprises of large state owned mining companies (listed), large integrated private mining-metal companies, and small fragmented independent holdings.

2.14 The sector has grown at an average rate of around 6% over the last 8 years. For the year 2010-11, Central Statistical Organisation (CSO) estimated mining and quarrying sector to account for 2.26% of GDP (at 2004-05 prices) with the contribution of ₹ 110,482 crore. If we consider the estimates of GDP at current prices, in 2010-11 the mining and quarrying sector is estimated to account for about 2.51% of GDP with the contribution of ₹ 182,278 crore. This indicates an increase of 18.2% compared to 2009-10.



Source: Reserve Bank of India, Index of Industrial Production, Value of Mineral Production as published by Indian Bureau of Mines and Annual Reports of Ministry of Mines.

Availability of Resources

2.15 As discussed earlier, India is endowed with variety of minerals including metallic, non-metallic, fuel, atomic and minor minerals. The table below shows the reserves and resources availability of the selected metallic and non metallic minerals (as on April, 2010):

Mineral	Unit	Reserves[1]	Remaining[2] resources	Total resources
Bauxite	000' tonnes	592,938	2,886,682	3,479,620
Copper	Ore 000' tonnes	394,372	1,164,086	1,558,458
	Metal 000' tonnes	4,768	7,518	12,286

[1] Economically mineable part of measured and or indicated mineral resource; UNFC classification (111, 121 & 122)

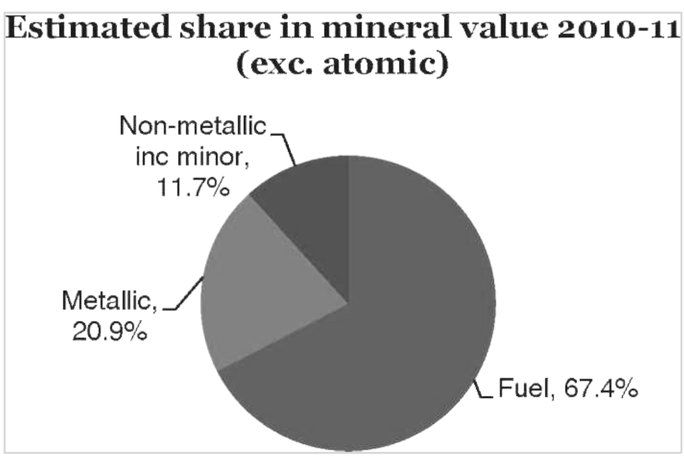
[2] Total mineral resources excluding Reserves

Iron	(Magnetite) 000' tonnes	21,755	10,622,305	10,644,060
	(Haematite) 000' tones	8,093,546	9,788,551	17,882,097
Lead and zinc ore	000' tonnes	108,980	576,615	685,595
Manganese ore	000' tonnes	141,977	288,003	429,980
Diamond	carats	1,045,318	30,876,432	31,921,750
Dolomite	000' tonnes	738,185	6,992,372	7,730,557
Mica	Kg.	190,741,448	341,495,531	532,236,979
Nickel	million tonnes		119	119
Silver	Ore tonnes	187,558,668	279,426,291	466,984,959
	Metal tonnes	8,039.47	19,588.68	27,628.25
Tin	Ore tonnes	7,131	83,719,066	83,726,197
	Metal tonnes	1,132	101,142	102,275

Source: Indian Bureau of Mines

Current Level of Production

2.16 Considering the overall trend, the index of mineral production (base 1993-94=100) for the year 2010-11 is estimated to be 208.83 as compared to 193.36 for 2009-10 indicating growth rate of 7.4%.



Source: Ministry of Mines, National Mineral Scenario

If we look at the world production data, in 2009-10, India ranked second in barytes, chromite and talc/ steatite/ pyrophillite, third in coal and lignite, fourth in iron ore and kyanite/ sillimanite, fifth in manganese ore, steel (crude) and zinc, sixth in bauxite, eighth in aluminium and tenth in magnesite.

The mineral production in the country is primarily dominated by the public sector. For e.g., in 2009-10, the public sector accounted for about three-fourth of the mineral production. It accounted for production 91% of coal, 86% of petroleum (crude), 77% of Natural gas (utilized), 58% of tin concentrate, 99% of Barytes, 84% of Kyanite, 74% of Sillemanite and 60% of Magnesite. Small mines, which were mostly in the private sector, continued to be operated manually either as proprietary or partnership ventures.

Sector-wise Usage Overview

Coal

2.17 The commercial coal in the country is mainly consumed by the power, steel and cement sector. Other industries have a marginal impact on the long term demand for coal as they are relatively small players and can resort to alternative fuels.

The power sector is the largest consumer of coal in India. It accounts for nearly 66% (72% including captive) of the total demand. Of the 185.5 GW (November 2011) of installed power generation capacity, coal-based capacity constitutes 55% while it contributes to more than 70% of the power generated.

The second major consumer of coal is the steel industry accounting for about 14% of the total consumption. India has limited reserves of coking coal with only 16% of proven coal reserves being coking, which is a key raw material for steel production. Further, about 70% of the Directly Reduced Iron (DRI) production is based on coal. For 2011-12, coal demand is estimated at 69 MT of coking coal and 29 MT of non-coking coal for the steel industry (Planning Commission). The per capita steel consumption is only 49kg which is about one-fourth of the world's average. This suggests that the demand has significant headroom to grow as India invests in infrastructure and as the penetration of consumer durables increases which in turn will drive demand for both coking as well as non-coking coal.

The cement industry accounts for about 4% of the coal consumption. For FY 2011-12 the assessed coal requirement for the sector is 33 MT. In the last few years, the consumption of coal to produce cement has reduced because of the dry process adopted to improve efficiency in cement kilns and increased use of fly ash and granulated slag in the production of cement. However, being queued after power and steel, the cement industry faces problems of inadequate coal supplies.

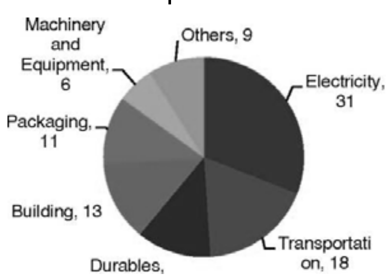
Iron Ore

2.18 Iron ore is consumed in various industries such as, iron & steel, sponge iron, ferro-alloys, alloy steel, coal washery and cement. In FY 2010, the country consumed about 91 million tonnes iron ore. The main consumers for the ore are iron & steel industry including, sponge iron. These account for about 98% of iron ore consumption.

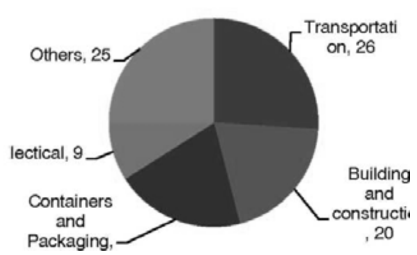
Aluminum

2.19 The electrical sector is the largest consumer of aluminum where bulk of the aluminum is used in overhead conductors and power cables used in generation, transmission and distribution of electricity. The Indian consumption pattern is in contrast with the global consumption pattern.

Consumption Pattern - India



Consumption Pattern - Global



Source: Mineral year book, 2010

Further, the per capita consumption of aluminum in India is very low (only 0.7 kg) compared to the world average (world average 12-15 kg).

Copper

2.20 The key demand drivers for copper are telecom, power and infrastructure sector. Electrical, Electronics and Telecommunications sectors account for nearly 52% of copper usage in India. Per capita consumption in India is about 0.50 Kg as compared to 10 Kg in developed nations. It has been observed that with increased application of fibre optic cables and fast penetration of wireless communication through cell phones, Wireless in Local Loop and DTH Telecasting there has been reduction in copper demand in telecom sector. The use of copper in building construction is gradually developing in the country, mainly in metro cities and industrial projects.

Lead and Zinc

2.21 The lead consumption in the country is mainly by battery industry. It consumes about 74% of lead followed by pigments and compounds 9%, rolled and extruded products 8%, alloys 3%, cable sheathing 2% and rest 4% is consumed by other industries.

Zinc is corrosion resistant due to which it is used for protecting steel by way of galvanising. The galvanising industry consumes about 57% of zinc, followed by coatings 16%, die-casting alloys 14%, oxides and chemicals 7% and extruded products 6%.

Type of Mines (Open Pit/ Underground)

2.22 The number of mines which reported mineral production (excluding minor minerals, petroleum (crude), natural gas and atomic minerals) in India was 2628 in 2010-11. Of these about 92% of mines are present in 11 states, i.e., Gujarat, Andhra Pradesh, Jharkhand, Madhya Pradesh, Rajasthan, Karnataka, Orissa, Tamil Nadu, Maharashtra, Chhattisgarh, and West Bengal. The table following shows the number of reporting mines in the last three years.

No. of reporting sector	2008-09	2009-10	2010-11
All Minerals*	3150	2999	2628
Coal (including Lignite)	574	574	574
Metallic Minerals	719	700	608
Non-Metallic Minerals	1857	1725	1446

*Excluding atomic minerals, petroleum (crude), natural gas (utilized) and minor minerals.

The number of reporting mines is decreasing due to closure or suspension of mining activities due to non-renewal of mineral concessions; non-renewal of environment and forestry licenses/ permits; uneconomic operations and scheduled closures.

2.23 Mines are broadly classified into two categories:

(i) Open Cast Mines (Surface Mines)

Open cast mining involves extraction of mineral/ coal by excavating whole of the material lying between the mineral/ coal body and the surface. The waste rocks so mined are termed as Over Burden (OB).

(ii) Underground Mines

In underground mining an opening (inclined or vertical) is made from the surface to reach the required depth and then tunnels (galleries) are developed horizontally to reach the mineral/ coal body. Presently, there are 359 underground mines in coal and 85 underground mines in other minerals (excluding fuel, atomic and minor minerals).

Methods of Mining

Open Cast Mines

2.24 Methods of mining in open cast mines are as follows:

(i) Shovel - Dumper Mining – The combination of shovel and dumper accounts for majority of the production from open cast mines in India. In this system, the shovel is used for loading the material on the dumper, which then hauls (transports) it to the assigned dumping point. This method enables fastest commencement of production. It is one of the most flexible mining method available.

(ii) Dragline Mining – Dragline is used only for the removal of the overburden. It is, generally, used in mines having high stripping ratio, so as to reduce the cost of overburden removal. This method enables overburden removal at a very high rate, although it involves huge capital investment for the procurement of a dragline. The procurement and installation of a dragline may itself take up to 3.5 years.

(iii) Bucket Wheel Excavator Mining – A Bucket Wheel Excavator (BWE) is used for continuous mining operations, generally in combination with conveyors. It is, generally, used when the mineral/ coal strata is relatively soft and amenable to direct extraction without the need of blasting. However, BWE can also be coupled with blasting operations as blasting loosens the material and increases productivity. In India, BWE is being used in lignite mining only. BWE is a continuous system of mining, wherein the excavated material is transported to the delivery point continuously and not in lots (as in case of shovel-dumper). A

BWE can cost about $100 million and its assembly at the site may take up to 5 years. This method of mining is not easily amenable to changes in the mine plan during the mine life.

(iv) Mining using Surface Miner – Surface miners eliminate the need for drilling and blasting and allows selective mining. The mineral/ coal can be cut and crushed in one machine pass with low manpower requirements. The excavated mineral/ coal is usually left behind in windrow fashion and can be loaded on demand. This technique of not loading simultaneously decouples the excavating and loading processes, and thus removes waiting time for trucks.

Underground Mines

2.25 Following are methods of mining in underground mines:

(i) Room and Pillar Mining – The room and pillar mining method is a type of open stoping used in near horizontal deposits in reasonably competent rock, where the roof is supported primarily by pillars. Ore is extracted from rectangular shaped rooms or entries in the ore body, leaving parts of the ore between the entries as pillars to support the hanging wall or roof. The pillars are arranged in a regular pattern, or grid, to simplify planning and operation. They can be any shape but are usually square or rectangular.

(ii) Shrinkage Stoping – Shrinkage stoping is a vertical, overhand mining method whereby most of the broken ore remains in the stope to form a working floor for the miners. The broken ore in the stope is to provide additional wall support until the stope is completed and ready for drawdown. Stopes are mined upward in horizontal slices. Normally, about 35% of the ore derived from the stope cuts (the swell) can be drawn off ("shrunk") as mining progresses. The method is labor intensive and cannot be readily mechanized.

(ii) Sublevel Stoping – Sublevel stoping, also known as blast hole or long hole stoping, is an open stoping, high-production, bulk mining method applicable to large, steeply dipping, regular ore bodies having competent ore and rock that requires little or no support. The method is often selected as an alternative to sublevel caving when dilution levels must be kept to a minimum. It is currently limited to steeply inclined ore bodies where both ore and country rock are competent and broken ore flows under the influence of gravity. Ore bodies should be regular, because the method is not selective.

(v) **Vertical Crater Retreat Method –** VCR (vertical crater retreat) mining is a horizontal, flat-back variation of sublevel stoping using spherical crater charges to break the ore. Blasting is carried out at the base of vertical holes, making horizontal cuts and advancing upward. Shrinkage can be utilized in the stopes for wall support. Because the method requires less development than sublevel stoping, it has the potential for lower costs and is finding increasing application not only for pillar recovery but also for primary stoping.

(vi) **Cut and Fill Stoping –** Cut and fill stoping is an underground mining method in which a single excavation pass (cut) is completed and backfilled before another cut is made. Cut and fill mining is primarily utilized for steeply dipping vein deposits and large, irregularly- shaped deposits. The major elements of the cut and fill mining cycle include drilling, blasting, mucking, ground support, cleanout, raising up, backfilling.

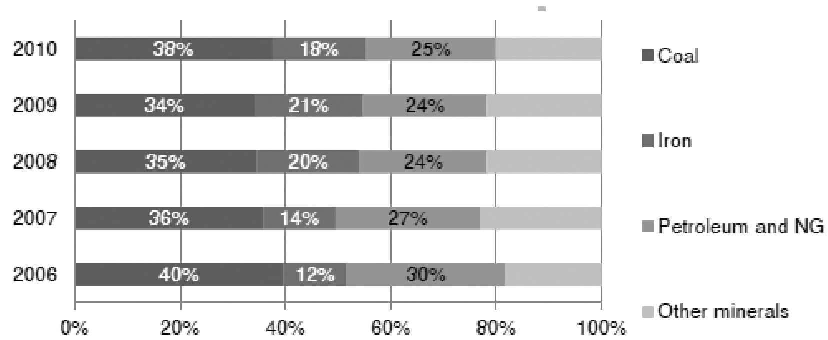
(vii) **Longwall Mining –** Longwall mining is a form of underground coal mining where a long wall of coal is mined in a single slice .The longwall panel is typically 3 to 4 km long and 250 to 400 m wide. Longwall panels are blocked out by the panel entries that are excavated in- seam on both sides of the main entries. Longwall mining is carried out in two types, namely advancing longwall and retreating longwall. Ore at the face cut by the shearer or plow is loaded onto the armoured flexible conveyor (AFC) and transported to the head entry T junction. Then ore is transferred from the AFC onto a stage loader, which in turn empties.

Business Outlook

Industry Overview

2.26 The mining and mineral sector has recorded a strong growth of 8.29% during 2009-10 over the previous year. This is significant over the historical growth (the last five years' average is a modest 4%). The mineral industry is valued at $28.8 billion in production, of which coal and iron ore contribute more than 50%.

Share in total value of minerals



Source: Indian Bureau of Mines

2.27 In coal, India has the fourth largest reserve in the world at 265 billion tonnes. It is also the third largest producer of coal in the world and the annual production is growing at 6%. Currently, total coal production stands at about 550 million tonnes against demand of more than 600 million tonnes. By the end of twelfth five year plan, the coal production is projected to be more than 1 billion tonnes. In Iron ore, India has the fifth largest reserve base at 25.25 billion tonnes. It is also the fourth largest producer in the world; and the annual production is growing at 13%. India is the world's top producer of sheet mica and the sixth- largest producer of bauxite too.

2.28 Though mining sector is growing but the mining in India is closely linked with forestry and environmental issues. A significant part of the nation's known reserves are in areas which are under forest cover. Further, many of these reserves are also located on scheduled areas (indigenous lands). Further, only around 10% of the country's landmass has been explored and there is uncertainty around the exact quantity of unexploited reserves, but many believe the potential to be significant.

Industry Structure

2.29 India's mining industry is a dominated by big companies and very small ones, with 5% of the mines in operation accounting for approximately 50% of total mineral output, highlighting a key focus area for supply and services providers entering the Indian market. The remainder of the market is highly fragmented, with a large number of small and inefficient mines, many of which are considered illegal by law enforcing agencies.

2.30 Though the mining industry is open to overseas competition and foreign investment, the investment volumes have been low till date. India's mining industry is being dominated by state-owned companies and public sector undertakings, such as Coal India, Steel Authority of India, National Aluminum Corp and National Mineral Development Corp. Coal India is the world's largest coal producer, accounting for 80% of India's domestic coal output.

Private companies too have been achieving success with Vedanta Resources and Tata Steel being two prime examples of Indian publicly traded companies from the lot. A number of coal, iron ore, bauxite, lead, zinc and uranium mines are currently under development in India, owned by Eastern Coalfields, Hindalco Industries, Uranium Corporation of India and Hindustan Zinc.

The list of global mining majors in India includes BHP Billiton, Rio Tinto, Vale and DeBeers. They have projects and exploration interests in India, but are not considered major players in the market at this stage. There are also roughly another 10-15 Australian, British and Canadian companies currently conducting exploration programs in India.

General Challenges

2.31 Despite being home to a wealth of natural resources, the mineral output of India's mining industry has suffered as a result of procedural challenges, project delays and captive mining laws. Some of the challenges faced by mining sector are as follows:

(i) Procedural Delays

Given the current allocation process, the multi-layered and extensive regulatory approvals and local permission, coal projects in India can take as long as eight to 12 years to commission as compared to other countries where it takes five to-six years. The uncertainty and differences in the administration, interpretation and enforcement of the rules and regulations adds to the challenges in the Indian coal industry. This has the effect of delaying investment in the sector even as growth in end user sectors has resulted in unprecedented growth in demand for commodities.

(ii) Lack of Evacuation Infrastructure

Infrastructure is a key cost component in the mining value chain. It needs investment in development of railways, road and port facilities for cost-effective and timely movement of materials. An individual mine licensee or user cannot invest in these, but is impacted by the deficiencies. Thus, a broader programme of infrastructure creation even by Build Own Operate and Transfer (BOOT) type projects is necessary.

(iii) Limited Fiscal Incentives

The mineral exploration has not attracted the required attention over the years. The fiscal incentives for investment in mineral exploration are far unattractive compared to incentives and fiscal benefits for say, the oil and gas sector.

(iv) High Lead Time in Equipment Deliveries

Delivery lead time for plant and mobile equipment has a significant impact on production volumes and operating costs. We need to offer mine operators fiscal and tax incentives to invest in larger and efficient technologies.

(v) Environmental Regulations and Sustainable Development

Environmental regulations in India are becoming more stringent and Indian courts are very conscious of the need to enforce environmental laws. There are many environmental organizations and lobby groups in India, who have been able to successfully influence public sector policy to create a heightened focus on environmental protection. Rehabilitation and resettlement requirements are now regarded as extensive. The Government is now preparing a sustainable development framework for addressing these issues.

(vi) Captive Mining Policies

India has long held a policy where mining operations could only be conducted by the government or government controlled enterprises. Over the years this policy position has evolved to allow captive mining by private companies who are engaged in the end production of iron, steel or power generation in selected regions.

This policy in itself has hindered the growth of mining in India. Many of the world's leading mining companies have a very limited presence in India as a result of this policy. This in turn has also led to a slow adoption of leading industry practices and technologies in India.

Evaluation and Assessment in Mining

2.32 The mineral resource classification system being followed in India is the United Nations Framework Classification (UNFC) style of classification. All the minerals, including coal, are classified under various categories of this system depending upon the level of confidence in their measurement and classification.

United Nations Framework Classification for Energy and Mineral Resources

Introduction

2.33 The United Nations Framework Classification (UNFC) for Energy and Mineral Resources is a universally applicable scheme for classifying/evaluating energy and mineral reserves and resources. Most importantly, it allows a common and necessary international understanding of these classifications/ evaluations. The Classification is designed to allow the incorporation of currently existing terms and definitions into this framework and, thus, to make them comparable and compatible.

This approach has been simplified through the use of a three-digit code clearly indicating the essential characteristics of extractable energy and mineral commodities in market economies, notably

- Degree of economic/ commercial viability
- Field project status and feasibility
- Level of geological knowledge.

Background

2.34 The UN-Economic Commission for Europe (UNECE) developed the United Nations Framework Classification for Resources/ Reserves (Solid Fuels and Mineral Commodities) to provide a basis for comparison of the various schemes in use around the world. The UNFC was developed because of a perceived need for an internationally acceptable reserve/ resource classification system.

The UNECE Working Party on Coal initiated the first version of the United Nations Framework Classification for Solid Fuels and Mineral Commodities in 1992, on the basis of a proposal made by the German Government. In 1997, after six years of efforts by the UN Task force, the ECOSOC recommended to all UN member countries to apply the Classification to their coal and mineral sectors. Since then, the classification has been applied in more than 60 countries worldwide, a number of them introduced the UNFC as a national system, and others adapted their national systems to the UNFC principles.

In October 1998, the UNECE Task Force and CMMI Expert Group reached an agreement to integrate their respective definitions into a single, universally applicable set of definitions. The joint UN/ CMMI definitions for mineral reserves and resources were completed in November 1999.

The UNECE Committee on Sustainable Energy decided, at its eleventh session in November 2001, to create an Inter-governmental Ad Hoc Group of Experts on the Harmonization of Energy Reserves/ Resources Terminology.

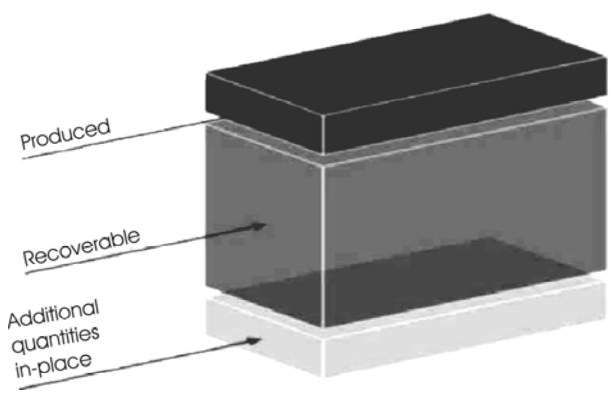
After completion of work of Ad Hoc Group of Experts, at its fifty-ninth session in February 2004, the UN Economic Commission for Europe endorsed the United Nations Classification for Energy and Mineral Resources and proposed to the ECOSOC that it recommend its application worldwide.

Key Features

2.35 According to the United Nations Framework Classification (UNFC) for Energy and Mineral Resources, the total resources initially in-place of naturally occurring energy and mineral resources, are described in terms of three quantities, namely:

- Produced quantities
- Remaining recoverable quantities
- Additional quantities remaining in place

The main focus of the UNFC is on remaining recoverable quantities.



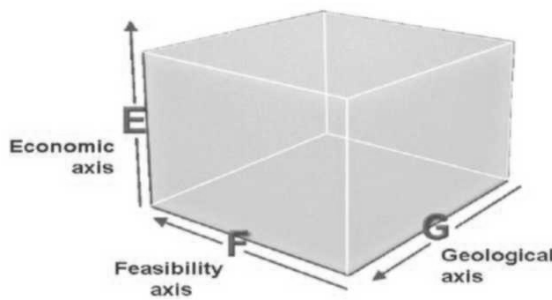
Total initial in-place resources

Source: United Nations Framework Classification for Energy and Mineral Resources

Classification

2.36 Total remaining resources are categorized using the three essential criteria affecting their recoverability:

- Economic and commercial viability (E).
- Field project status and feasibility (F).
- Geological knowledge (G).



Principal Elements of the UNFC

Source: United Nations Framework Classification for Energy and Mineral Resources

2.37 The three criteria are easily visualized in three dimensions as shown in the figure below:

UN International Framework	National System	Detailed Exploration	General Exploration	Prospecting	Reconnaissance
Feasibility Study and/or Mining Report		1 (111) 2 (211)	usually		
Prefeasibility Study		1 (121) 2 (221)	+ (122) + (222)	not	relevant
Geological Study*)		3 (331)	3 (332)	3 (333)	3 (334)

Economic Viability Categories: 1: economic; 2: potentially economic; 3: intrinsically economic (economic to potentially economic)

UNFC International Framework

Three main categories are used to describe economic and commercial viability, three to describe field project status and feasibility and four to describe the level of geological knowledge. Further, subdivision of the main categories is useful for special applications.

Resource quantities are then grouped into classes that are defined by categories E, F and G (each denoted by numerics resulting in codification of resources) represented by the sub-cubes as presented in the figure above. A class of quantities may be a single sub-cube, i.e. 111, or a collection of sub-cubes. Total resources are an example of such a class where all sub cubes are included in the class.

Codification

2.38 Due to variation between terminologies in different systems and languages, it is recommended to use only three digit numeric codes for individual categories, so that they will be universally understood. For this to be possible, the sequence is always fixed, so that the quantity characterized as E1; F1; G1 may be written in number form as 111, independent of languages. In practice, only a limited number of combinations (classes) are valid.

Sub-categories may be added under the main categories when required. Categories and sub-categories shall be numbered. A sub-category shall be separated from the main category number by a decimal point, e.g., E1.1. In such cases the categories have to be separated by a semicolon to distinguish the different categories that are included in the codified unit, e.g. 1.1; 1; 1 for the subcategory defined by E1.1, F1and G1.

Qualified Person

2.39 The studies referred to in the UNFC must be undertaken by a person(s) with the appropriate qualifications to assess resources/ reserves of the type of commodity in question. The qualifications and experience required will vary from country to country. In certain circumstances licensing may be required.

Mapping and Modeling

2.40 The UNFC style classification system describes the mapping and modeling techniques of the identified/ measured resources for mineral deposits that are classified into following three categories:

- Stratiform, Stratabound and Tabular deposits of Regular habits
- Stratiform, Stratabound and Tabular deposits of Irregular habits
- Dimensional stones

The mapping and modelling are made on a pre-defined scale, varying from 1:1000 to 1:50000, depending on the type of mineralisation and also on the level of confidence, as per the codification system. However, in general, for other minerals than coal, a smaller (enlarged view) map has been prescribed owing to the fact that the mineral composition of the basic mineral present in the ore body varies from place to place which needs a higher level of precision to be dealt with so as to prepare a better mine plan based on the mineral content.

Chapter 3
Technical Aspects of Mining Industry

Mine Planning and Mine Scheduling

Mine Planning – In General

3.1 For designing a mine plan and mine scheduling, all the data and information collected from the exploratory studies are collated at a single place. Software tools like, SURPAC, MINEX, MineSight, and other tools are available with the help of which a mine is designed, based on which the planning and scheduling is made.

In India, the mines have been categorised in the following two categories for the purpose of Mine Planning:

- Category A mines: Category A mines shall be such mines where the work is being carried out by deployment of heavy mining machinery for deep hole drilling, excavation, loading and transport is carried out with the help of heavy machinery.
- Category B Mines: Other than fully mechanized category A mines, where the number of average employment exceeds 150 in all or 75 in workings below ground.

There are minor differences in mine plans for category A and B mines

Components of a Mine Plan

3.2 Following are the components of a Mine Plan:

(i) Part A

- Geology and Exploration
  - Indicating general topography and geology.
  - Geological sections and year wise future program of exploration.
  - Indicate geological and recoverable reserves and grade. Availability of resources should also be indicated for the entire leasehold.
  - Indicate mineable reserves by slice plan / level plan method, as applicable, as per the proposed mining parameters.

- Mining
  - Existing/ proposed method for developing/ working the deposit with all design parameters
  - Quantum of development and tonnage and grade of production expected pit-wise.
  - Year wise plans and sections.
  - Proposed rate of production when the mine is fully developed and expected life of the mine and the year from which effected.
  - Conceptual mining plan based on the geological, mining and environmental considerations.
  - In case of open cast mining, following are the further components specific to it:
    - Mode of working
    - Layout of mine workings, the layout of faces and sites for disposal of overburden / waste.
  - In case of underground mining, following are the further components specific to it:
    - Mode of entry
    - System of winding / hoisting
    - Underground layout
    - Method and sequence of stoping
    - Mine ventilation
    - Extent of mechanization (Drilling machine, loading equipment, haulage and transport and miscellaneous).
- Blasting
  - Broad blasting parameters
  - Type of explosives used
  - Powder factor in ore and overburden/ waste/ development heading/ stope
  - Whether secondary blasting is needed
  - Storage of explosives.

- Mine Drainage
  - Depth of water table
  - Progress of working related to above or below water table
  - Quantity and quality of water likely to be encountered
  - Pumping arrangements
  - Discharge of pumped out water.
- Stacking of mineral rejects and disposal of waste
  - Nature and quantity of top soil, overburden/ waste and mineral rejects likely to be generated during the next five years
  - Land chosen for disposal of waste with proposed justification
  - Manner of disposal, sequence of buildup of dumps along with the proposals for the stacking of sub-grade ore.
- Use of mineral
  - End-use of the mineral
  - Physical and chemical specifications stipulated by buyers
  - Details of blending of sub grade ore being practiced or need to be practiced.
- Other
  - Site services
  - Employment potential
    - Highly Skilled
    - Skilled
    - Semi-Skilled
    - Un-Skilled.
- Mineral processing
  - Nature of the processing / beneficiation (If required) indicating size grade of feed material and concentrate and recovery rate.
  - Disposal method for tailings
  - Schematic diagram of the processing procedure
  - Specify quantity and type of chemicals to be used

- Quantity (cu.m./day) of water required, sources of supply of water
- Disposal of water and extent of recycling.

(ii) Part B

- Environmental Management Plan
  - Existing land use pattern
  - Water regime
  - Flora and fauna
  - Quality of air, ambient noise level and water
  - Climatic conditions
  - Human settlements
  - Public buildings, places of worship and monuments
  - Attach plans showing the locations of sampling stations
  - Does area (partly or fully) fall under notified area under Water (Prevention & Control of Pollution), Act, 1974
  - Environmental Impact Assessment
    - Land area
    - Air quality
    - Water quality
    - Noise levels
    - Vibration levels (due to blasting)
    - Water regime
    - Socio-economics
    - Historical monuments etc.
  - Temporary storage and utilization of topsoil
  - Year wise proposal for reclamation of land
  - Programme of aforestation, year wise for the initial five years
  - Stabilization and vegetation of dumps along with waste dump management
  - Measures to control erosion/ sedimentation of water courses
  - Treatment and disposal of water from mine.

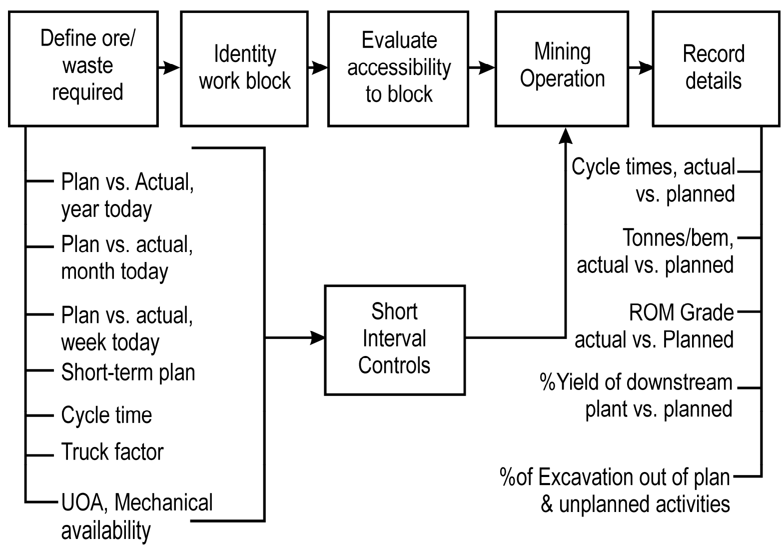
Mine Scheduling

3.3 An approved mine plan contains the scheduling for all the time bound components, like Mine Development, Mine operations (year-wise/ month-wise), Mine Closure activities, Offtake of the Run of Mine (ROM)/ processed ore/ mineral.

Some of the general time schedules prepared even during the pre-development stages of the mine are:

- Timelines for the processing plants construction – This would specify the various timelines required for the construction and commissioning of the ore processing plant. This would be aligned with respect to the mine production start date.
- Timelines for various infrastructure constructions – This timeline would include the developmental constructions on the surface.
- Material procurement planning – Material procurement and storage are equally important aspect of any type of industry. Plans would be made for the long-term consumables and for the daily consumables, depending on the requirement of the mine development and operation.

3.4 The mine scheduling aspect can be broadly segregated into various heads which have been defined in the process flow diagram below:



Process Flow Diagram of Mine Scheduling

Mine Development

Mine Development Strategy

3.5 If the mining deposit, after all the due diligence and exploratory studies, is found to be economically feasible, the mine is developed to achieve its desired production.

Depending on whether the mine is to be operated by Open Cast Mining Method or Underground Mining Method, as per the Letter of Allocation (LoA)/ Mining Lease for the mining area and subsequently the approved mine plan, the mine development strategy is made.

Site Survey

3.6 The first step involved in the mine development activity would be to perform a general site survey. This would involve the survey of the whole mining area from the perspective of:

- Topographical survey
- Planimetric survey
- Contour survey

Site Identification

3.7 This step would be followed to identify the main and the basic mine infrastructure and facilities. The identification would be carried based on the results and interpretation obtained from the site surveys. Following are the features of the mine that would require their respective allocation:

Comparison of Features of Opencast and Underground Mining Methods

Open Cast Mining Method	Underground Mining Method
Development of access roads to the ore/mineral, including mining haul roads	Shafts location
Box cut (This is the first opening designed from where the first OB removal starts)	Ventilation cooling plant
Settling Ponds	Main fan for mine ventilation
Site workshop	Pit-head workshop
Site base camp/ hutments	Pit-head base camp/ hutments

Open Cast Mining Method	Underground Mining Method
Dump Yard	Recreation centre
Recreation centre	Pit-head office
Site office	Communication facilities
Communication facilities	Pit-head canteen
Site canteen	Pit-head store for PPEs
Site store for PPEs	Pit head store for spare parts and other ancillaries
Pit head store for spare parts and other ancillaries	Pit-head Light Room
Site Light Room	Pit-head Ore Processing Plant, including stock yard (processed ore/ tailings)
Site Ore Processing Plant, including stock yard (processed ore/ tailings)	
Electrical substations	Electrical substations
Pumping stations (head, etc.)	Pumping stations (head, etc.)
Water supply arrangements	Water supply arrangements
Material (Ore/ Processed products) transportation facilities	Material (Ore/ Processed products) transportation facilities
Wagon loading arrangement, including tipping arrangements	Wagon loading arrangement, including tipping arrangements

Mine Development Methodology - Opencast Mining/ Underground Mining

3.8 The following are the activities involved in mine development:

- Forestry and Land Clearance – The first and the foremost activity involved in the Mine Development activity is the Site Clearance, also known as Deforestation. This activity is performed by using heavy equipments like, dozers and graders. The activity is essential in the sense that it provides access to the mining area and the mining activities to be carried out.
- Development of Mine – For the development of mine, various plans showing the following are prepared. These plans are part of either

Opencast or Underground mine depending on the method of working adopted.

(a) General Layout of the Surface – This plan is prepared on a large scale plan, showing all key surface features, lease boundary, mining boundary, presence of any type of water body, presence of habitation, presence of civil or mechanical constructions, if any. All these features are incorporated if they are present inside the lease area or in the nearby vicinity of the mine. This is to ensure the specific precaution, for all the above mentioned features, that needs to be taken during the mine operation.

(b) Shaft – Shafts are the most important capital openings of deep mines, providing all services for underground operations including fresh air, transportation of ore and supplies, personnel traffic, power (electricity and compressed air), communications, water supply, and drainage. Depending on the depth of the mine, shaft sinking may consume as much as 60% of the mine development time.

Mine technical data are used for determining the shaft location which is to be followed by plan for designing a 2-shaft mine, or a multiple-shaft mine. The number of shafts in a mine depends directly on the daily production rate and the dimensions of the mining area. To obtain a minimum cost per tonne of production, it is essential that an optimum balance between capital expenditure and operating costs be found.

- Shaft Design – The shaft sinking plan would include all the key features of a shaft design.
  - Description of the geologic column in the form of a table identifying the rock strata, their geotechnical parameters, and groundwater levels together with water heads, calculated inflow, and degree of chemical contamination, if any.
  - Determination of the shaft diameter, with justification.
  - Choice of shaft sinking technology and its justification.
  - Description of the shaft lining and a list of lining sections with the thicknesses.
  - The shaft foundations (footings), their locations and dimensions.

- The shaft collar, its depths and foundation, thickness and construction material, kind and number of openings with their function, and dimensions and elevations.
- The shaft sump, its depth, structural characteristics, pumping arrangement, and cleaning system.
- Surveying data for particular shaft elements.
- Calculations comprising ground and water pressure acting on lining, resulting lining thicknesses, shaft insets with their dimensions, and airflow capacity.
- Timetable of construction, with such elements as preparatory works, shaft sinking, lining erection, shaft equipment installation, and liquidation of construction arrangements.
- Cost specifications.
- Drawings of the general mine layout, with shaft location, plan of shaft site (construction stage), and shaft cross section with an outline of equipment and compartments.

• Underground Mine Development Plan – Underground mine development begins with the positive investment decision to mine and ends with the inception of full scale exploitation. It incorporates all activities, personnel, and equipment required for creation of underground access to a mineral deposit.

  - Mine Access Road – The basic mine approach road needs to be developed which provides the approach to the mining area. The roads are developed by using heavy machineries like, Excavators, Trucks, Graders, Dozers and Compactors along with the access roads, mining haul roads are also developed in parallel.
  - Material Transportation and Winding Plan – For the transportation of ore on the surface, various combinations of wagon system integrated with belt conveyor system is made. Ore is brought onto the surface from inside the mine using the material winding shaft. From the pit-head it is transported to the processing plant from where it would be transferred onto the wagons to be dispatched out of the mine.
  - Stowing Plan – Stowing in an underground mine is an equally important activity. This requires civil and mechanical construction

in the form of bunkers, pipeline networks and chambers. Site allocation for this is, therefore, equally important, as all the stowing characteristics, like, fluid flow, head, throw, rate of stowing, would depend on the proper site allocation.

- Ventilation Plan – Ventilation plan of a mine is very important to maintain the acceptable working environment for the miners. The exhaustive plan would encompass designing the ventilation circuits during development, during mine operation and during mine closure. The Ventilation Plan consists of the following parameters for which different plans are prepared:
  - Ventilation (air flow) route.
  - Plan showing quality of air (humidity, temperature, percentage of methane on the general body of air, percentage of any other gases which needs to be measured) at various points in the mine.
  - Ventilation stopings to divert and channelize the air flow as per the mine design and requirements at various points in the mine.
  - Placement of secondary ventilators (like, booster fans).
- Electricity Supply Plan – Electricity is a very vital source for energy in such mines. Proper lighting arrangements provide a hassle free and safe working environment inside the mine. Therefore, a site location for an electrical sub-station is very important. Power source, from the nearby main station is identified and electricity would be drawn from that source to the substation from where it is re-distributed inside the mine, or on the surface.
- Water Supply Plan – Water in any mine area is an essential commodity. Proper circulation of water for various purposes, like, water sprinkling, drinking would contribute towards Environmental Health and Safety issue.For this, we would, therefore, provide adequate water supply in the mine through water network system involving forcing pumps, water coolants, recirculation of fresh drinking water, separate water pipelines for drinking, water sprinkling, etc.
- Pumping Plan – Pumping forms an integral part of underground mining technology. The mine water, flowing in either from the

ground water or seeping in from the surface needs a continuous pumping so as to serve the following purposes:

- o Provide a water-free working face.
- o Avoid water logging in the areas where activities like, material transport, man transport, electrical substations, voids for stowing, pumping sub-stations, etc.

It is very essential to locate area for installation of the main pumps on the surface. Generally, an area with the highest of the altitude is selected for the station. The sump is created at a low lying area where water, either through pumping, or through gravity flows to it.

Various type of pumping system may be combined to counter the issues of water logging. The main pumping route is as per the following:

- o Transfer from the working face to the nearby local sump.
- o Transfer from the local sumps in the mine to the main sump area which may be near the shaft inset, having exhaust route for the mine air.
- o Throw from the main pump to the surface.

All these activities require respective type of pumps which have been mentioned below:

- o Pumps with high head, less throw.
- o Pumps with high throw, less head.

These two types of pump may be moveable or may be fixed at one particular place, except for the main pump which throws the water out of the main pump to the surface which is stationary.

- Ore processing Plans – The Ore processing plans are important for production of saleable product as per market conditions as well as to control the environmental pollution. Ore processing plans will describe the process to be employed, material handling and handling of rejects.
- Phasing and Planning for Procurement/ Operations – Equipment selection and sizing is a major mining engineering activity. It follows the positive investment decision to mine and begins with selection of a mining method. Although equipment

selection begins during the formulation of a "milestone diagram," in which the minable reserve is parceled out into zones and distinguished by method of mining, suitability and production analyses for mining equipment are not conducted until after layout and sequencing are accomplished and before scheduling is undertaken.

With the advancement of mining industry, various technologies and software are being used for the purpose. Different types of plans are developed for their serving and their specific use during the starting of the mine, or during the operation stage.

Key Activities in Mining

Mining Operations

3.9 Mining, in general, involves the following operations:

- Site Preparation
- Drilling and Blasting
- Loading and Hauling
- Stockpile management
- Off take arrangements
- Equipment maintenance process

After which the mined material is further beneficiated to improve its quality and render it useful for use in various industries.

Site Preparation

3.10 This step involves preparing the site where bore holes are to be drilled. This may involve cutting trees, leveling, etc. Leveling is required to provide a stable ground to the drilling rig. Generally, a dozer is used for leveling in open cast mines.

Drilling and Blasting

3.11 Boreholes are drilled in which explosive is loaded for blasting in the next step. The pattern and number of the holes to be drilled is pre-decided so as to optimally utilize all of the blast energy, achieve proper fragmentation and restrict blast waves. In opencast mines drilling rigs are used for drilling, while in underground simple jackhammers, jumbo drills or specialized drilling machines may be used depending on the level of automation and the desired level of production.

Followed by drilling of boreholes, explosives are loaded and the material is blasted so as to fragment it using shock waves and enable easier loading in the next step. The blasting pattern is carefully designed to control the blast and cause proper fragmentation, minimize fly rocks, prevent the surrounding rock structures, etc. In India, strict government guidelines govern the amount and type of explosives that can be used.

Loading and Hauling

3.12 Following blasting, the blasted material is loaded onto haulage equipment (dumpers, tubs, conveyors, etc.) using shovels, LHD or SDL. After loading, the transport equipment (dumpers, tubs or conveyor) hauls the extracted material from the working area and dumps it in the designated stockyard/plant/dump.

Stockpile Management

3.13 The Stockpile Management process is used to stock the product. In case of metalliferous mines, the stockpiling of the ROM and the processed ore are maintained separately. While in case of coal, the stockpiling is mainly made for the purpose of crushing, blending or washing, or combined.

The Stockpiling activity requires equipments like, crushers, dozers, trucks, excavators and in cases where the ROM needs to be treated to form the saleable product. Ore/Mineral Washeries are needed which treat the ROM chemically (or non-chemically). Another important activity from the Stockpile which takes place is the off take of the ROM/ processed ore/ mineral to the desired location/ end-use plant/ export destinations.

Off take Arrangements and Material Handling

3.14 The mined/ processed material may be required to be off take from mine face; stockpile; railway siding or any other point. The choice of inland transportation mainly depends on the available and feasible infrastructure. The common mode for transportation includes railways, MGR, belt conveyor, stacker reclaimer, ropeways, trucks, etc. Quite often the combination of various modes is used for the arrangement. For example, the material from belt conveyors is discharged on to chutes and is then transported by stacker to stock yard.

(i) Belt conveyor – In this a rubber belt with two or more pulleys is used to transport the material. One or both of the pulleys are powered which move the belt and the material on the belt forward. Sometimes, series of belt conveyors few kilometers long are also used for transportation of material.

(ii) Ropeway – In this material is transported using an aerial ropeway moving at a constant speed. This mode can be used to transport material to long distances (few kilometers).

(iii) MGR – A merry-go-round (MGR) train is a block train of hopper wagons which both loads and unloads its cargo while moving. The locomotives used are fitted with electronic speed control which allows the driver to engage the system and the train proceeds at a fixed slow speed under the loading and unloading facilities.

(iv) Stacker Reclaimer – In the stacker reclaimer system, stacker is used to pile the bulk material while reclaimer is used to recover the material. For longitudinal stores the commonly used stacking methods are Chevron, Windrow and Cone Shell. In these methods a large number of layers are stacked on top of each other in the longitudinal direction of the pile.

In Chevron method stacker moves to and fro over the centre line of the pile. This result causes segregation of the material with fine particles in the central part of the pile and coarse particles on the surface and at the bottom of the pile. In Windrow method, number of positions across the width of the pile is used to deposit the material which ensures even distribution of fine and coarse particles across the pile. When homogenization is not the priority then Cone Shell method can be used. In this cone of material is formed from a fixed position and when the conical pile is full, a new cone is formed against the shell of the first one.

For circular stores generally continuous Chevron stacking method is used. The reclaimers are equipped with constant speed motors and the reclaimed material is carried by belt conveyors and discharged into a feed bin of a relatively large volume.

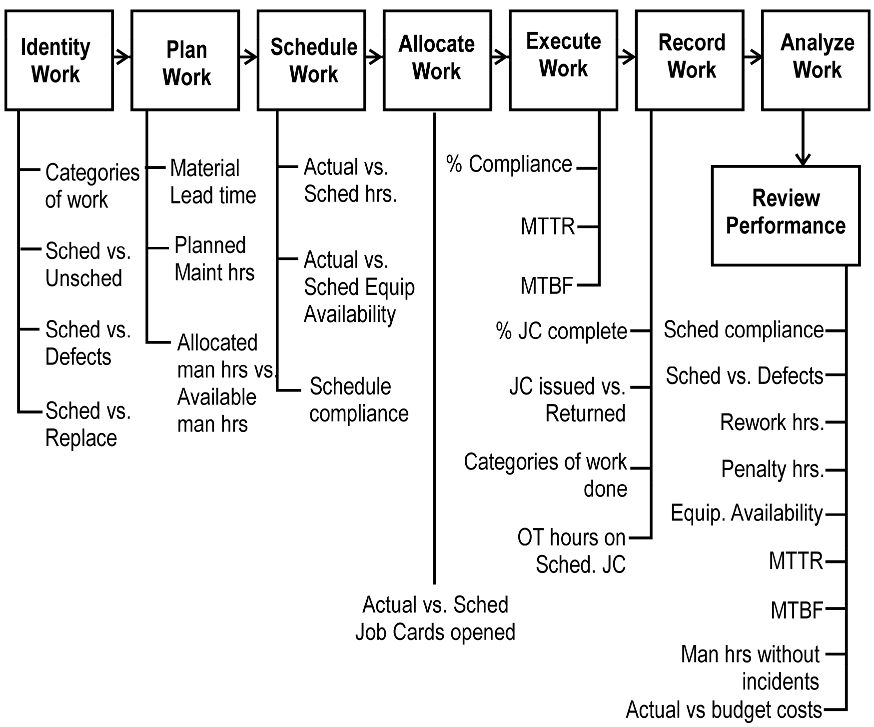
Equipment Maintenance Process

3.15 The Equipment maintenance process forms another important integral part of any mining operation. This is a specialized activity which involves expertise in the areas of machineries and their maintenance. As the mining operations completely rely on the machine and equipment availability and utilization, it is therefore, very important to select the correct type of equipments for the complete operations and subsequently the maintenance.

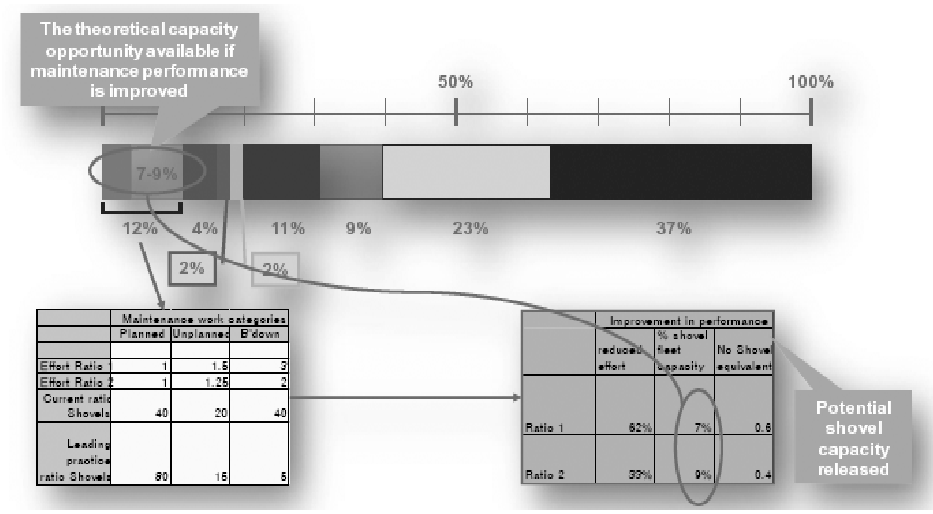
Broadly, the maintenance is carried out in the following different ways:

- Regular maintenance – This involves the regular machine check-ups on a daily and shift-to-shift basis and also involves attending of breakdowns.
- Scheduled maintenance – The machines/ equipments are sometimes withdrawn from their production activity and are checked thoroughly which may include change of filter oils, lube oils, hoses and other mechanicals smaller parts .
- Over-hauling – This activity involves the complete change of major mechanical/ electrical components of an equipment/ machine like gear, swing motors. This activity is performed after the machine has achieved its rated maximum hours of operations. The over-hauling activity almost renews the complete equipment/ machine.

3.16 The diagram below explains the maintenance procedures, generally, followed in the mining activity.



3.17 A proper maintenance in any mining activity is very important as it affects the total production, productivity and the mining cost controls. A typical example showing potential impact on operational efficiency due to proper maintenance of shovel is depicted in the diagram below:



Example showing Potential Impact on Operational Efficiency due to Proper Maintenance

Mineral Processing

3.18 Minerals are valuable natural resources of a country. They constitute the vital raw materials for many basic industries and are a major resource for development. The wide availability of coal/minerals in the form of abundant rich reserves has made it very conducive for the growth and development of the mining sector in India. India's mining sector has enough potential, but lack of planning, long-drawn official procedure of license procuring and to some extent insurgency are major obstacles in its growth. The Government of India (GOI) is planning to take up the mining sector's contribution in GDP from 3% to 9% in near future.

3.19 In continuation of the same, under National Mineral Policy (2008), Indian government has taken steps for utilization of lower grade materials. R & D organization will be encouraged for development of process routes for low grade ore beneficiation. This will result in effective utilization of the available natural resources. Therefore, coal/ mineral beneficiation will play a dominant role in growth rate of nation's economy. The extraction of minerals from the earth crust is carried out through mining operation followed by mineral beneficiation. The GDP of a country is significantly influenced by per capita consumption of mineral resources. In India the per capita consumption is low as compared to the world's average.

Mineral resources of country are finite and non-renewable. The basic steps to extract a Washed Valuable Mineral from ROM Ore are mining and mineral beneficiation. Coal/ Mineral beneficiation can be described as a collection of one or more technologies involved in upgrading and recovering minerals from ores.

Mineral Beneficiation

3.20 "As-mined" or "run-of-mine" Ore consists of valuable parts and gangue. Mineral processing, sometimes called ore dressing, mineral dressing or milling, follows mining and prepares the ore for extraction of the valuable metal in the case of metallic ores, and produces a commercial end product of products such as, iron ore and coal. Apart from regulating the size of the ore, it is a process of physically separating the grains of valuable minerals from the unwanted/ gangue minerals, to produce an enriched portion, or concentrate, containing most of the valuable minerals, and a discard, or tailing, containing predominantly the gangue minerals. Mineral beneficiation is generally defined as a combination of various processes, involving various steps such as, comminution, classification and concentration, to separate out the valuable mineral from the non-valuable mineral. Comminution involves size reduction activities like crushing, grinding etc for liberation of the valuable mineral particles from gangue mineral particle based on ore characteristics. After liberation, size specific activity; classification is carried out to produce different size fractions. In continuation of the same concentration operation (if required) is carried out to separate the valuable mineral from the gangue mineral through different separation techniques like, gravity separation, magnetic separation, electrostatic separation, flotation, heavy media separation, etc.

3.21 A step by step description of the major beneficiation processes is given as follows:

(i) *Comminution*

As the mined minerals are finely disseminated and associated with the gangue/unwanted particles, the liberation of the same from gangue particles is achieved through comminution. In this process step, particle size of the ore is progressively reduced until the valuable particles can be separated by available methods. Explosives are used in mining to remove ores from their natural beds, and blasting can be regarded as the first stage in comminution. Comminution in the Coal washery/ Mineral processing plant, or "mill", takes place as a sequence of crushing and grinding processes.

(a) Crusher

Crushing reduces the particle size of run-of-mine ore to such a level that grinding can be carried out until the mineral and gangues are substantially produced as separate particles. Crushing is the first mechanical stage in the process of comminution in which the main objective is the liberation of the valuable minerals from the gangue. It is, generally, a dry operation and is usually performed in two or three or more stages such as, primary, secondary and tertiary crushing, etc.

Primary crushers are heavy-duty machines, used to reduce the run-of-mine ore down to a size suitable for transport and for feeding the secondary crushers or AG/SAG mills. They are always operated in open circuit, with or without heavy-duty scalping screens (grizzlies). There are two main types of primary crusher in metalliferous operations jaw and gyratory crushers, although the impact crusher has limited use as a primary crusher and will be considered separately.

Secondary crushers are much lighter than the heavy-duty, rugged primary machines. Since they take the primary crushed ore as feed, the maximum feed size will normally be less than 15 cm in diameter and, because most of the harmful constituents in the ore, such as tramp metal, wood, clays, and slimes have already been removed, it is much easier to handle. Similarly, the transportation and feeding arrangements serving the crushers do not need to be as rugged as in the primary stage. Secondary crushers also operate with dry feeds, and their purpose is to reduce the ore to a size suitable for grinding. In those cases where size reduction can be more efficiently carried out by crushing, there may be a tertiary stage before the material is passed to the grinding mills. Tertiary crushers are, to all intents and purposes, of the same design as secondaries, except that they have a closer set. The bulk of secondary crushing of metalliferous ores is performed by cone crushers, although crushing rolls and hammer mills are used for some applications.

(b) Grinding Mill

Grinding is the last stage in the process of comminution; in this stage the particles are reduced in size by a combination of impact and abrasion, either dry or in suspension in water. It is performed in rotating cylindrical steel vessels which contain a charge of loose crushing bodies (the grinding medium) which is free to move inside the mill, thus comminuting the ore particles. According to the ways by which motion is imparted to the charge, grinding mills are generally classified into two types: tumbling mills and stirred mills.

In tumbling mills, the mill shell is rotated and motion is imparted to the charge via the mill shell. The grinding medium may be steel rods, balls, or rock itself. Tumbling mills are typically employed in the mineral industry for coarse-grinding processes. The basic types of tumbling mills are rod mill, ball mill and autogenous mill. Structurally, each type of mill consists of a horizontal cylindrical shell, provided with renewable wearing liners and a charge of grinding medium. The drum is supported so as to rotate on its axis on hollow trunnions attached to the end walls. The diameter of the mill determines the pressure that can be exerted by the medium on the ore particles and, in general, the larger the feed size the larger needs to be the mill diameter. The length of the mill, in conjunction with the diameter, determines the volume, and hence the capacity of the mill. The feed material is usually fed to the mill continuously through one end trunnion, the ground product leaving via the other trunnion, although in certain applications the product may leave the mill through a number of ports spaced around the periphery of the shell. All types of mill can be used for wet or dry grinding by modification of feed and discharge equipment.

In stirred mills, the mill shell with either a horizontal or a vertical orientation is stationary and motion is imparted to the charge by the movement of an internal stirrer. Fine grinding media inside the mill are agitated or rotated by a stirrer, which typically comprises a central shaft to which are attached pins or discs of various designs.

(ii) *Industrial Screening*

Industrial sizing is extensively used for size separations from 1000 mm down to micron sizes, although the efficiency decreases rapidly with fineness. Dry screening is generally limited to material above 5mm in size, while wet screening down to around 250 micron is common. Although there are screen types that are capable of efficient size separations down to 40 micron, sizing below 250 microns is also undertaken by classification. Selection between screening and classification is influenced by the fact that finer separations demand large areas of screening surface and, therefore, can be expensive compared with classification for high-throughput applications. The types of screening equipment are many and varied. Likewise, there are a wide range of screening objectives. The main purposes in the minerals industry are:

(a) Sizing or Classifying, to separate particles by size, usually to provide a downstream unit process with the particle size range suited to that unit operation;

(b) Scalping, to remove the coarsest size fractions in the feed material, usually so that they can be crushed or removed from the process;

(c) Grading, to prepare a number of products within specified size ranges. This is important in quarrying and iron ore, where the final product size is an important part of the specification;

(d) Media recovery, for washing magnetic media from ore in dense medium circuits;

(e) Dewatering, to drain free moisture from a wet sand slurry;

(f) Desliming or de-dusting, to remove fine material, generally below 0.5 mm from a wet or dry feed;

(g) Trash removal, usually to remove wood fibres from a fine slurry stream.

There are numerous different types of industrial screens available. The dominant screen type in industrial applications is the vibrating screen, of which there are many sub-types in use for coarse and fine-screening applications. There are also numerous other screen types in wide use for both coarse and fine screening applications. The major screen types, based on their method of operation are inclined or circular motion screen, Grizzly screen, Horizontal screen, Resonance screen, Dewatering screen, Banana screen, circular screen, flip-flow screen, Trommels, etc.

(iii) *Classification*

Classification is a method of separating mixtures of minerals into two or more products on the basis of the velocity with which the grains fall through a fluid medium. In mineral processing, this is usually water, and wet classification is generally applied to mineral particles which are considered too fine to be sorted efficiently by screening. Since the velocity of particles in a fluid medium is dependent not only on the size, but also on the specific gravity and shape of the particles, the principles of classification are important in mineral separations utilising gravity concentrators. Classifiers also strongly influence the performance of grinding circuits.

Many different types of classifier have been designed and built. They may be grouped, however, into two broad classes depending on the direction of flow of the carrying current. Horizontal current classifiers such as, mechanical classifiers are essentially of the free-settling type and accentuate the sizing function; vertical current or hydraulic classifiers are usually hindered-settling types and so increase the effect of density on the separation. The major available classifiers in the industry are teeter bed separator, hydrocyclones, spiral/ rake classifier, flotex, hydrosizer, etc.

(iv) *Gravity Concentration*

Gravity methods of separation are used to treat variety of materials, ranging from coarse to finer sizes. Gravity concentration methods separate minerals of different specific gravity by their relative movement in response to gravity and one or more other forces, the latter often being the resistance to motion offered by a viscous fluid, such as, water or air. The major gravity separation equipment can be described as follows:

(a) Jigs

In the jig the separation of minerals of different specific gravity is accomplished in a bed which is rendered fluid by a pulsating current of water so as to produce stratification. The aim is to dilate the bed of material being treated and to control the dilation so that the heavier, smaller particles penetrate the interstices of the bed and the larger high specific gravity particles fall under a condition probably similar to hindered settling.

(b) Pinched Sluices

Pinched sluices of various forms have been used for heavy mineral separations for centuries. In its simplest form, it is an inclined launder about 1 m long, narrowing from about 200 mm in width at the feed end to about 25 mm at the discharge. Pulp of between 50 and 65% solids enters gently and stratifies as it descends; at the discharge end these strata are separated by various means, such as by splitters, or by some type of tray.

(c) Richert Cone

The Reichert cone is a wet gravity concentrating device designed for high capacity applications. Its principle of operation is similar to that of a pinched sluice, but the pulp flow is not restricted or influenced by side-wall effect, which is somewhat detrimental to pinched-sluice operation.

(d) Spirals

It is composed of a helical conduit of modified semi-circular cross-section. Feed pulp of between 15% and 45% solids by weight and in the size range 3 mm to 75 micron is introduced at the top of the spiral and, as it flows spirally downwards, the particles stratify due to the combined effect of centrifugal force, the differential settling rates of the particles, and the effect of interstitial trickling through the flowing particle bed. These mechanisms are complex, being much influenced by the slurry density and particle size.

(e) Wet Gravity Tables

When a flowing film of water flows over a flat, inclined surface the water closest to the surface is retarded by the friction of the water absorbed on the surface; the velocity increases towards the water surface. If mineral particles are introduced into the film, small particles will not move as rapidly as large particles, since they will be submerged in the slower moving portion of the film. Particles of high specific gravity will move more slowly than lighter particles, and so a lateral displacement of the material will be produced. The flowing film effectively separates coarse light particles from small dense particles, and this mechanism is utilized to some extent in the shaking table concentrator, which is perhaps the most metallurgically efficient form of gravity concentrator, being used to treat the smaller, more difficult flow-streams, and to produce finished concentrates from the products of other forms of gravity system.

(f) Dense Medium Separation (DMS)

Dense medium separation (or Heavy Medium Separation (HMS), or the sink-and-float process) is applied to the pre-concentration of minerals, i.e., the rejection of gangue prior to grinding for final liberation. It is also used in coal preparation to produce a commercially graded end-product, clean coal being separated from the heavier shale or high-ash coal. In principle, it is the simplest of all gravity processes and has long been a standard laboratory method for separating minerals of different specific gravity. Heavy liquids of suitable density are used, so that those minerals lighter than the liquid float, while those denser than it sink. Several types of separating vessel are in use, and these may be classified into gravitational ("static-baths") and centrifugal (dynamic) vessels.

(g) Flotation

Flotation is a physico-chemical separation process that utilises the difference in surface properties of the valuable minerals and the unwanted gangue minerals. The theory of froth flotation is complex, involving three phases (solids, water, and froth) with many sub-processes and interactions, and is not completely understood. The process of material being recovered by flotation from the pulp comprises three mechanisms:

- Selective attachment to air bubbles (or "true flotation").
- Entrainment in the water which passes through the froth.
- Physical entrapment between particles in the froth attached to air bubbles (often referred to as "aggregation").

(h) Magnetic Separators

Magnetic separators exploit the difference in magnetic properties between the ore minerals and are used to separate either valuable mineral from non-magnetic gangue. Magnetic separators can be classified into low- and high intensity machines, which may be further classified into dry-feed and wet-feed separators.

The different types of magnetic separators can be listed as drum separators, counter current separators, cross belt separators, high intensity separators, high gradient separators, super conducting separators, etc.

(i) Electrical Separation

Electrical separation utilises the difference in electrical conductivity between the various minerals in the ore feed. Since almost all minerals show some difference in conductivity it would appear to represent the universal concentrating method. In practice, however, the method has fairly limited application, and its greatest use is in separating some of the minerals found in heavy sands from beach or stream placers. There are different types of electrical separators as plate/ screen separators, high tension separators, etc.

(j) Dewatering

With few exceptions, most mineral-separation processes involve the use of substantial quantities of water and the final concentrate has to be separated from a pulp in which the water solids ratio may be high. Dewatering, or solid-liquid separation, produces a relatively dry concentrate for shipment. Partial dewatering is also performed at various stages in the treatment, so as to prepare the feed for subsequent processes. Dewatering methods can be broadly classified into three groups:

- Sedimentation – Rapid settling of solid particles in a liquid produces a clarified liquid which can be decanted, leaving thickened slurry, which may require further dewatering by filtration. The settling rates of particles in a fluid are governed by Stokes' or Newton's laws, depending on the particle size. Very fine particles, of only a few microns diameter, settle extremely slowly by gravity alone, and centrifugal sedimentation may have to be performed. Alternatively, the particles may be agglomerated, or flocculated, into relatively large lumps, called flocs, that settle out more rapidly. The different types of thickeners (cable/ high rate or tray thickeners, etc) and centrifuges are used for sedimentation and recovery of the water from the concentrate.
- Filtration – Filtration is the process of separating solids from liquid by means of a porous medium which retains the solid but allows the liquid to pass. Cake filters are the type most frequently used in mineral processing, where the recovery of large amounts of solids from fairly concentrated slurries is the main requirement. Those where the main requirement is the removal of small amounts of solid from relatively dilute suspensions are known as screening or clarification filters. Cake filters may be pressure, vacuum, batch, or continuous types.
- Thermal Drying – The drying of concentrates prior to shipping is the last operation performed in the mineral-processing plant. It reduces the cost of transport and is usually aimed at reducing the moisture content to about 5% by weight. Dust

losses are often a problem if the moisture content is lower. Example: Rotary thermal dryer

(k) Tailings Disposal

The disposal of mill tailings is a major environmental problem, which is becoming more serious with the increasing exploration for metals and the working of lower grade deposits. Apart from the visual effect on the landscape of tailings disposal, the major ecological effect is usually water pollution, arising from the discharge of water contaminated with solids, heavy metals, mill reagents, sulphur compounds, etc. Waste must, therefore, be disposed of in both an environmentally acceptable and, if possible, economically viable manner. Disposal is governed by legislation and may involve long-term rehabilitation of the site. The nature of tailings varies widely; they are usually transported and disposed of as slurry of high water content, but they may be composed of very coarse dry material, such as the float fraction from dense medium plants.

Due to the lower costs of mining from open pits, ore from such locations is often of very low grade, resulting in the production of large amounts of very fine tailings. The tailings disposal could be to a natural/ man-made tailings dam or in an abandoned mines or coarse tails can be used for back filling, etc.

Beneficiation Practices in India

3.22 The beneficiation process was introduced in the country during 1960s in the form of wet processing of ore confined to mainly washing only. Wet processing modified the earlier practice of multistage crushing and screening with addition of scrubbing of crushed ore in rotary drum scrubber, followed by washing of scrubbed ore with high pressure water jet wet vibrating screen to produce clean lumps.

During the period 1970 to 2000, no significant development took place in beneficiation techniques in India, but the search for suitable process routes for further up gradation was on. Many processing techniques such as, magnetic separation, multi-stage hydrocyclone, teeter bed separator, air pulsated jig, spiral concentrator, heavy media separation, flotation, etc. were tested in the R & D laboratories during this period.

3.23 In the past few years, many test laboratories in India have tested the feasible process route for beneficiation of Ore to maximize the recovery of valuable parts. In order to obtain washed upgraded concentrate, proper liberation of mined Ore from gangue particles is the essential pre-requisite. For liberation of low grade material, grinding to finer size is required. After liberation, these low grade materials can be beneficiated suitably/ economically with the available techniques. The major size specific process equipment tested so far for beneficiation are Jig, Teeter bed separator, Heavy media separation, Multistage cyclone, Spiral concentration, Falcon separator, Knelson separator, Wet tables, Magnetic separation, and Froth flotation etc. One or combination of more than one of the above technologies can be used for beneficiation.

With the use of advance Mineral Beneficiation techniques in India would serve many purposes at the same time as:

- The Ore reserve base of the country will increase substantially by taking low grade in-situ deposits and dumped material as well as slimes accumulated in the tailings ponds/ dams into its realm, which can be utilized/ extracted through advanced beneficiation techniques.
- It will help the country in optimization and conservation of limited resources.

The mining industry will be in a position to address environmental issues and concerns arising due to tailings disposal and stacking of sub grade material in form of dumps. The adoption of low grade ore/ slimes beneficiation process would increase the life of tailing ponds, thereby, addressing the issue of ever increasing area required for tailings disposal and dumping of low grade ore.

Mine Closure

Afforestation and Mine Closure

3.24 "Progressive Closure Plan" and "Final Closure Plan" should be in the format and as per the guidelines issued by the Indian Bureau of Mines. The Mine Closure Plan (progressive and final) shall be approved along with the approval of Mining Plan/ Feasibility Report / Project Report as applicable.

Progressive Mine Closure Plan would include various land use activities to be done continuously and sequentially during the entire period of the mine operations from the day one of the mining operations. Such a plan ensures that the land and the other affected areas are being continuously recovered (or afforested) to the planned state from the very first day of mining operations.

Whereas the Final Mine Closure activities would start towards the end of mine life, generally during the last 4-5 years of the mine life. This type of plan ensures the full and the final closure of the mine. In case of Opencast mine, this is, generally, followed by finally covering the mined out area by top soil and subsequently followed by plantations or creating some kind of place for flora and fauna to develop, as per the Ministry Guidelines and the approved plan. While in case of Underground mining activity, this is followed by abandoning the complete mining activity and finally followed by the shaft closures, as per the Ministry Guidelines and the approved plan.

3.25 Mine closure encompasses rehabilitation process as an ongoing programme designed to restore physical, chemical and biological quality disturbed by the mining to a level acceptable to all concerned. It must aim at leaving the area in such a way that rehabilitation does not become a burden to the society after mining operation is over. It must also aim to create as self-sustained ecosystem.

Mine closure operation is a continuous series of activities starting from day one of the initiation of mining project. Therefore, progressive mine closure plan will be an additional chapter in the present mining plan and will be reviewed every five years in the Scheme of Mining. As progressive mine closure is a continuous series of activities, it is obvious that the proposals of scientific mining have included most of the activities to be included in the progressive mine closure plan. Therefore, reference to relevant paragraphs and a gist of the same in progressive mine closure plan will be sufficient.

Closure Plan

3.26 The mine closure plan consists of the following parameters and objectives:

- Mined-Out Land – Describe the proposals to be implemented for reclamation and rehabilitation of mined-out land including the manner in which the actual site of the pit will be restored for future use. The proposals should be supported with relevant plans and sections depicting the method of land restoration / reclamation / rehabilitation.
- Water Quality Management – Describe in detail the existing surface and ground water bodies available in the lease areas and the measures to be taken for protection of the same including control of erosion, sedimentation, siltation, water treatment, diversion of water courses , if any, measures for protection of contamination of ground water from leaching, etc. Quantity and quality of surface water bodies

should also be indicated and corrective measures proposed to meet the water quality conforming to the permissible limits should also be described. Report of hydrological study carried out in the area may also be submitted. The water balance chart should be given. If there is potential of Acid Mine Drainage then the treatment method should be given.

- Air Quality Management – Describe the existing air quality status. The corrective measures to be taken for prevention of pollution of air should be described.
- Waste Management – Describe the type, quality and quantity of overburden, mineral reject etc. available and their disposal practice. If no utilisation of waste material is proposed, the manner in which the waste material will be stabilised should be described. The protective measures to be taken for prevention of siltation, erosion and dust generation from these waste materials should also be described. If toxic and hazardous elements are present in the waste material the protective measures to be taken for prevention of their dispersal in the air environment, leaching in the surface and ground water etc, should be described.
- Top Soil Management – The top soil available at the site and its utilisation should be described.
- Tailing Dam Management – The steps to be taken for protection and stability of tailing dam, stabilisation of tailing material and its utilisation, periodic desilting, measures to prevent water pollution from tailings, etc., arrangement for surplus water overflow along with detail design, structural stability studies, the embankment seepage loss into the receiving environment and ground water contaminant if any should be given.
- Infrastructure – The existing infrastructural facilities available such as, roads, aerial ropeways, conveyer belts, railways, power lines, buildings and structures, water treatment plant, transport, water supply sources in the area, etc. and their future utilisation should be evaluated on case to case basis. If retained, the measures to be taken for their physical stability and maintenance should be described. If decommissioning proposed, dismantling and disposal of building structures, support facilities and other infrastructure like, electric transmission line, water line, gas pipeline, water works, sewer line, telephone cables, underground tanks, transportation

infrastructure like roads, rails, bridges, culverts etc., electrical equipments and infrastructures like, electric cables, transformers to be described in connection with restoring land for further use.

- Disposal of Mining Machinery – The decommissioning of mining machineries and their possible post mining utilisation, if any, to be described.
- Safety and Security – Explain the safety measures implemented to prevent access to surface openings, excavations, etc., and arrangements proposed during the mine abandonment plan and up to the site being opened for general public should be described.
- Disaster Management and Risk Assessment – This should deal with action plan for high risk accidents like, landslides, subsidence flood, inundation in underground mines, fire, seismic activities, tailing dam failure, etc. and emergency plan proposed for quick evacuation, ameliorative measures to be taken, etc. The capability of lessee to meet such eventualities and the assistance to be required from the local authority should also be described.

Time Scheduling for Abandonment

3.27 The manpower and other resources required for completion of proposed job should be described. The schedule of such operations should also be supplemented by PERT (Programme Evaluation & Review Technique), Bar chart, etc.

Abandonment Cost

3.28 Cost to be estimated based on the activities required for implementing the protective and rehabilitation measures including their maintenance and monitoring programme.

Financial Assurance

3.29 In the mine closure plan, the manner in which financial assurance has been submitted and its particulars have to be indicated. The financial assurance can be submitted in one of the following forms:

- Letter of Credit from any Scheduled Bank
- Performance or surety bond

- Trust fund build up through annual contributions from the revenue generated by mine and based on expected sum of amount required for abandonment of mine
- Any other form of security or any other guarantees acceptable to the authority

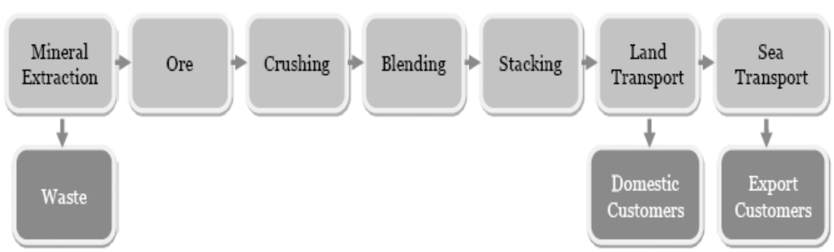
The lessee shall submit the financial assurance before executing the mining lease deeds. In case of an existing mining lease, the lessee shall submit the financial assurance along with the progressive mine closure plan. Release of financial assurance shall be effective upon the notice given by the lessee for the satisfactory compliance of the provisions contained in the mine closure plan.

Process Monitoring

Budgeting, Cost Recording and Reconciliation Process

3.30 Many mining operators effectively fix their mine plans and budgets on an annual basis and often there are poor linkages between the mine plan, the budget and the real drivers of cost and value. Such operations struggle to determine the cost and margin impact of significant changes to production particularly when they scrambled to quickly reduce the production and unit cost. On the contrary, those mining companies which manage their performance effectively based on the understanding of the cost and value drivers across all areas of mine production and processing are able to quickly respond to both the sudden changes in the price and economy.

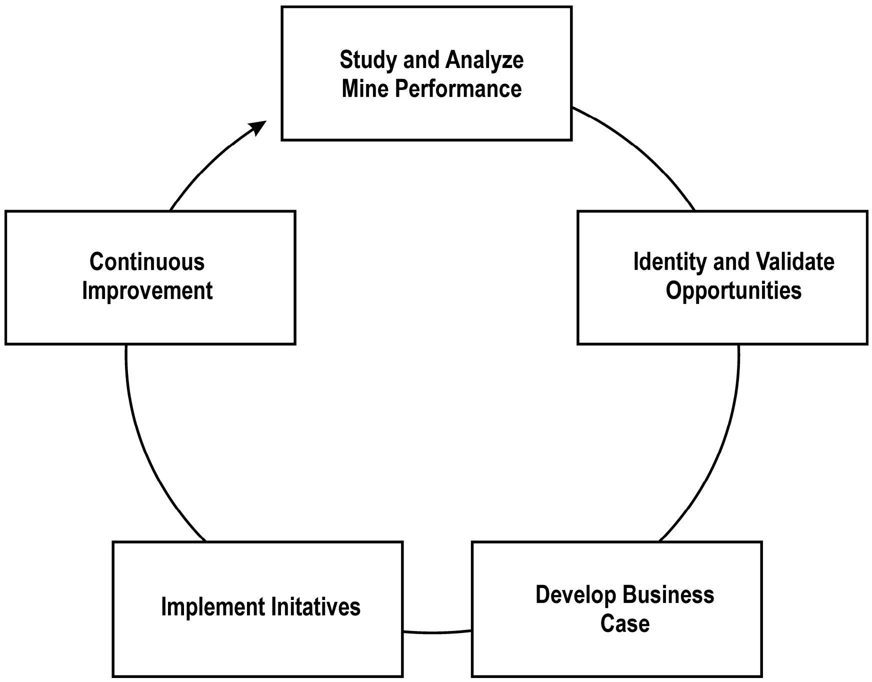
The mining supply chain is as follows:



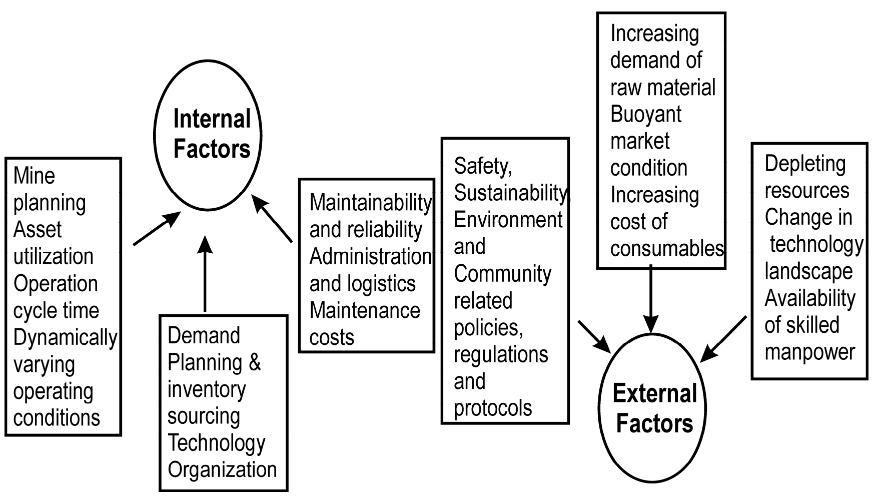
Mining Supply Chain

For monitoring the mining performance, key areas in the mining supply chain are identified and supervised. Budgeting, cost recording and reconciliation help in analyzing and identifying the scope of improvement in the operations.

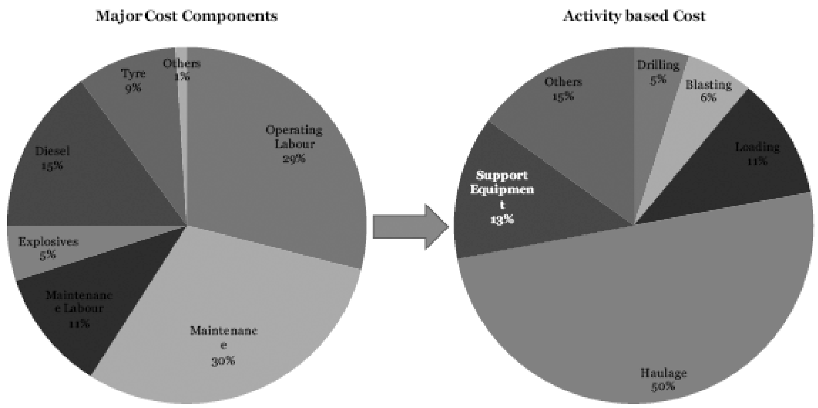
The following approach may be followed:



To study and analyse the performance, various internal and external factors influencing the mining operations need to be considered. Some of the key factors influencing the operations are mentioned below:

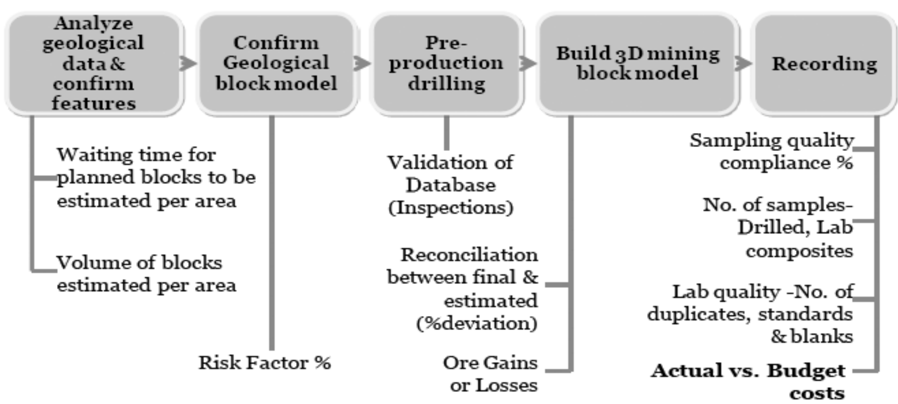


Further, it is very much necessary to analyze the distribution of operating costs in various components and activities. This helps in identifying the major focus areas where if costs are reduced, may result in significant reduction in the overall production costs. For e.g., a major part of the operating costs is incurred towards maintenance and labor while if we consider activity-wise breakup the major chunk is towards haulage activity.

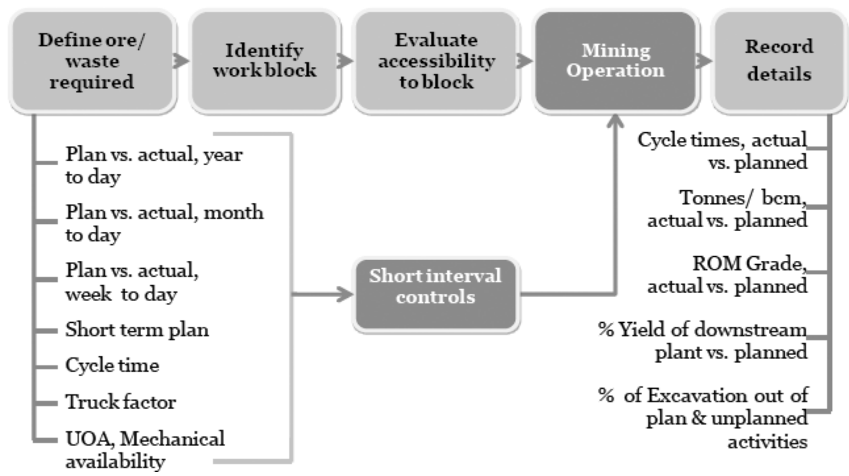


3.31 The activity-wise methodology for performance analysis is presented in the charts below:

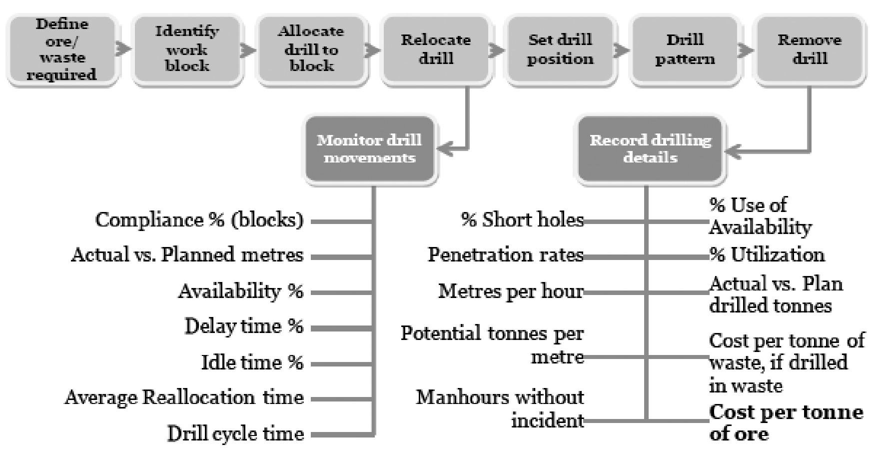
Geological Modeling for Production



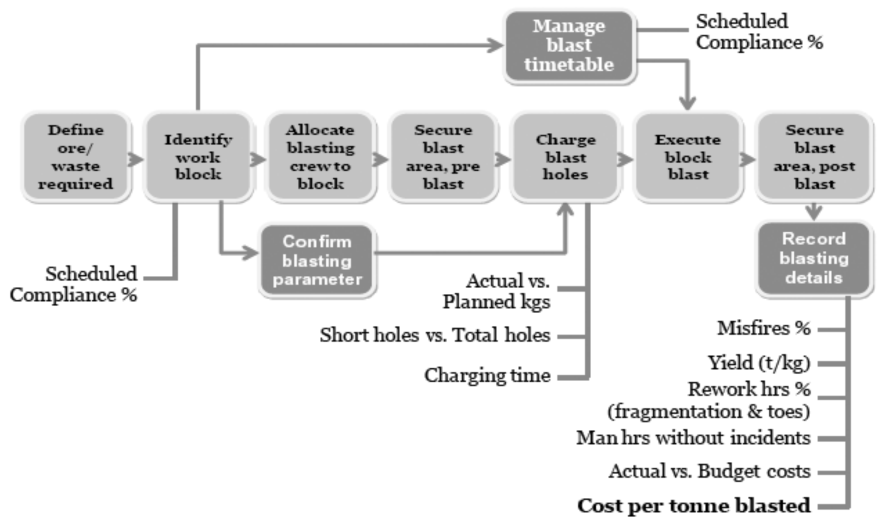
Activity - Production planning



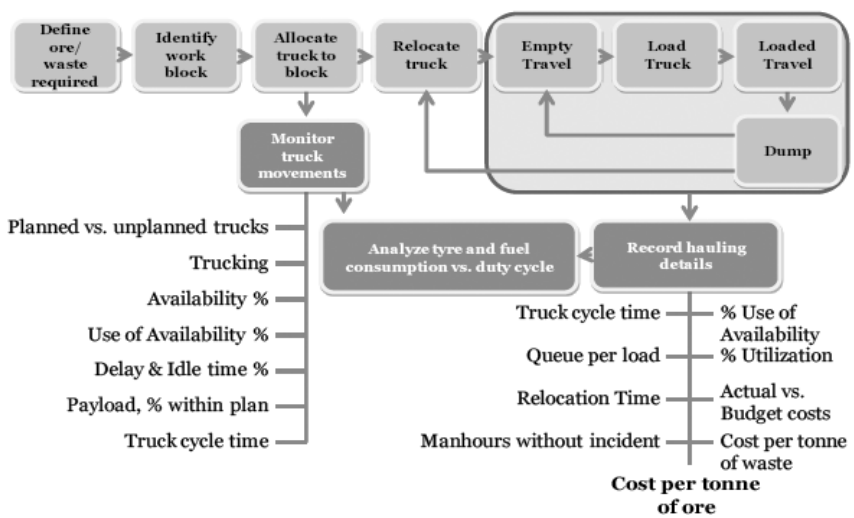
Activity - Blasthole drilling



Activity - Blasting



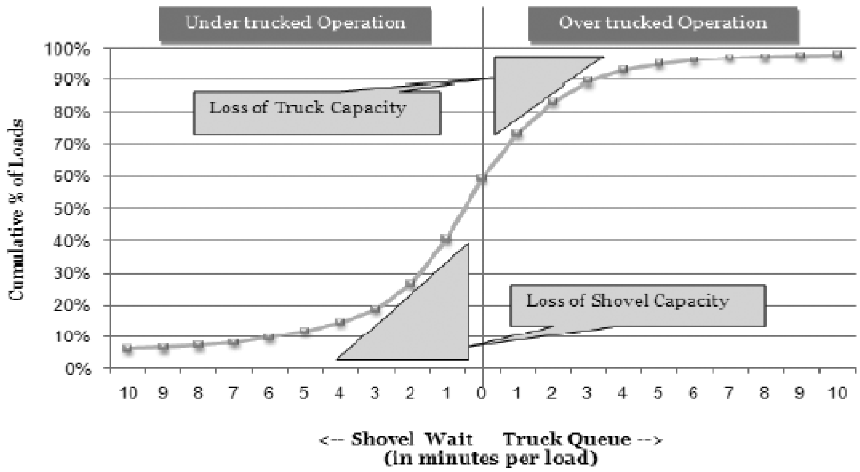
Activity - Hauling



Variance Analysis

3.32 Variance analysis is a process of comparing performance against a benchmark or optimum level. Each equipment or process is expected to operate at targeted/ benchmark level. Variance analysis is aimed to identify the gaps between the target and actual level of operation which in turn reflects the scope of improvement. During the monitoring of operations, large data is recorded (e.g., hourly, shift wise, daily, weekly, monthly, etc.). This data is analyzed to arrive at the deviation from the benchmark or targeted level.

3.33 An example of trucking analysis in shovel truck operation based on cycle time data collected at a mining operation is shown in figure below:

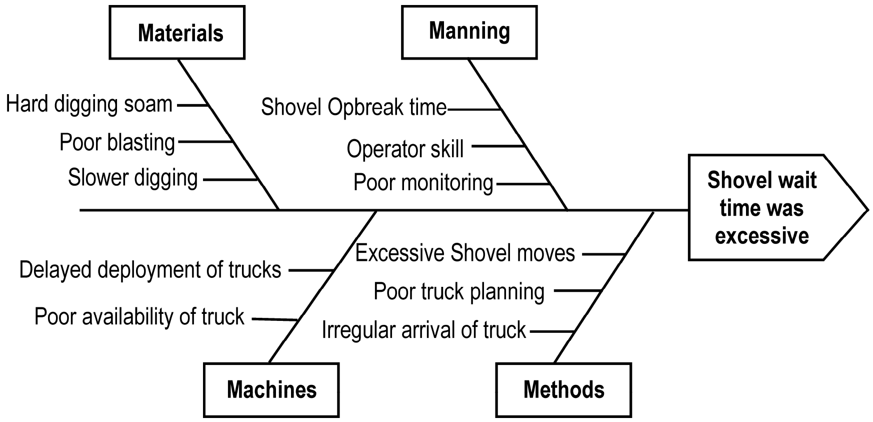


Trucking Analysis in Shovel Truck Operation

The above analysis shows that about 60% time shovels were waiting for trucks. In any shovel-truck operation there will be some amount of shovel wait and truck queue due to randomness and dynamic nature of operation. However, proper resource matching, monitoring and control can reduce the losses during operation.

3.34 In case of mismatch (below benchmark level), it is possible to conduct root cause analysis from the data generated and/or recorded.

For example, the following figure shows the root cause analysis of the loading capacity loss in the trucking analysis.



Quality Management Process

3.35 The quality and the characteristics of the coal/mineral delivered should meet the required quality parameters. For example, in coal the parameters for assessing the quality are calorific value, moisture, ash, volatile matter, sulfur content, etc. In addition to the chemical composition, the size of the material delivered is also an important aspect of quality.

3.36 For analysis of the quality, there is provision for sampling systems at various key points where material is kept/ stored (like, stockpile, delivery point, railway siding, etc.). The sampling may be performed manually or using automated sampling systems. The sampling is done in accordance with the standard sampling procedures such as Bureau of Indian Standards as this helps in ensuring proper and uniform sampling. The frequency of the sampling is pre-determined. All samples are tested and analyzed at the delivery point (or any other point as decided) laboratory manned by any certified agency. The arrangement is done to send the samples collected from the online automatic mechanical sampler or manually, under proper seal and security to the laboratory as soon as possible after the sampling. Generally, the detailed procedure for the analysis is agreed prior to the start of the production. The collected samples are divided into two splits - one split is analyzed by the laboratory for the purpose of providing the daily composite specification certificate and the second split of each sample is sealed and placed in a suitable air tight container, properly marked so as to provide unquestionable identification and retained by the laboratory for some fixed days unless a dispute has been raised. If any dispute arises regarding the results of the testing of the first split, the second split can be tested.

3.37 If the mining company is supplying material to another party it is better to have the representatives from all the involved parties to witness the sampling for transparency purpose. Generally, it has been observed that there are penalty provisions if the supplied material is of inferior quality than required. In such cases the control on quality is more important as inferior quality may have significant financial impact also. For ensuring more control over quality, the foreign material detectors (like, metal detectors in coal) may be installed for segregating the impurities.

Chapter 4
Overview of Policies and Regulations

Existing Policies and Regulations

Constitutional Mandate and Regulatory Framework

4.1 The Constitution allocates the subject of mineral development and regulation to state governments (entry number 23, State list (List II) of Seventh Schedule) subject to the law of Parliament (entry number 54, Union List (list I) of Seventh Schedule). The role of Union Government is limited by the boundaries set by such law, which in this case is The Mines and Minerals (Regulation and Development) Act, 1957 and rules and regulations framed thereunder. As mandated by The Mines and Minerals (Regulation and Development) Act, 1957, the Union Government has framed rules for regulating grant of mineral in respect of all minerals other than atomic minerals and minor minerals. The State Governments have framed the rules for minor minerals. The Ministry of Mines, Government of India administers the The Mines and Minerals (Regulation and Development) Act, 1957 in India.

4.2 Further, Constitution allocates the subject of development and regulation of mineral resources in the territorial waters, continental shelf, exclusive economic zone and other maritime zones of India to the Union Government. The Union Government, through Ministry of Mines, exercises this right through The Offshore Areas Mineral (Development & Regulation), Act, 2002. The Ministry of Coal, under Union Government, administers rules and regulation including the Coking Coal Mines (Nationalisation) Act, 1972 and the Coal Mines (Nationalisation) Act, 1973, for development of coal resources in the country. Department of Atomic Energy, under Union Government looks after the development and regulation of atomic mineral resources through The Atomic Energy Act, 1962.

4.3 The Constitution allocates the subject of regulation of labour and safety in mines to the Union Government (entry number 55, Union List (list I) of Seventh Schedule). The Union Government, through Ministry of Labour and Employment, exercises this right through Mines Act, 1952 and rules and regulation framed there under. Administration of environment and forestry issues through various acts including the Air Act, Water Act and Forest Conservation Act, etc. are carried out by both Union and State government.

4.4 The Mines and Minerals (Regulation and Development) Act, 1957 had already been amended several times and as further amendments may not clearly reflect the objects and reasons emanating from the new National Mineral Policy, it is considered necessary to reformulate the legislative framework in the light of the new National Mineral Policy, 2008 by repealing the Mines and Minerals (Regulation and Development) Act, 1957. The salient features of the Mines and Minerals (Development and Regulation) Bill, 2011, *inter alia,* are as follows:

(a) it provides for a simple and transparent mechanism for grant of mining lease or prospecting licence through competitive bidding in areas of known mineralization, and on the basis of first-in-time in areas where mineralization is not known;

(b) it enables the mining holders to adopt the advanced and sophisticated technologies for exploration of deep-seated and concealed mineral deposits, especially of metals in short supply through a new mineral concession;

(c) it enables the Central Government to promote scientific mineral development, through Mining Plans and Mine Closure Plans enforced by a central technical agency namely the Indian Bureau of Mines, as well as the Regulatory Authorities and Tribunals;

(d) it empowers the State Governments to cancel the existing concessions or debar a person from obtaining concession in future for preventing the illegal and irregular mining;

(e) it empowers the Central Government and State Governments to levy and collect cess;

(f) establishment of the Mineral Funds at National and State level for funding the activities pertaining to capacity building of regulatory bodies like Indian Bureau of Mines and for research and development issues in the mining areas;

(g) it provides for reservation of an area for the purpose of conservation of minerals;

(h) it enables the registered co-operatives for obtaining mineral concessions on small deposits in order to encourage tribals and small miners to enter into mining activities;

(i) it empowers the Central Government to institutionalise a statutory mechanism for ensuring sustainable mining with adequate concerns for environment and socio economic issues in the mining areas, through a National Sustainable Development Framework;

(j) it provides for establishment of the National Mining Regulatory Authority which consists of a Chairperson and not more than nine members to advise the Government on rates of royalty, dead rent, benefit sharing with District Mineral Foundation, quality standards, and also conduct investigation and launch prosecution in cases of large scale illegal mining;

(k) it provides for establishment of the State Mining Regulatory Authority consisting of such persons as may be prescribed by the State Government to exercise the powers and functions in respect of minor minerals;

(l) it provides for establishment of a National Mining Tribunal and State Mining Tribunals to exercise jurisdiction, powers and authority conferred on it under the proposed legislation;

(m) it empowers the State Governments to constitute Special Courts for the purpose of providing speedy trial of the offences relating to illegal mining;

(n) it empowers the Central Government to intervene in the cases of illegal mining where the concerned State Government fails to take action against illegal mining;

(o) it provides for stringent punishments for contravention of certain provisions of the proposed legislation; and

(p) to repeal the Mines and Minerals (Development and Regulation) Act, 1957.

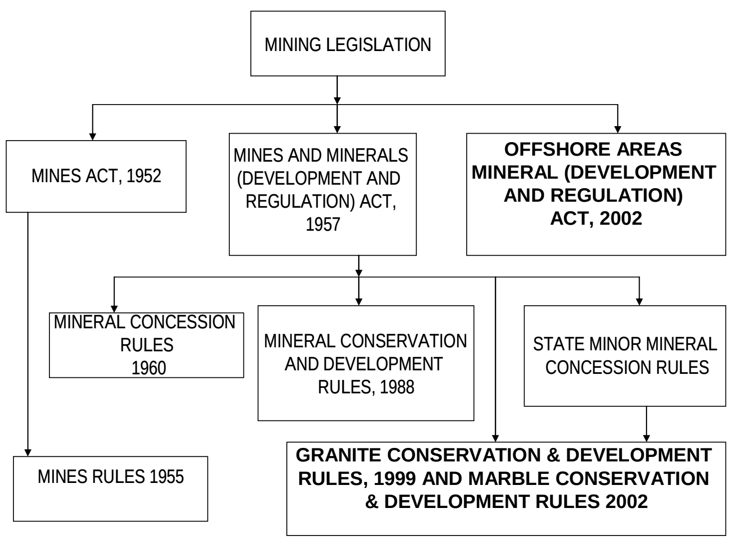
List of Central Acts and Rules, Regulations and Policies

4.5 The Mines and Minerals (Development & Regulation) Act, 1957, (‘MMDR’) and the Mines Act, 1952, together with the rules and regulations framed under them constitute the basic laws governing the mining sector on land in India. For territorial waters, continental shelf, exclusive economic zone and other maritime zones of India, the Offshore Areas Mineral

(Development and Regulation) Act, 2002 has been enacted and is effective with effect from 31st January, 2003.

The relevant rules in force under the MMDR Act, are the Mineral Concession Rules, 1960, the Mineral Conservation and Development Rules, 1988, Granite Conservation and Development Rules, 1999 and Marble Development and Conservation Rules, 2002. The health and safety of the workers is governed by the Mines Rules, 1955, framed under the Mines Act, 1952.

The Mineral Concession Rules, 1960 outline the procedures and conditions for obtaining a Reconnaissance Permit or a Prospecting Licence or a Mining Lease, for all minerals other than petroleum and natural gas and also other than those minerals notified as `minor' minerals. The Mineral Conservation and Development Rules, 1988 lay down the guidelines for ensuring mining on a scientific basis, while at the same time, conserving the environment. The provisions of Mineral Conservation and Development Rules are, however, not applicable to coal, atomic minerals and minor minerals. The State Governments have powers to formulate the Minor Mineral Concession Rules and grant mineral concessions for such minerals under such rules.



4.6 Important Acts, rules and regulations for Atomic Minerals are as follows:

(i) Atomic Energy Act, 1962

(ii) Atomic Energy (Radiation and Protection) Rules, 2004.

4.7 Important policies are as follows:

(i). National Mineral Policy, 2008

(ii) New Coal Distribution Policy, 2007

(iii) National Steel Policy, 2005

4.8 Some other enactments are as follows:

(i) Marble Development and Conservative Rules, 2002

(ii) Mining Leases (Modification of Terms) Rules, 1956

(iii) Mines Rescue Rules, 1985

(iv) Goa, Daman and Diu Mining Concessions (Abolition and Declaration as Mining Leases) Act, 1987

(v) CESS and other Taxes on Minerals (Validation) Act, 1992

4.9 Other Acts, Rules, Regulations and Policies are as follows:

(i) Some Environmental Acts applicable to mining projects are as follows:

- (a) The Environment (Protection) Act, 1986
- (b) The Air (Prevention and Control of Pollution) Act, 1981
- (c) The Water (Prevention and Control of Pollution) Act, 1974
- (d) National Green Tribunal Act, 2010
- (e) The Indian Forest Act, 1927
- (f) The Forest (Conservation) Act, 1980
- (g) The Wild Life (Protection) Act, 1972
- (h) The Public Liability Insurance Act, 1991

(ii) Contract Labour (Regulation & Abolition) Act, 1970 is applicable for employment of contract labour in mining projects.

The Mines and Minerals (Development and Regulation) Act, 1957

4.10 The Mines and Minerals (Development and Regulation) Act, 1957 provides for the regulation of mines and the development of minerals under the control of the Union. This Act provides that no person shall undertake any reconnaissance, prospecting or mining operations in any area, except under and in accordance with the terms and conditions of reconnaissance permit or of a prospecting licence or, as the case may be, a mining lease, granted under this Act and the rules made thereunder.

Further, it provides that any State Government may, after prior consultation with the Central Government and in accordance with the Rules under Section 18,undertake reconnaissance, prospecting or mining operations with respect to any mineral specified in the First Schedule in any area within that State which is not already held under any reconnaissance permit, prospecting licence or mining lease.

4.11 Section 4A of the Act provides that "Where the Central Government, after consultation with the State Government, is of opinion that it is expedient in the interest of Regulation of Mines and Mineral Development, Preservation of natural environment, control of floods, prevention of pollution or to avoid danger to public health or communications or to ensure safety of buildings, monuments or other structures or for conservation of mineral resources or for maintaining safety in the mines or for such other purposes, as the Central Government may deem fit, it may request the State Government to make a premature termination of prospecting licence or mining lease in respect of any mineral other than a minor mineral in any area or part thereof, and, on receipt of such request, the State Government shall make an order making a premature termination of such prospecting licence or mining lease with respect to the area or any part thereof."

The Mines Act, 1952

4.12 The Mines Act, 1952 amends and consolidates the law relating to the regulation of labour and safety in mines. It lays down that every mine should make effective provisions for drinking water, conservancy, medical appliance, etc. It requires that in every mine there shall be arrangements for the conveyance to hospitals or dispensaries of persons who, while employed in the mine suffer bodily injury or become ill. It also prescribes rules for weekly day of rest and compensatory days of rest for persons working in mines. Further, it limits the hours of work below ground to forty eight hours in any week or for more than eight hours in any day.

The Offshore Areas Mineral (Development and Regulation) Act, 2002

4.13 The Offshore Areas Mineral (Development and Regulation) Act, 2002 provides for development and regulation of mineral resources in the territorial waters, continental shelf, exclusive economic zone and other maritime zones of India and provides for matters connected therewith or incidental thereto. The Act shall apply to all minerals in the offshore areas including any minerals prescribed under the Atomic Energy Act, 1962 except mineral oils and hydrocarbons related thereto.

The Coal Mines (Nationalisation) Act, 1973

4.14 The Coal Mines (Nationalisation) Act, 1973 provides for the acquisition and transfer of the right, title and interest of the owners in respect of the coal mines specified in the Schedule with a view to re- organising and reconstructing such coal mines so as to ensure the rational, co- ordinated and scientific development and utilisation of coal resources consistent with the growing requirements of the country, in order that the ownership and control of such resources are vested in the State and thereby so distributed as best to subserve the common good, and for matters connected therewith or incidental thereto.

Coal Mine (Nationalisation) Act (CMNA) 1973

4.15 CMNA recognises that all the coal resources within India belong to Union Government.

Eligibility for Unrestricted Coal Mining

The eligibility to undertake coal mining in the country has been laid down in Section 3 (3) of the Coal Mines (Nationalisation) Act, 1973. As per the provisions of the Act, the parties eligible to undertake coal mining in India without the restriction for captive consumption are:

(a) The Central Government, a Government Company (including a State Government Company), a Corporation owned, managed and controlled by the Central Government.

(b) A person to whom a sub-lease has been granted by the Government or a company/corporation having a coal mining lease where the coal reserves covered from the sub-lease are in isolated small pockets or are

(c) not sufficient for scientific and economic development in a coordinated manner and the coal produced will not be required to be transported by rail.

Default Lessee

(a) Coal India Limited (CIL), Singareni Collieries Company Limited (SCCL) and Neyveli Lignite Corporation (NLC) enjoy the status of central agencies for coal mining.

(b) Subsidiaries of CIL have statuary rights for mining of coal which falls within the areas of respective subsidiaries.

(c) SCCL have mining rights for coal mining in Godavari Valley coalfields (State of Andhra Pradesh).

(d) NLC have mining rights for lignite mining in India.

Provisions for Captive Coal Mining in India

4.16 Under the provisions of Section 3 (3) (a) (iii) of the Coal Mines (Nationalisation) Act, 1973, a Private Company engaged in the following activities is allowed to undertake coal mining operations for captive consumption:

(a) Production of iron and steel

(b) Generation of power

(c) Washing of coal obtained from a mine

(d) Cement manufacturing

(e) Surface and Underground Coal Gasification and Coal-to-Liquids conversion

(f) Such other end use as the Central Government may by notification, specify.

Definition of "Captive" was enhanced in 2006 and any company with a firm supply agreement with approved end-users is allowed to undertake coal mining operations.

List of Important Stakeholders having significant Impact on Mining Sector

4.17 List of important stakeholders having significant impact on mining sector are as follows:

I. Ministry of Mines

II. Ministry of Coal

III. Department of Atomic Energy

IV. Central Ministry for Tribal Welfare

V. Ministry of Environment and Forest

VI. Ministry of Labor and Employment

Chapter 5
Internal Audit – Concepts

Internal Audit – Definition

5.1 The definition of internal audit as per the "*Preface to the Standards on Internal Audit*" issued by the Institute of Chartered Accountants of India is as follows:

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

Thus, internal audit activity can play an important role and support the board and management in fulfilling an essential component of their governance mechanism. The internal auditor furnishes analysis, appraisals, recommendations, counsel and information concerning the activities reviewed. The internal auditor can suggest ways for reducing costs, enhancing revenues, and improving profits.

5.2 Key features identified on the basis the above definition of internal audit are as follows:

- Internal auditor should be independent in the performance of his duties, so that he can carry out his work freely without admitting interference, and as objectively as possible. Independence permits him to render impartial and unbiased judgements, which are essential to the proper evaluation of management and controls. It also allows internal auditor to view the financial actions, procedures and decisions in an independent way.
- 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.
- Role of internal audit is continuously changing and it differs from organization to organization. Internal audit aims at meeting the need of the organization.

- An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organization through ethical and effective governance.
- Risk management relates to how an organization sets objectives, then identifies, analyzes, and responds to those risks that could potentially impact its ability to realize its objectives. Internal audit plays an important role in assisting organization to evaluate the effectiveness of risk management.
- Internal auditing activity is primarily directed at improving internal control. Internal audit is performed to review and evaluate whether the internal controls are designed and operating effectively and provide recommendations for improvement

Internal Audit – Objectives

5.3 The overall objective of an internal audit, as defined in the Preface to the Standards on Internal Audit are:

- to suggest improvements to the functioning of the entity; and
- to strengthen the overall governance mechanism of the entity, including its strategic risk management as well as internal control system.

Internal audit *inter alia* helps:

- To understand and assess the risks and evaluate the adequacies of the prevalent internal controls.
- To review and ascertain availability and compliance with policies and procedures of the various processes involved (that compliance activities have been properly planned, organized and directed).
- To review operations or programs for consistency with established management goals and objectives.
- To ascertain compliance with applicable legal laws, and regulations (that compliance activities have been properly planned, organized and directed).
- To determine if assets are safeguarded and verify the existence of those assets (that activities associated with asset acquisition,

recording, storage, use and disposal have been properly planned, organized and directed).

- To determine resources are used efficiently and economically (i.e., that the organization is doing things the best way) utilised. The objective then, is to determine whether operating standards have been established for measuring economy and efficiency, whether deviations from operating standards are identified, analyzed and communicated to those responsible for corrective action, and whether effective corrective action has been taken.
- To determine the adequacy of information systems security and control.
- To review and ensure adequacy, reliability, accuracy and timeliness of financial and management information systems.
- To determine whether operational problems are identified and reported for correction.
- Identify areas for systems improvement and strengthening controls.

Internal Control – Definition

5.4 Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations
- reliability of financial reporting
- compliance with applicable laws and regulations.

5.5 Standard on Internal Audit (SIA) 12, "*Internal Control Evaluation*" defines internal control as a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

Internal Audit Team

5.6 With increased expectation of the audit committee and the management requiring internal auditors not only to provide reasonable assurance on organizational governance, as well as to meet ever increasing demands of management and other stakeholders, internal auditor must excel as internal to ensure that the controls over key systems and business processes are robust and effective.

5.7 The skill set, depth of knowledge and size of the audit team should be determined by the nature/ scope of services expected by the audit committee and management in order to meet organizational needs. Audit activity should comprise individuals with diverse backgrounds, skill sets and experience to provide adequate control review to support the business on a broad range of risk and internal control matters. Increasingly internal audit activities are performed by multi-disciplinary teams that include engineers, accountants, management graduates, environmental specialist, and information technology audit experts and so on.

A sufficient number of individual possessing the requisite degree of proficiency in the relevant disciplines is a major determinant of the effectiveness with which an internal audit of mining sector is performed.

Legal Requirements for Conducting Internal Audit

5.8 Earlier, internal audit was largely voluntary and management used to appoint internal auditors as and when they felt the need. However, now with increased complexities in business, frauds and scams internal audit has become essential for most organisations. Internal Audit has now gained so much importance that conducting internal audit has been made mandatory by regulators for listed and other specified companies.

5.9. The following are the legal and regulatory requirements with regard to carrying out internal audit and to establish an effective internal control system in an organization:

(i) The Companies (Auditor's Report) Order, 2003 (CARO)

Clause 4(vii) – In the case of listed companies and/or other companies having paid-up capital and reserves exceeding ₹ 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business"

Clause 4(iv) - "Is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services? Whether there is a continuing failure to correct major weaknesses in internal control system."

(ii) Requirements of Clause 49 of the Listing Agreement

Few important requirements worth mentioning included in the provisions of Clause 49 of the Listing Agreement defined by The Securities and Exchange Board of India (SEBI) and applicable to listed entities are as below:

(a) Review by Audit Committee

The Audit Committee is required to review:

- With management the adequacy of internal control systems;
- The adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit including the appointment, removal and terms of remuneration of the Chief Internal Auditor;
- Discussion with internal auditors on any significant findings and follow up there on;
- Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or

a failure of internal control systems of a material nature and reporting the matter to the board;

- The finding of any internal investigations by the internal auditors into matters where there is a suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board;
- Internal audit reports relating to internal control weaknesses.

(b) Certification by CEO & CFO

The CEO & CFO shall certify to the Board that:

- They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- They have indicated to the auditors and the Audit committee;
- Significant changes in internal control during the year;
- Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

(iii) Others

- Section 292A of the Companies Act, 1956, requires public companies having paid up capital not less than Rs. 5 crores to constitute a committee of the Board, i.e., the Audit Committee. In terms of sub section 5 of the said Section, the internal auditor is required to attend and participate at the meetings of such Audit Committees.
- The Securities and Exchange Board of India has mandated complete internal audit on a half-yearly basis for stock brokers/ trading members/ clearing members.
- Companies those seeking listing in US stock exchanges, NASDAQ, NYSE, etc., need a strong internal audit function to meet the stringent

corporate governance and internal control requirements of those stock exchanges.

Standards on Internal Audit

5.10 Internal Audit Standards Board (IASB)[3] of ICAI was formed in 2004 with one of the primary objective to review the existing internal audit practices in India and to develop Standards on Internal Audit (SIAs). The SIAs 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. The SIAs are issued under the authority of the Council of the Institute.

While formulating the SIAs, the Board will take into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India. The Board may also, where it considers appropriate, take into consideration the international practices in the area of internal audit, to the extent they are relevant to the conditions existing in India. Preface to the Standards on Internal Audit also lays down the detailed scope and procedure for issuance of SIAs.

5.11 The Board has till date issued seventeen SIAs covering various important aspects of an internal audit activity including planning, gathering evidence, documentation, sampling, using the work of other experts, evaluating internal controls and risk management systems, reporting and assuring quality.

List of Standards of Internal Audit issued by the Internal Audit Standard Board:

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

[3] Earlier known as Committee on 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

Stages in Internal Audit

Audit Planning

5.12 The internal plan should be consistent with the goals and objectives of the internal audit function as listed in the internal audit charter and the overall organisational goals and objectives. The internal audit charter defines the purpose, roles and responsibilities and authority of the internal auditors.

In case the internal audit activity is outsourced, the internal auditor should ensure that the plan is consistent with terms of the letter of engagement.

5.13 At the onset of the internal audit activity, it is important to formulate the risk based audit plan. Every company that is in business has to take risks. Risks are those unforeseen situations the outcome of which may have an adverse affect on achievement of the organisationals goals and objectives. Hence, it is important that internal audit focuses on areas which are critical to organisational goals and objectives. Risk assessment helps internal auditor to identify those focus areas. Risk assessment activity includes identification of risk and its evaluation in terms of risk appetite and impact on organisational objectives. Weights and ranks based on criteria which will form the basis of ranking the audit areas to finally arrive at the score and shortlist the auditable areas. The role of internal auditor in the risk assessment activity will vary from organisation to organisation.

5.14 On completion of risk assessment activity and identification of audit areas, detailed audit plan is prepared. Key elements and components of audit plan are as follows:

- The audit plan should describe the coverage or the details of work to be performed in each auditable area.
- Internal audit plan should also reflect the time and cost budget allocated by management.
- The coverage of the areas should be aligned and fit into the budget assigned.
- The audit schedule should be included in the audit plan. Audit schedule would also depend on the management and audit committee perception and priortisation of the areas.
- Audit plan should also demonstrate the audit objectives.
- Audit team and the resource allocation should also be included in the audit plan. Resource allocation should take into consideration the skills set required, involvement of specialists, resource availability.
- Tentative start and completion dates.
- Audit plan should be reviewed periodically.

Annual audit plan for an organization should be approved by the audit committee.

Field Work

5.15 Internal audit process would include the following:

(i) Preliminary Understanding

Prior to start of audit and opening meeting with the process owners, it is important to gain an initial understand of the area to be audited, the potential risks and objectives. Typically the internal audit team should consider:

(a) Organisation structure

(b) Company's financials

(c) Existing internal control process documentation

(d) Previous year's internal audit reports

(e) Policies and procedures documented for the processes covered under audit

(f) Applicable legal laws and regulations.

(ii) Initial Meeting

The objective of the initial meeting is to develop an effective approach for the assignment by discussing and getting an agreement on the following:

(a) Scope of review

(b) Process owners expectations

(c) Identification and availability of process owners

(d) Coordinate timing and milestones

(e) Roles and responsibilities

(f) Internal auditor should take this opportunity to get an insight on the systems and processes and its risks and objectives, and identify the areas of concerns and special focus that should be addressed.

(iii) Audit Programme

On the basis of scope of review and the information and understanding gathered, a detailed audit programme is prepared. At this time, the audit programme should be prepared considering the proposed procedures, checkpoints, budgeting and basis for controlling the audit. A well defined audit programme ensures focused approach, prevents the auditor from going off the scope and ensures completion of audit in an efficient and effective manner.

The audit programme may be updated during the course of audit in cases required.

(iv) Internal Control Design Review

The internal auditor will review the internal control structure to assess the design of internal control. At this stage the internal audit team, the system or processes to understand the flow of transactions. In order to complete the control design review effectively, it is important to consider the following:

(a) The objective of the proces / systems;

(b) Key stages in the process or system;

(c) Risks that may prevent achievement of process or system objectives;

(d) Control defined and implemented to manage the risks;

(e) The auditor may use various tools and techniques to complete the system or process review. The stage helps auditor to identify high risks and the control designs which need to be evaluated for effectiveness and efficiency.

(v) Transaction Testing

Transaction testing involves testing of controls to assess their operating effectiveness. Operating effectiveness means that the controls are consistently operating the way it has been designed and intended to operate. During this stage we obtain audit evidence as to whether the controls are operating effectively or ineffectively. There are various testing techniques which either individually or in combination may be used to obtain audit evidence.

While doing transaction testing, it may not be possible and also not required to perform the audit procedures on the entire population (i.e., all the transactions which were undertaken), hence, sampling is required. Sampling means performing the audit procedures to less than 100% of the population. Internal auditor needs a consistent approach to draw a sample from the population and draw a conclusion based on the sample. Sampling becomes extremely critical as it should represent the entire population. Again, there are various methods of sampling. The manner in which the population is filed or distributed will determine the kind of selection techniques to be used to select the sample.

(vi) Observation Finalization and Closing Meeting

On completion of review of design of controls and the transaction testing, the team should start finalising the observations noted. It is important that the issues noted should be discussed with the process owners and the management on an ongoing basis to obtain initial confirmation on the factual accuracy of the data. However, a formal discussion and agreement on the observations with the management, generally, happens at the completion of testing.

During the closing meeting the audit team should obtain management agreement on the issues and findings and the remediation plan to address the control gaps. The remediation plan should include the actions to be taken by management, a timeline to implement the actions and the individual responsible for implementation.

(vi) Reporting

The preparation and issuance of internal audit report is one of the most important stage of the entire internal audit process as this the means by which the auditor's work is communicated to management. It is a formal document summarizing the work done and reports the findings and recommendations. The internal audit report contains a clear and concise written expression of audit findings, recommendations based on the policies, procedures, risks, controls and transaction testing taken as a whole alongwith management responses.

The internal audit report generally contains the following:

(a) Report title

(b) Distribution List

(c) A brief background on the area audited, its scope, objectives and review period

(d) Brief overview of the audit area

(e) Summary of population and sample

(f) Summary of critical observations which highlight the critical observations, control weakness and exceptions

(g) Detailed finding and observations

(h) Implication and risk rating

(i) Recommendations/ suggestions

(j) Management responses

(k) Place of signature

(l) Report date

(m) Risk rating matrix

The format of the report will vary from organization to organization. However the basic and important content of the report will remain the same as indicated above.

The audit report must be written in a neutral tone and flawless in its accuracy, logic, clarity, grammar and spelling.

During the audit, initially a draft report is prepared for final management responses and confirmation on audit issues and its recommendations. On receipt of the management confirmation, the final report is issued. The final report is generally issued in print form and addressed to the agreed authority.

(vii) Audit Documentation

Audit documentation refers to the working papers prepared or obtained by the internal auditor and retained by him in connection with the performance of internal audit. The internal auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the Standards on Internal Audit, scope agreed with management and support his findings or the report submitted by him. In addition, the working papers also help in planning and performing the internal audit, review and supervise the work and most importantly, provide evidence of the work performed to support his findings or report.

At the end of the assignment, the internal auditor should finalise the audit programme and the related working papers which can be both in electronic form and paper files.

(viii) Audit Committee Presentation

In addition to the distribution discussed earlier, the contents of the audit report, client response, and follow-up report may also be communicated and presented to the Audit Committee periodically. The audit committee presentation should contain the status of audit plan and its current status, budgets and its current status alongwith the critical audit issues.

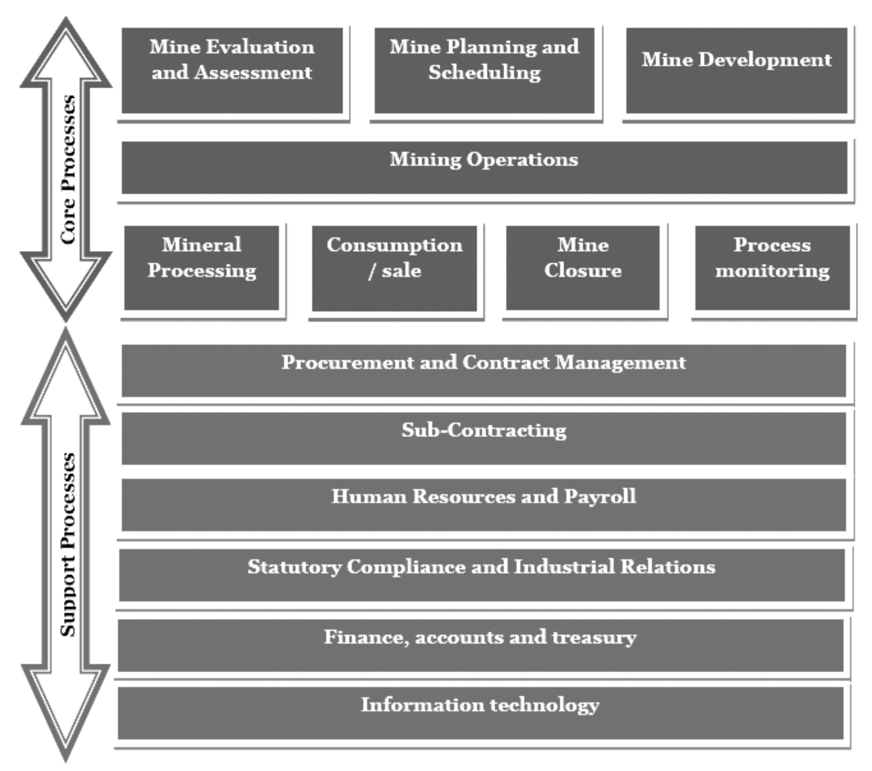
(ix) Follow up Audit

Generally, the follow up audit is undertaken after a year of issue of final report to give substantial time to management for implementation. As a part of follow up audit, initially the management responses should be obtained with regard to the action taken and implementation status of the audit observations. There could be situations wherein no action has been taken by management as agreed in the final report. The review will be carried out only where management has listed down actions taken for resolving the issue. All the observations alongwith unresolved issues will be reported as a part of follow up audit report. The similar cycle of discussion, closing meeting and report finalization will be followed during this stage. The follow up audit report will be issued to the original addressees and any other official, if deemed necessary.

Chapter 6
Relevance and Role of Internal Audit in Mining Industry

6.1 A generic process framework comprising of the core mining processes and the relevant support processes is depicted below. The key focus areas for internal audit in each of the processes, as depicted in the framework, have been detailed later in the document.

Core processes are integral part of a mining company and outline the broad areas of operation for a mining company. Support processes enable functioning of the core processes by aligning their objective and functioning with the primary objective of the core processes. Although, these support processes are common across various industries, certain key factors specific to the mining operations have been enumerated in detail for better understanding.



Mine Evaluation and Assessment

6.2 The key focus areas for internal audit in mine evaluation and assessment are as follows:

- Standardization of factors and processes to ensure completeness of the factors on which the evaluation and assessment is carried out:
  - (a) Geological factors;
  - (b) Technical factors;
  - (c) Social and Political factors;
  - (d) Environmental factors;
  - (e) Regulatory aspects;
  - (f) Economic factors, etc.
- Quantity considered in resource estimation (available quantity, recoverable quantity or additional quantity remaining in place).
- Assumptions made during the evaluation and assessment process and documentation of the same for future monitoring and tracking purposes.
- Team composition formed for mining, ensuring skills sets related to the factors to be assessed.
- Checklist for ensuring completeness of information to be gathered for effective decision making.
- Timeline for conducting the assessment and the validity of the assessment carried out.
- Documentation and approval of the assessment carried out.
- Mineral content at various places of the mine to assist during the mine planning and scheduling process.
- Commercial and operational implications of the technique of mining feasible, Open cast/ underground, depending upon the mine modeling and the ore body.
- Evaluation of logistics infrastructure and cost for ore transportation within the mine and sale to external customers/ captive consumption (access to ports, railways, etc).

- Formal risk assessment document to assess and document the risk envisaged and the possible mitigants proposed.
- Capital investment estimation and revenue estimations made and the key assumptions made in the same.
- Impact of rehabilitation and possible issues in the same.

Mine Planning and Scheduling

6.3 The Key focus areas for mine planning and scheduling audit are as follows:

- Linkage of the assumptions made during the evaluation and assessment stage with the mine plan and schedule.
- Planning technique and template used.
- Adequacy of critical components of the mine plan:
  - (a) Mining layout and topography;
  - (b) Mining technique;
  - (c) Mechanization and equipments required;
  - (d) Manpower requirement and planning (skilled and unskilled);
  - (e) Environmental management plan.
- Approval and documentation of the mine plan and communication to the relevant stakeholders.
- Existence of adequate mining licenses and lease agreements.

Mine Development

6.4 The key focus areas related to mine development are as follows:

- Template and components of a mine development plan:
  - (a) Surface layout, shaft planning and designing;
  - (b) Transportation, stowing, storage and disposal plan;
  - (c) Waste management plan;
  - (d) Grade control and segregation;
  - (e) Preventive maintenance;
  - (f) Mineral processing plan and infrastructure;

(g) Mine evacuation plan;

(h) Electricity and water;

(i) Ventilation and pumping (for underground mine).

- Approval and documentation of the development plan and communication to the relevant stakeholders.

Mining Operations

6.5 Mining operations include the following:

- Site Preparation
- Drilling and Blasting
- Excavation, Loading and Hauling
- Stockpile management
- Equipment maintenance process
- Environment, health and safety requirements

6.6 The key focus areas for internal auditor in mening operations are as follows:

- Site Preparation
  - Comparison of budget vs actual for the site preparation activity (time and cost)
  - Handling and disposal of debris, considering the environment norms
  - Consideration of afforestation norms
  - Basis of defining and checking adherence to the leveling norms.
- Drilling and Blasting
  - Existence and approval of a drilling and blasting plan
  - Physical custody and access controls over stock of explosives
  - Consumption records of explosives and reporting as per the regulatory requirements, wherever applicable
  - Equipment utilization analysis
  - Equipment breakdown analysis
  - Replacements/ repair of drilling machines

- Safety protocols prior to and during the blasting process
- Consumables utilization and record maintenance
- Manpower utilization and record maintenance
- Sand consumption for restoration post blasting/ drilling, wherever required
- Fuel and electricity consumption during the drilling process
- Adherence to drilling plan.

- Excavation, Loading and Hauling
    - Type and technique of excavation – plan and approval
    - Excavation efficiency analysis – time and cost
    - Pre-excavation risk assessment and the engineer's report are in place
    - Safety training and protocols during the excavation process
    - Analysis of under cutting/ over cutting
    - Signage and security for access restriction at the excavation site
    - Testing and calibration of weight sensors on the conveyor belt used while loading
    - Availability of haulage equipment (loaders, dumpers, etc)
    - Transit losses during haulage and tolerance definition
    - Calibration of the distance reading and fuel consumption reading meters in the haulage equipment
    - Vehicle fitness test and documentation
    - Vehicle capacity planning and route analysis
    - Haulage delay and penalty, in case of outsourced service provider
    - Selection parameters for outsourced haulage equipment provider
    - Existence and maintenance of weigh bridge at the mining site
    - Existence and adherence to the weighment procedure
    - Analysis of the difference in tare weight of same/ similar vehicles

- Controls over automated recording of tare and gross weight and time difference between the tare weight and gross weight
- Loading/ unloading time taken analysis
- Calibration of the weighbridge and records maintenance
- Commercial implications of lease vs buy for the equipments utilized in the process
- Equipment utilization analysis
- Fuel utilization analysis
- Analysis of additional cost of transporting the overburden – link to strip ratio and excavation technique employed
- % of revenue generating ore and overburden during excavation

• Stockpile Management

  - Technique of stocking employed – heap clearance of ore to ensure grade wise classification/ segregation
  - Heap wise record maintenance and updation
  - Heap stacking, height norms
  - Receipt through mother heap and issue through child heaps
  - Standard weights for the child heaps
  - Verification of the stockpile on a periodic basis by an independent surveyor
  - Assumptions considered by the surveyor in the stockpile assessment and basis of assessment – volumetric, eye estimation, etc
  - Sampling of the material lying in various heaps for testing the quality of the ore
  - Layout and design for stockpile management ensuring optimum utilization of the area and maintaining easy accessibility for movement of materials
  - Storage conditions - Open storage / covered storage, weather protection, access controls, safety for hazardous material storage, etc

  - Stock reconciliation: (quality and quantity)
    - o Grade wise
    - o Metal content wise
    - o Heap wise
  - Grade wise and metal content wise record maintenance, recording the accounting/ operational system.

- Equipment Maintenance
  - Existence of a preventive maintenance plan for all the equipments (loaders, haulers, excavators, drilling machines, PPE, hopper wagons, etc)
  - Maintenance budget vs actual
  - Periodicity of replacement of spare parts and handling of the discarded spares
  - Replacement of spare parts from OEM / alternate sources
  - Breakdown analysis of the equipments and ascertaining the root cause
  - Light and air equipment maintenance for underground mines
  - Uptime of the conveyor belts, automatic feeders, etc
  - Handling of discarded wheels/ tyres – exploring rotation of front and rear tyres
  - Downtime taken for preventive maintenance
  - Use of consumables in maintenance activity and control over stock for the same
  - Parameters for selection of outsourced service provider for maintenance activity
  - Maintenance of the railway sidings, wagons, engines, etc operating inside the mine
  - Access road upkeep and maintenance – additional fuel / time spent due to road conditions
  - Replacement periodicity for the conveyor belts, pumps, ropeway pulley, etc.
  - Environment, Health and Safety

- Existence of policies and monitoring framework for safety and environment compliance
- Adequacy of procedures for generating awareness on the company policies – training session, etc.
- Compliance with procedures for updating the company policies and procedure for safety and environment using internal/ external reviews and evaluation exercise
- Compliance with roles and responsibilities of the Safety committee, if any
- Compliance with laid down procedures for evaluation of environment/ safety measures, equipment and policies:
    - Frequency
    - Reporting
    - Corrective action
- Assignment of responsibilities at various levels for safety compliances
- Compilation and reporting on safety/ environment performance information
- Compliance with laid down procedures for Mock Drills
- Accidents/ mishaps reporting
- Root cause analysis
- Corrective actions
- Inventory management procedures for safety material
- Existence of dedicated staff for ensuring compliance with health and safety policies and procedures
- Procedures for ensuring compliance with critical requirements under various statutes
- Loss time injury frequency (LTIF) monitoring and reporting

Mineral Processing

6.7 The key faces areal for mineral processing for internal auditor are as follows:

- Stages of processing required and the yield at various stages (Crushing, grinding, screening, separation, etc)
  - Normal loss
  - Abnormal loss
  - Handling loss
  - Storage and transportation loss
- Recording of input and output at various stages
- Measurement technique at various stages
- Stage wise consumables management
- Stage wise waste management

- Outsourcing of processing activity
  - Costing calculation and ROI calculation for the outsourced service provider
  - Yield as per contract and actual yield
  - Sub-contracting order maintenance for input and output comparison
  - Labor employment by the service provider
  - Record maintenance protocols of the service provider
- Sampling
  - Sampling at various stages of processing
  - Maintenance of chemical properties of the heap
  - Sampling procedure and techniques adopted
  - In-house v/s lab test for sampling
  - Sample retention and record maintenance – approval of samples and results
  - Sampling technique – taking ore for sampling from the heap
  - Evaluation of the service provider

- Declaration of saleable ore post processing
  - Categorization of saleable ore post processing (fines / lumps)
  - Maintenance of chemical properties of lumpy grade material
  - Segregation of saleable ore from intermediary ore

Consumption/ Sale

6.8 Captive consumption includes following important areas:

- Planning of dispatch from the mine to the plant
- Communication and approval for the dispatch plan
- Dispatch plan adherence
- Wagon and vessel arrangement
- Demurrage analysis – wagon loading/ unloading time vs free time made available by the lessor (say railways)
- Wagon Weighment
- Quality and quantity reconciliation – transit losses and adulteration
- Security during transit – wagon seals, wagon covers, etc.

6.9 Sale includes following important aspects :

- Material specifications as per contract and as per the pick list (mixing of different grades)
- Tolerance allowed as per the contract and the error/ calculation margin kept as a buffer
- Weighment protocol as per contract;
  - Weighment at load port / discharge port
  - Assaying and umpiring – selection of service providers – independent / joint selection
- Tolerance allowed as per contract vs actual – appropriateness of the mixing / tolerance defined
- Handling of rejection at the discharge port
- Transportation mode selection and lead time management considering the delivery schedule

- Reference of terms in the contract
- Price fixation and relation with the commodity indices.

Mine Closure

6.10 In case of mine closure, following aspects are important:

- Restoration/ Reclamation/ Rehabilitation
  - Method adopted for restoration/ reclamation/ rehabilitation – documentation and approval
  - Adherence to the plan and escalations, if required
  - Budget vs actual for expenses related to restoration/ reclamation/ rehabilitation.
- Inventory and Waste Management
  - Disposal of inventory at the site
  - Management of waste at the site
  - Disposal of hazardous/ toxic waste.
- Infrastructure disposal/ sale
  - Dismantling plan for infrastructure – losses/ damage during dismantling
  - Sale of equipments – condition assessment and valuation
  - Utilization of infrastructure at other sites/ captive use
  - Record maintenance and linkage with asset register
  - Calculation and approval of profit/ loss on sale
  - Classification of usable asset and scrap – basis, documentation and approval.
- Safety and Security
  - Mine abandonment plan
  - Disaster management plan.
- Licensing / leasing condition and regulatory compliance
  - Adherence to conditions for closure as per the mining license / leasing agreement

- Release of any guarantees or other financial assurance instruments given
- Release of security deposits, if any
- Submission of notices, as may be required
- Adherence to the regulatory requirements during closure.

Process Monitoring

6.11 Following aspects are important in case of process monitoring:

- Management information system (MIS):
  - Type of MIS prepared and circulated
    - Operational and technical
    - Commercial
    - Financial
    - Regulatory Compliance
  - Parameters in each of the above MIS and basis of selecting/ computing the same
  - Basis of preparing the MIS and the cut-off procedures adopted
  - Circulation list of the MIS
  - Formal review of the MIS and documenting the action plans
  - Follow up of the action plans
- Reconciliations
  - Critical reconciliations prepared and process of reviewing the same
    - Metal reconciliation (Mined, processed, dispatched, stored)
    - Fuel consumption reconciliation
    - Equipment usage reconciliation
    - Electricity and water consumption reconciliation.
  - Assumption used in reconciliation (Basis, review and updation)
  - Reconciliation templates and consistency
  - Reconciliation review, approval and escalation matrix

- Corrective action on reconciliation
- Determining acceptable thresholds for reconciliation

Human Resource and Payroll

6.12 Aspects relating to human resource and payroll are as follows:

- Planning and scheduling of mine workers ensuring availability in all the shifts considering the restrictions of working in a mine, specially underground mines
- Maintenance and updation of employee rosters for various shifts ensuring that all workers are timely updated in the rosters and details maintained therein
- Recording the attendance of employees shift wise
- Overtime approval and recording by the shift in charge
- Daily updation and reconciliation of hours worked by the workers in all the shifts
- Process of approval and recording the leave availed by the workers
- Employee master data maintenance and updation for the new workers being appointed
- Timely updating of employee master data, blocking of employee sub-ledgers subsequent to separation
- Adherence to maximum permissible working hours including overtime hours
- Timeliness and correctness of computation of salaries and wages and accounting
- Timeliness of payment of salaries and wages
- Adherence to Minimum Wages Act
- Controls over payments of wages in cash to workers (list of workers to be paid, preparation of pay packets for workers, identification of worker for payments, acknowledgement from worker, control over non disbursed pay packets, its tracking and reconciliation)
- Policy for bonus meeting legal requirements
- Performance evaluation and rating process
- Computation of incentive and bonus including festive bonus

- Availability of workers related insurance policies
- Claims received, approved and paid against the insurance policies
- Review of loans and advances given to workers
  - Eligibility
  - Approval
  - Recording
  - Recovery in form of deduction from salary
- Full and final settlement in case of termination including gratuity payment
- Statutory compliance including Provident Fund, ESI, Gratuity, Professional Tax, TDS, Payment of Bonus Act, Workmen Compensation Act, etc.
- Reimbursement of employee expenses as applicable
- Accounting for annual benefits like gratuity, pension, bonus, etc.
- Reconciliation of month on month salary and wages payments
- Existence of policies and procedures for recruitment, attendance and leave, payroll processing & disbursement, termination and separation, loans and advances, terminations
- Manpower budgets and its monitoring.

Sub-Contracting Process

6.13 Following aspects of sub-contacting process are important:

- Manpower requirement planning for sub-contracting to ensure continuous and timely availability of the mine workers:
  - Defining the levels of workers required basis the skills set
  - Scheduling the requirements as per the shift's working hours
  - Approval / authorisation to the labour requirements
- Selection and appointment of sub contractors for supply of mine workers
  - Identification of labour contractor keeping in view the workers skills set and levels
  - Documenting the parameter for selection of sub contractor

  - Evaluation and finalization of sub contractor

- Availability of agreements with labour contactors containing necessary terms and conditions
- Formation of agreements in standard formats and obtaining legal clearance to the agreements to ensure inclusion of all necessary and applicable legal requirements related to mining companies
- Approval of agreements by appropriate authority
- Monitoring and analysis of supply of mine worker by the sub contractor as per the agreement
- Maintenance and updation of separate register for workers on contract basis for various shifts ensuring that all workers are timely updated in the rosters and details maintained therein
- Recording and approval to the attendance of workers shift-wise by the company official in addition to sub-contractor supervisor
- Overtime approval and recording by the shift in charge
- Daily updation and reconciliation of hours worked by the workers in all the shifts
- Adherence to legal requirements with regard of permissible working hours
- Monitoring adherence to PF, ESI, etc. requirements by labour contractor prior to release of payments
- Adherence to Contract Labour Act, Mine Act, etc. requirements
- Reconciliation of the labour contractor bills with the internal attendance records
- Correctness of computation of payment to labour contractors
- Periodic performance evaluation of labour contractors, particularly, with respect to timeliness and quality of manpower supply
- Monitoring the corrective actions required as per the performance evaluation
- Existence of policies and procedures for labour sub contracting.

Finance, Accounts and Treasury Activities

6.14 Important aspects of finance, accounts and treasury activities are as follows:

(i) *Cash and Bank*

- Existence and compliance to documented procedure and schedule of authority exists for various cash and bank related areas:
- Cash disbursements/ payments / receipts / deposits
  - Bank Receipts/ Payments
  - Receipt and deposit of Cheques
  - Physical verification of cash
  - Bank Reconciliation Statement
  - Accounting
- Segregation of duties with respect to operating bank accounts and processing receipts and payments
- Authorized signatory for bank accounts are presently working with the company
- Bank and cash entries, its appropriateness of accounting and authorisations
- Deposit of cheque and cash in banks
- Periodic physical verification of cash
- Controls over cheque inventory
- Bank reconciliation statements
- Stale cheque and its accounting
- Payments and receipts through RTGS, EFT, ECS, etc.
- Control on issue and receipts of cheques, demand drafts, LCs, etc.
- Bank balance confirmation process
- Cut-off process
- Book closure process
- General ledger code creation and maintenance process.

(ii) *Loans and Borrowings*

- Approvals to borrowings by authorized individuals as per Board resolutions.
- Adherence to the process defined for loans and borrowings
- Periodic review of borrowing limits to eliminate, decrease or enhance borrowing limits and authority
- Basis of borrowing decisions - formal analysis prepared that includes contracts reviewed by treasury, legal, tax and accounting
- Loans details of independent confirmation
- Recording and accounting of loans and borrowings
- Reconciliation of debt details with the general ledger
- Tracking and monitoring of the loan covenants
- Amortization of material debt issuance costs
- Interest expense accrual computation and accounting
- Repayment of interest and principal amount and accounting of the same
- Registration of charges as per the loan agreements
- Adherence to RBI guidelines and also FEMA requirements in case of international borrowings.

(iii) *Insurance*

- Identification of the insurance policies applicable for the company
- Process to arrive at and periodic review of the coverage and value/ upper limits of the policy
- Basis of selection of the third party to advise on insurance policies
- Agreements with the insurance advisors appointed by the company
- Policies obtained to cover the various assets and liabilities as identified by the company
- Tracking process to ascertain timely renewal of insurance policies
- Process for identification and submission of insurance claims
- Follow up mechanism for pending insurance claims.

(iv) *Working Capital and Trade Finance*

- Adherence to Board resolution defining the approving authority for Trade Finance *viz.*, letter of credit, bank guarantees, buyers credit, etc.
- Tracking, monitoring and adherence to the trade finance limits
- Supporting documents and linking with purchase requirements for availing trade finance
- Bank agreements defining the limits of various trade finance instruments
- Interest expense accrual computation and accounting
- Repayment of interest and principal amount and accounting of the same
- Working capital arrangement with banks and the related agreements
- Adherence to the limits and covenants as per bank agreements
- Authorization process before utilizing any working capital
- Physical custody and existence of the agreements and bank guarantees

Procurement and Contract Management

6.15 Following are important aspects of procurement and contract management:

(i) *Contract Formation*

- Existence of documented procedure and delegation of authority for procurement process
- Procurement budgets preparation and monitoring
- Material requirement planning process for long term consumables and daily consumables requirement for mine operation
  - Basis of preparation, source and approvals to production plan/ capacity which is the basis for material requirement planning
  - Relevant factors/ logics that has been used for planning, consistency with prior periods, accuracy of source data and adherence to timelines

  - Monitoring over monthly production plans and deviations, if any with reasons are approved
  - Comparison of actual procurement with the planning
- Process of raising purchase requisition as per the requirements ascertained during the planning process
- Approval of purchase requisitions
- Mandatory fields in purchase requisition forms
- Vendor identification and selection process
  - Mode of obtaining bids/ quotations from approved vendors
  - Process for issue of request for quotations
  - Process of handling the receipt of quotations
  - Analysis of quotations to identify the most suitable vendor
  - Consideration of quality aspects/ legal requirements as applicable for the material
  - Negotiation process
  - Approval to vendor selection.
- Purchase order creation and issuance
  - PO raised only against approved PRs
  - System controls over raising of POs against unapproved PRs
  - Quantity in PR and PO
  - Delivery schedule
  - PO raised on approved vendors
  - PO linked to purchase budgets
  - Purchase price agreed during vendor negotiation
  - Approval to PO as per the authority matrix
  - Inclusion of relevant and necessary terms and conditions in the PO
  - Process of communication of PO to vendors
  - Payment terms
  - PO amendments

- PO cancellations.

- Monitoring over open POs and PRs
- Vendor advance process
- Performance and bank guarantees issuance process
- Lead time analysis.

(ii) *Contract Execution*

- Goods receipt note/ service receipt note preparation process
- System controls over edits allowed while creating GRN/ SRN and auto flow of data from PO
- Weighment/ count process at time of receiving the materials
- Quality inspection process
- Certification for receipt of service
- Rejection process
- Return process for rejected goods
- Accounting at various stages
- Physical storage of materials
- Inventory analysis (ABC classification and inventory holding norms)
- Item master database maintenance

(iii) *Contract Monitoring*

- Monitoring process for ensuring ongoing compliance with terms and conditions of the contract
- Vendor performance evaluation process
- Amendments to contracts

(iv) *Contract Closure*

- Process of receipt and review of vendor bills
- Bill parking and posting process
- Accounting for liability
- Control over processing of duplicate payments
- Advance adjustment

- Payment due date tracking process
- Payments as per the PO terms and conditions
- Cheque generation and EFT payment process
- Debit notes and credit notes issuance process
- Creditors ledgers and aging
- Payments to vendors
- Segregation of duties between PR, PO, GRN and payment processing
- Provisions and book closure
- Vendor balance confirmation and reconciliation.

(v) *Vendor Management*

- Vendor master database maintenance
- Vendor development process
- Approved vendors
- Vendor creation/ amendment/ deletion process.

Statutory Compliance and Industrial Relations

6.16 Following are important aspects related to statutory compliance and industrial relation:

(i) *Statutory Compliance*

- Statutory compliance related policies and procedures
- Availability of statutory compliance checklist including all the requirements of the applicable acts (as listed above and including health, safety and environment related legislations)
- Process of updation of checklist
- Monitoring and review process to ensure adherence to the checklist
- Escalations and corrective action process
- Self certification of statutory compliance checklist periodically.

(ii) *Health, Safety and Environment (HSE)*

- HSE related legal requirements and management policy including and not limited to the following
  - Worker health and safety management
  - Soil and land management
  - Water management
  - Air quality management
  - Noise and vibration management
  - Waste and hazardous material management
  - Waste rock management
  - Erosion management
  - Cultural heritage management
  - Socio economic management
  - Review mechanism for adherence to the requirements and policy including self certification process.

(iii) *Industrial Relations*

- Adherence to the collective bargaining agreement with labour unions
- Incident reporting process for effective resolution
- Labour welfare policy and compliance
- Workers grievance and Redressal mechanism.

Information Technology

6.17 Following aspects of information technology are important:

- Existence of information security policies and procedures
- Scheduling and batch processing procedures
- Change control process to scheduled jobs and appropriate authorization
- IT help desk process
- System, application and network access control
- Review of Personal Computers

- Local Area Networks (including wireless)
- Program development process including pot-implementation reviews
- Program change management process
- Existence and adherence to service level agreements
- Disaster recovery plans / Business Contingency Plans to facilitate recovery from operational failures
- Data back up process
- Storage of back up media
- Anti-Viruses process
- Physical security of servers and IT equipments
- Insurance policy.

I-14

TECHNICAL GUIDE ON INTERNAL AUDIT OF NOT-FOR-PROFIT ORGANISATIONS (NPOs)

Foreword

A strong, vibrant and innovative Not-for-Profit sector is essential to achieve a productive and inclusive nation. The Not-for-Profit sector plays a central role in enriching people through its charitable, social, cultural, educational and environmental contribution and in providing support to weaker section of the society. They are sometimes referred to as the “third sector”, the first sector being the “government” and the second sector being the “market” or private business. It is difficult to define their characteristics as these organisations are extremely varied.

Financial accountability, transparency and good governance are the need of the hour in the NPO sector. There are nearly more than three million Non-Profit Organizations (NPOs) in the country and this sector offers challenging and rewarding opportunities to Chartered Accountants in particular. They can play an important role in increasing the standards of resource mobilization, accountability and transparency in Not-for-Profit Sector.

I am happy to note that the Internal Audit Standards Board and the Committee for Co-Operatives and NPO Sectors are jointly issuing this Technical Guide on Internal Audit of Not-for-Profit Organizations for guidance of members in this crucial area. I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and CA. Vijay K. Garg, Chairman, Committee for Co-Operatives and NPO Sectors and members of both the Boards on issuance of this Technical Guide. This Technical Guide comprehensively deals with the peculiar aspects of NPO sector, 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.

March 24, 2012 — CA. Jaydeep Narendra Shah
New Delhi — President, ICAI

Preface

India witnessed a rapid increase in and diversification of the NPO sector as a response to the national political scenario and increasing concern about poverty and marginalization. It has been noted that as the financial and human resources employed in this sector grow year after year, the need for proper financial planning, financial management and financial accountability is also increasing.

More efficient utilization of public resources through effective implementation of programs, minimization, if not eradication, of corruption, sensitivity to the needs of poor, providing timely information to citizens are the demands of NPO Sector. Transparency is institutionalised by recording, maintaining and providing access to relevant and timely information regarding the organization. Thus, the potential for improving the management of the sector is significant. Also NPOs have begun to view Chartered Accountants as pathfinders rather than faultfinders. The NPO sector offers challenging and rewarding opportunities for CAs in the sector.

With a view to providing appropriate guidance to the members of the Institute on the internal audit of NPOs, the Internal Audit Standards Board jointly with the Committee for Co-Operatives and NPO Sectors has issued this Technical Guide on Internal Audit of Not-for-Profit Organisations. This Technical Guide is divided into six chapters. Chapter I is introductory in nature. It also describes the history and characteristics of NPOs. Chapter II discusses about the legal framework applicable to the sector alongwith the brief description of different types of NPOs. Chapter III deals with the key concepts related to the non-profit sector including the description of accounting of fund and expenses. Chapter IV deals with the accounting and internal audit standards for NPOs. Chapter V explains the internal audit of NPOs including the concepts and objective of the internal audit. It also explains the need of internal audit of NPO sector and internal audit approach. Chapter VI deals with the audit of specific accounts balances followed with the illustrative checklist for the internal auditor reference.

At this juncture, we are grateful to CA. Meenakshi Gupta and her study group member *viz.*, CA Debaditya Gupta and also CA. Brijesh R. Shah for sharing

their experience and knowledge with us and preparing the draft of this Technical Guide.

We also wish to thank CA. Jaydeep N. Shah, ICAI, President and CA. Subodh Kumar Agrawal, Vice President, ICAI, for their continuous support and encouragement to the initiatives of the Board. We must also thank our colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Rajendra Kumar P., Vice-chairman, IASB, CA. Amarjit Chopra, CA. Shiwaji B. Zaware, CA. Ravi Holani, CA. Anuj Goyal, CA. Nilesh Vikamsey, CA. Atul C. Bheda, CA. Charanjot Singh Nanda, CA. Pankaj Tyagee, CA. G. Ramaswamy, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. S. Santhanakrishnan, Shri Prithvi Haldea, Smt. Usha Narayanan, Smt. Usha Sankar, Shri Manoj Kumar and Shri Sidharth Birla and the colleagues from the Council at the Committee for Co-Operatives and NPO Sectors, *viz.*, CA. V. Murali, CA. Bhavna G. Doshi, CA. Charanjot Singh Nanda, CA. Jayant P. Gokhale, CA. Madhukar N. Hiregange, CA. Pankaj I. Jain, CA. Pankaj Tyagee, CA. Ravi Holani, CA. Sanjay K. Agarwal, Shri Anil K. Agarwal, Shri Ashutosh Dikshit and Shri Deepak Narain for their vision and support.

We are sure that the readers, especially members of the institute, working as internal auditors in NPO sector would find this technical guide immensely useful.

March 23, 2012
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

March 23, 2012
Jaipur

CA. Vijay K. Garg
Chairman
Committee for Co-Operatives
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Contents

Chapter 1
Introduction

1.1 Philanthropy has been an important part of life in India since ancient times. The word is derived from the Greek term Philanthropos, which means the "love of humanity". Philanthropy broadly encompasses any altruistic activity intended to serve others, or the act of donating money, goods and services to support a socially beneficial or humanitarian cause, with no financial or material reward to the donor. Charity is a similar concept, except it is usually linked to religion... While Hindus believe in daana (giving) and Buddhists have bhiksha (giving to a monk), Islam directs its followers to give in the form of sadaqah (voluntary charity), and zakat (obligatory charity).Charity focuses on providing a solution to the immediate need of an individual or a group, whereas philanthropy attempts to deal with the root cause of the problem to prevent them from happening. For example, providing food to a hungry person would be charity but prov iding education so that the person can find a job and fend for himself is philanthropy. In recent times the focus has shifted from charity to philanthropy, with the ancient tradition of donating to temples and to needy and destitute giving way to contributing for social causes like women's empowerment, promotion of education, social welfare, etc.

1.2 There has been corporate involvement too in the philanthropic movement. Jamshedji Tata launched the J N Tata Endowment Scheme in 1892, long before the first major foundation was formed in the US. His biggest contribution was the establishment of the Indian Institute of Science. Similarly, Ardeshir Godrej's gave a generous donation to the Tilak Fund for the upliftment of Harijans .The Tatas and the Murugappas pioneered charitable contributions to hospitals and schools. Now, companies are entering into newer areas like environmental conservation and preservation of history and art and have institutionalised their philanthropic activities in the form of family foundations. While the Azim Premji Foundation and the Infosys Foundation support education initiatives, industrial houses such as Bajaj, Birla, Reddy laboratories etc., have foundations which support an array of development initiatives. Various socio religious institutions like Satya Sai Sewa Trust, the Chinmaya and the Ramakrishna Missionshave increased their scope to include developmental activities, like, rural development, healthcare, etc.

1.3 Elsewhere, the concept of Non-Government Organisation gained impetus after the formation of United Nations. The UN introduced the term "NGO" to distinguish between the participation of international private organizations and intergovernmental specialized agencies. The UN defined them as organizations that do not form part of the government and are not conventional for-profit business. "NGOs" cannot seek to diminish a nation's government in the shape of an opposing political party; NGOs also need to be non-criminal and non-profit. They operate independently outside the realm of government by excluding government representatives from membership in the organization though financially they depend on government and private business.

1.4 There is a growing movement within the sector to define itself in a more constructive, accurate way as the term NGO focuses not on the organization's purpose but what it is not .The terms "Social Benefit Organization" (SBO), "Civil Society Organization" (CSO) and Not-for-Profit Organizations) are being used by a growing number of organizations. In this Technical Guide we will use the term Not-for-Profit Organization as the term is widely understood and is also being used all over the world by professional accounting bodies.

Characteristics

1.5 Not-for-Profit Organisations (NPOs) form a significant segment of the economy due to their sheer numbers and the extent and nature of their activities .They are sometimes referred to as the third sector", the first sector being the "government" and the second sector being the "market" or private business. It is difficult to define their characteristics as these organisations are extremely varied. Their range of activities include health, economic and social assistance, education, promotion or defence of various causes etc., The services are not limited to merely charitable causes and include training, recreational services, artistic or cultural endeavours(museums, theatres), professional associations, farmers' networks, academic centres, labour unions etc. Many of these activities are not exclusive to NPOs and there are for-profit organisations doing the same for a fee. For instance, Profit oriented sports clubs, theatres also exist .

1.6 They cannot be categorised through size or legal structure. Though the majority of them are small and have a limited budget, there are NPOs with national and even international reach. In India, there is Child Rights and You (CRY) and Helpage which are national level entities. Some of the well known international names are Amnesty International, Rotary International, Carnegie Corporation of New York, the Red Cross and Red Crescent Organizations, United Nations Educational Scientific and Cultural Organisation (UNESCO) and World Wide Fund for Nature. There are various legal forms prevalent in the sector.

1.7 Many NPOs need to have their financial statements audited under statutory or donor requirements. The Income tax Act requires filing of annual returns and audit report for certain NPOs. Some of the state legislations relating to trusts and charitable institutions provide for compulsory audit even where the income is below the maximum amount which is not chargeable to income tax. Such ceiling limits are dependent in terms of the statutory provisions of the relevant State Acts. Many donors demand annual accounts and audit report when applying for grant. Some donors give consideration to the fact that the not-for-profit organizations may not have audited financial statements but may require a yearly audit after the funds are transferred.

It has to be kept in mind that the above characteristics may not be applicable to all NPOs. Depending on the size, nature and objectives, some features may be significant for one and non-existent for another.

Definition

1.8 The World Bank defines NPOs as *"Private organisations that pursue activities to relieve suffering, promote the interests of the poor, protect the environment, provide basic social services, or undertake community development".*

1.9 The Canadian Institute of Chartered Accountants (CICA) handbook defines them as: *"Non Profit organisations are organisations in which there is normally no transferable ownership interest and from which the members or contributors do not receive any direct economic gain and that are formed, for example, for social, educational, religious, health or philanthropic purposes."*

Objective and Scope of the Technical Guide

1.10 This Technical Guide is intended to assist internal auditors in carrying out internal audit of not-for-profit organisations. It is aimed to provide an insight into the functioning of the not for profit organisations, its concepts and its peculiar characteristics. As the size, legal structure, functioning, nature of activities may vary widely from one NPO to another; the Technical Guide cannot cover all the aspects of functioning of entities within such a wide spectrum. Therefore, the various aspects and principles enunciated in this

Technical Guide should be applied mutatis mutandis, exercising professional judgement.

This Guide is not intended to dwell on the basic internal audit procedures, which are common to all types of organisations. It purports to provide insight into the special aspects of the not-for-profit sector.

The Guide also discusses special areas of compliance applicable to this sector that call for internal auditor's scrutiny.

1.11 The management in concurrence with the internal auditor has to take into consideration- the various pronouncements of ICAI and the regulatory requirements, assessment of control environment and business domain knowledge to decide the scope of the internal audit. The scope and criteria of internal audit would be determined by the following:

(i) entity's policies

(ii) entity's systems

(iii) entity's procedures

(iv) entity's processes

(v) entity's products

(vi) entity's standards

(vii) entity's laws and regulations

(viii) entity's systems

(ix) entity's specification

(x) entity's contract requirements

This Technical Guide deals with the operational areas of entities operating in this sector with emphasis on compliance of various regulations as applicable to such entities.

1.12 The following organisations are not included under NPO in this Guide:

(i) Public sector organisations formed under central or state governments (municipalities, corporations and other government owned corporations)

(ii) Organisations formed under special acts of Parliament.

(iii) Private or public hospitals and other public health organisations

(iv) Political parties

(v) Unions

(vi) Pension funds

1.13 Some examples of NPOs that fall into the scope of this Technical Guide are as follow:

(i) Charitable organisations

(ii) Foundations

(iii) Endowment Funds

(iv) Religious organisations

(v) Chambers of commerce

(vi) Professional bodies and associations

(vii) Artistic and cultural organisations

(viii) Museums and art galleries

Chapter 2
Legal Framework

2.1 There are innumerable NPOs in India, engaged in wide varieties of activities. India has possibly the largest number of active non-government, not-for-profit organizations in the world. In spite of this, there is no national regulatory body or framework governing the sector. NPOs are governed under the statute or state law under which they are formed.

2.2 The Constitution of India guarantees the right of all citizens to form associations or unions is under Article 19(1)(c). Also, Article 30(1) in the Constitution gives all minorities, whether based on religion or language the right to establish and administer educational institutions of their choice. Thus, non-profit/voluntary organisation can be set up without any kind of registration or recognition under any of the entries mentioned above. In fact, some of the community based organisations like village committees, small religious groups and many welfare Associations function in this manner. However, to claim exemptions under the Income Tax Act, 1961 and for availing of other benefits from the Government, there is insistence on formal registration.

Types of Not-for-Profit Organisations

2.3 A not-for –profit organisation can be set up either as:

(i) Registered Trust

(ii) Registered Societies

(iii) Non-trading Corporations

(iv) Section 25 Company of the Companies Act, 1956

(v) Religious Endowment and Waqf, Gurudwara, etc.

(vi) Government Acquired Trusts

(vii) Unregistered Trusts/ Societies/ NGO

Registered Trust

Trusts are usually set up when someone wishes to set apart either property or money for a specific purpose, usually a charitable cause and wants to limit control over the distribution and administration to selected persons only . These persons are known as trustees. Trusts can be public or private. Public charitable trusts are governed by the Public Trust Act, if any (e.g. Maharashtra, Gujarat, Rajasthan, and Madhya Pradesh) applicable in the relevant State. In the absence of such an act in any particular state or territory the general principles of the Indian Trusts Act 1882 are applied. A public trust can be set up by registration of the trust deed with the registrar. Public charitable trusts, as distinguished from private trusts, are designed to benefit members of an uncertain and fluctuating class. To determine whether a trust is public or private, the key question is whether the class to be benefited constitutes a substantial segment of the public.

Registered Societies

A registered society is viewed as an independent juridical 'person'. It is different from the people who form it. Property which is vested in the members of an unregistered society becomes "property belonging to the society" after registration, and there is no transfer of ownership.

Features of Society *v.* Trust

Features	Society	Trust
Objects	Charitable, Literary, Scientific, etc.	Non-profit activities
Formation	Procedure is simple and easy	Procedure is complicated
Name	Selection of name is not difficult	Name approval by Registrar of Companies
Management	Easy and simple and not much restrictions imposed under the Act	Provisions of the Companies Act have to be complied with and are complex, rigid and time consuming
Meetings	Annual Meeting of society to be held as per provisions in the Act. Meetings of the Governing body are held as prescribed in the Rules of the	All the meetings are to be held as per provisions of the Companies Act, 1956

	Society	
Penalties	Very few offences and penalties have been prescribed	Provisions under the Companies Act are more stringent and attract penalties
Reputation	Registered societies enjoy same reputation as companies	Same
Legal Entity	Registered Society is a legal entity with certain limitations	Is a legal entity.

Section 25 Company of the Companies Act, 1956

The Companies Act, 1956, which principally governs for-profit entities, permits certain companies to obtain not-for-profit status as "section 25 companies." Such a company can be formed with the objective of "promoting commerce, art, science, religion, charity or any other useful object" provided the profits, if any, or other income is applied for promoting only the objects of the company and no dividend is paid to its members. It requires at least three individuals to form a section 25 company. The founders or promoters of have to submit application to the Regional Director of the Company Law Board along with copies of the memorandum and articles of association of the proposed company, as well as a number of other documents, including a statement of assets and a brief description of the work proposed to be done upon registration.

A Section 25 company is governed by directors or a managing committee or a governing council elected by its members.

Comparative Analysis of Society, Trust and Non-Profit Company

Particulars	Company	Society	Trust
Statute/ Legislation	Companies Act, 1956	Societies Registration Act, 1860	(Bombay) Public Trusts Act, 1950
Jurisdiction	Registrar of Companies (or charity commissioner as in Maharashtra	Registrar of Societies	Charity Commissioner
Objects	Non-profit Activities	Charitable,	Charitable,

		Literary, Scientific, etc.	Socially Beneficial
Main Document	Trust deed	Memorandum of Association and Articles, Rules and Regulations (bye-laws)	Memorandum and Articles of Association
Alteration of Objects	Complex legal procedure	Simple procedure	Bound by covenants of Trust Deed; Normally only Settlor can modify and is almost always impossible to modify if settlor is deceased
Formation	Complex Procedures; Three to six months required	Simple and easy	Simple and easy
Number of Members Required	Minimum seven and no upper limit	Minimum seven and no upper limit	Minimum two and no statutory limit
Registration	As a company under section 25 of the Companies Act	Both as a society and a trust in some States, e.g., Maharashtra	As trust
Stamp Duty	No stamp paper required for Memorandum of Association and Articles	No stamp paper required for Memorandum of Association and Rules and Regulations	Trust required to be executed on non-judicial stamp paper (Valued at 4% of the trust property)
Name	Prior approval required from the Registrar of Companies in the	Comparatively simple	Comparatively simple

	relevant State/U.T.		
Board of Management	Board of Directors/ Managing Committee	Governing Body	Trustees
Management	Formalities of company law in terms of the Companies Act, 1956 to be observed	Few restrictions imposed under the Act	Very few restrictions imposed under the Act
Mode of Succession in the Management	Usually by election by members	Usually by election by members	By appointment
Meetings	To be held as per provisions of company law which are quite extensive	Annual Meeting according to provisions of law. Governing body meetings as prescribed in Rules of the Society	No provisions laid down
Penalties	Various offences and corresponding penalties for violations have been provided	Few offences and penalties have been prescribed	Very Negligible
Legal Status	Full legal status	Legal status with certain limitations	Legal status with certain limitations
Statutory Regulation	Exhaustive but mature	Very limited	Nominal
Transfer of Membership	Totally free or controlled, as desired	Not possible	Not applicable
Admission of New Members	Controlled by general body or Board through issue of capital	Controlled by Governing Body	Not applicable
Removal of Members	Not possible without consent	Possible without consent	Not applicable

Dissolution of take-over by State	Very difficult	Possible	Possible
Payment to Members	As approved by deed company and State	Not restricted	As specified in Trust

Religious Endowments and Waqf, Gurudwara, etc.

Religious Endowments and Waqfs are variants of Trusts which are formed for specific religious purposes e.g. for providing support functions relating to the deity, charity and religion amongst Hindus and Muslims respectively. Unlike Public Trusts, they may not necessarily originate from formal registration, nor do they specifically emphasise on a triangular relationship among the donor, Trustee and the beneficiary. Religious endowments arise from dedication of property for religious purposes. The corresponding action among the Muslim community leads to the creation of Waqfs. Waqfs tie up the property and devote the usufruct to people.

Waqfs in India

The concept of Waqf is rooted to the Quranic injunctions, which deal with charity. It gained prominence under Muslim rule when the rulers generously dedicated property such as land and its revenue rights to Waqf created with the purpose of maintaining mosques, tombs, orphanages (yatimkhanas), madrasas, etc.

Waqf implies the endowment of property, moveable or immovable, tangible or intangible to God by a Muslim, under the premise that the transfer will benefit the needy.

Unregistered Trusts/ Societies/ NGO

As mentioned earlier, in India, there is a plethora of acts under which any group desirous of commencing a not-for-profit, voluntary or charitable work can organize themselves into a legal body depending on the type of activity, purpose, beneficiaries, etc. They can register themselves under the applicable Act (or a combination of Acts). However, for most entities, these provisions are not mandatory and therefore, there exists a vast group of voluntary bodies which have not registered themselves under any of the available provisions.

An unregistered association is not recognised as an independent juridical person under law. Failure to register the associations gives it no legal face and only the trustees in charge of the fund have a legal status.

Although registration is not compulsory, unregistered not for profit organisations miss out on important advantages of incorporation. Some of them are:

(i) the organisation acquires legal status to sue and/or be sued as a separate and distinct "person"

(ii) Incorporation bestows legal rights to the members to hold property in a common name. It also enables the not-for -profit organization to open bank account(s) against its registered identity.

(iii) Any property held by the organisation can pass from one generation of managers to another without having to pay any transfer fees or taxes and without any cumbersome documentation.

(iv) Only incorporated organizations can get benefits of tax-exemptions, and other benefits.

(v) Registration under the Foreign Contribution Regulation Act (FCRA), 1976 is more easily granted if the not-for-profit organization is incorporated.*

Legal Framework

2.4 Trusts, Endowments and Waqfs are legally created as modes of property arrangement/ settlement dedicated for definite charitable and religious purposes. The law concerning Societies, Trusts, Waqfs and other religious and charitable endowments in India can be placed in three broad groupings.*

(i) Societies registered under the Societies Registration Act, 1860, States amendments on it after 1947and various State Registration Acts;

(ii) Those engaged in pure religious and charitable work registered under the Religious Endowments Act, 1863; the Charitable and Religious Trusts Act,1920; the Waqf Act, 1995 and similar other State Acts;

(iii) Trusts and charitable institutions registered under the Indian Trusts Act, 1882; Charitable Endowments Act, 1890; the Bombay Public Trusts Act, 1950; and similar other State Acts.

2.5 The mode of incorporation, organisational structure and distribution of functions and powers are governed by the provisions of the specific law under

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* http://www.pria.org/publication/Legal%20Framework%20for%20Non-profit%20Institutions%20in%20India%20%20Working%20Paper%202.pdf

*www *arc.gov.in/9threport/ARC_9thReport_Ch3.pdf* which they are registered. Broadly, such organisations can assume a legal personality in the following five ways:

(i) By way of formal registration before the Charity Commissioner / Inspector General of Registration under the respective State Public Trusts Act e.g., the Bombay Public Trusts Act,1950.;

(ii) By invoking interference of civil courts to lay down schemes for governing a Trust under Sections 92 and 93 of the Civil Procedure Code;

(iii) By registering the Trust deed of a Public Charitable Trust under the Registration Act, 1908;

(iv) By notifying an organisation in the list of Charitable Trusts and Religious Endowments which are supervised by the Endowments Commissioner of the State or by a Managing Committee formed under the Charitable Endowments Act, 1890 or under other State laws on Hindu Religious and Charitable Endowments; and

(v) By creating a Waqf to be managed under the provisions of the Waqf Act, 1995.

The main features of these enactments are indicated in the Appendix 1.

2.6 In addition to meeting the requirements of legislation mentioned above, the not-for–profit organizations are also required to follow the provisions of law as applicable to their functional areas. For example, a NPO whose working affects the natural resources or environment needs to take into account the provisions of Water (Prevention and Control of Pollution) Act, 1974, the Air (Prevention and Control of Pollution) Act, 1981 and the Forest (Conservation) Act, 1980, etc.

The Indian Trusts Act, 1882

Introduction

2.7 After the establishment of British rule in India, it was felt all over that there was no comprehensive enactment in India governing the private trusts. The very question of enacting a law relating to the trust was treated as one of the important matter which was referred to the Indian Law Commission of 1879 which reported the advisability of the Codification of the Trust Law.

In the words of Justice Phear "*There is, probably no country in the world where fiduciary relations exhibit themselves so extensively and in such varied form as in India, and possession and dominion over property coupled with the obligation of use it wholly or partially, for the benefits other than the possessor, is, I imagine familiar to every Hindu*". Muslims also had concept of entitlements too. But with the exceptions of certain provisions of Penal Code, Code of Civil Procedure (Sections 92 and 93 related to power of Civil Courts and Collector) and couple of other Acts, the Indian Statute book was silent on this matter. An attempt was made to define and amend the law relating to private trust and the Indian Trusts Act, 1882 came into being. It applies to private trusts other than religious or charitable endowments. Also it does not affect the rules regarding waqf or mutual relations of members of an undivided family.

The most fundamental distinction between private and public trusts depends upon the character of the person for whose benefit they are created.

The decisions in *Radhavallabh* v. *Damodardas*, AIR 1955 NUC (MB) 3799; (1983) 144 Tax LR (MP) 108 that the act applies to private trusts only and in *Shri Ram Krishna Mission* v. *Dogar Singh*, AIR 1984 All 72; *Shanti Devi* v. *State*, AIR 1982 Del 453 that the provisions of the Act do not apply to public (charitable or religious) trusts should be considered in the light of observations of the Hon'ble Supreme Court.

2.8 Under Schedule 7 of the Indian Constitution, the subject 'Trust and Trustees' finds mention at Entry No.10 in the Concurrent List. 'Charities & Charitable Institutions, Charitable and religious endowments and religious institutions' find place at Entry No.28 of this list.

2.9 The first legislation governing public trusts is the Bombay Public Trusts Act which was meant to deal with an express or constructive Trust for either public, religious or charitable purposes or both and included a temple, a math, a Waqf, or any other religious or charitable endowment and a Society formed either for a religious or a charitable purpose or for both and registered under the Societies Registration Act, 1860 – Section 2(13). When the Bombay province got separated into the states of Maharashtra and Gujarat, both the states adopted this act with Gujarat making some variations. Only two other states - Madhya Pradesh and Rajasthan have enacted their own Public Trusts laws, others do not have any specific act. In states which have the public trust act, it is compulsory for every public trust to register with the charity Commissioner.

2.10 List of Public Trusts Act is as follows:

(i) Rajasthan Public Trusts Act, 1959

(ii) The Madhya Pradesh Public Trusts Act, 1951

(iii) Bombay Public Trusts Act, 1950

(iv) Gujarat Public Trusts Act , 2011

Scope of the Indian Trusts Act, 1882

2.11 The scope of the Act is as follows:

(i) Creation of Trusts - Chapter II (Sections 4 to 10)

(ii) Duties and Liabilities of Trustees - Chapter III (Sections 11 to 30)

(iii) Rights and Powers of Trustees - Chapter IV (Sections 31 to 45)

(iv) Disabilities of Trustees - Chapter V (Sections 46 to 54)

(v) Rights and Liabilities of Beneficiaries - Chapter VI (Sections 55 to 69)

(vi) Vacation of the Office of Trustees - Chapter VII (Sections 70 to 76)

(vii) Extinction of Trusts - Chapter VIII (Sections 77 to 79)

(viii) Certain Obligations in the Nature of Trusts - Chapter IX (Sections 81 to 94)

The *First Chapter* of the Act states that "*Trust is an obligation annexed to the ownership of property and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner*".

The *Second Chapter* of the Act deals with the creation of trusts. It declares that a trust may be created for any "*lawful purpose*" and states that the purpose of a trust is lawful unless it :

(a) forbidded by law, or

(b) is of such a nature that, if permitted, it would defeat the provisions of any law, or

(c) is fraudulent, or

(d) involves or implies injury to the person or property of another, or

(e) the Court regards it as immoral or opposed to public policy.

Chapter III deals with a trustees's duties and also liablities arising from breach of these duties. Section 20 gives a list of securities on which a trustee can invest trust funds. Sectio 23 declares the measure of the trutee's liablity in case of a breach of trust

Chapter IV treats of the rights ad powers of trustees. Section 34 fo the Chapter empowers turstees to apply to a principal Civil Court of original jurisdiction for advice on any questions regarding the management and administration of the trust-property. Section 36 of the Act deals with the general authority of a trustee.

Chapter V deals with disabilities of the trustee and *Chapter VI* cover the rights and liabilities of the beneficiary. *Chapter VII* deals with vacating the office of trustee and incidentally deals with the appointment of new trustees, and declares that, on the death or discharge of one of several co-trustees, and declares that, on the death or discharge of one of several co-trustees, the trust survives and the rust-property passes to the other, unless the instrument of trust expressly declares otherwise.

Chapter VIII treats of the extinction of trusts and incidentally of their revocation. Section 77 states that *a trust is extinguished* –

(a) when its purpose is completely fulfilled; or

(b) when its purpose becomes unlawful; or

(c) when the fulfillment of its purpose becomes impossible by destruction of the trust-property or otherwise; or

(d) when the trust, being revocable, is expressly revoked.

Chapter IX specifies the cases in which an obligation arises.

Societies Registration Act, 1860

2.12 The Societies Registration Act 1860 is modeled on the English Literary and Scientific Institutions Act, 1854. It was enacted mainly to give legal standing to various organisations and groups related to politics, literature, arts and science which were coming ulp at that time. It was also meant to enable the colonial government to keep a watch over those entities but the Act was not intrusive, it gave full freedom to the Societies/ organisations which chose to register with the government. There was minimal State interference into affairs of such institutions, except routine matters of filing annual statements.

2.13 The Societies Registration Act, 1860 provides for formation of a Society for any literary, scientific, or charitable purpose, or for any such purpose as is described under Section 20 of the Act. In terms of Section 20, the following Societies may be registered under this Act:

*"Charitable societies, the military orphan funds or societies established at the several presidencies of India, societies established for the promotion of science, literature, or the fine arts for instruction, the diffusion of useful knowledge, *[the diffusion of political education], the foundation or maintenance of libraries or reading-rooms for general use among the members or open to the public, or public museums and galleries of paintings and other works of art, collections of natural history, mechanical and philosophical inventions, instruments, or designs."*

2.14 After Independence the subject came under the State list of Schedule 7. Most States made a number of amendments and states like, Andhra Pradesh, Rajasthan, Tamil Nadu, West Bengal, Uttar Pradesh, Gujarat and Maharashtra made major amendments in the original Act. The amendments mainly concern the following four issues:

(i) Purpose for which Societies can be formed.

(ii) Regulatory powers with regard to change in memorandum of association, bye-laws, alienation of property and investment, amalgamation and dissolution of the Body.

(iii) Powers with regard to submission of annual returns.

(iv) Powers of the State Government with regard to enquiry and investigation, supersession, dissolution or cancellation of registration.

2.15 The Act is not applicable in States (or parts thereof), which have independent legislations framed by their legislatures. They are:

(i) Andhra Pradesh Societies Registration Act, 2001

(ii) Jammu & Kashmir Societies Registration Act, 1998

(iii) Madhya Pradesh Societies Registrikaran Adhiniyam, 1973; amended by M.P. Society Registrikaran (Sansodhan) Adhiniyam, 1976

(iv) Meghalaya Societies Registration Act, 1983

(v) Karnataka Societies Registration Act, 1960

(vi) Rajasthan Societies Registration Act, 1958; amended as Rajasthan Societies Registration Act, 1967

(vii) Tamil Nadu Societies Registration Act, 1975

(viii) West Bengal Societies Registration Act, 1961; as amended by West Bengal Societies Registration Act, 1964.

Kerala has an act 'Travancore-Cochin Literary, Scientific & Charitable Societies Act, 1955' which provides for the registration of literary, scientific and charitable societies in the State of Kerala excluding the Malabar Districts. The Societies Registration Act, 1860 applies to all other societies.

Comparative Analysis between various State Legislations on Societies is given as Appendix 2.

Religious and Charitable Endowments

2.16 Endowments are the dedication or entrustment of property either for a religious purpose or for a charitable purpose or both: religious and charitable purposes. It may be called a religious endowment or a charitable endowment depending upon its objects. The ultimate decision on whether or not an endowment is religious or/and charitable rests not with the settler but with the legislature and the court.

2.17 Hindu society has always been, at least apparently, a religious society. Majority of donations in India occurs in the context of religious charity. Additionally, during the British rule reformist orthodox Hindu socio-religious organisations fostered and shaped religious norms, precepts and ritual practices through charitable gifting. They also attempted to revitalize the Hindu dharma to craft citizenship, nationalism and a modern civil society.[*] Thus, we see innumerable religious and charitable endowments all over the country. However, in comparison to their numbers there is very meagre legal literature. This can be attributed to the trust in character of the priests who managed the institutions and the binding nature of the customs which regulated such organisations. When the British ruled over India, they passed a number of regulations. Out of them, there are three all India enactments on the subject of endowment still in force. The Religious Endowments Act, 1863; The Charitable Endowments Act, 1890; and the Charitable and Religious Trusts Act, 1920. These Acts are not comprehensive: they legislate on only a fraction of the subject.

2.18 The Religious Endowments Act, 1863 was basically a law on private endowments which placed a property under the management of Trustee/Trustees under a will for religious and charitable purposes for a

[*] All gifting is sacred'- The Sanatana Dharma Sabha movement, the reform of dana and civil society in late colonial India by Malavika Kasturi.

predefined set of beneficiaries. It was a type of contract between the will maker and the Trustee. The objective of the Act was to enable the Government to divest itself of the management of religious endowments. Since it was a contract between the Will maker and the Trustees, the only intervention possible was through filing of a civil suit in a court of law. Following this many Zamindars started creating endowments which generated a lot of civil disputes.

2.19 The Government then came up with a new law - The Charitable Endowments Act, 1890 to provide for vesting and administration of property held in trust for charitable purposes. This enactment led to appointment of a Government officer as a treasurer to oversee the functioning of charitable endowments and State formulated schemes for administration of property vested in the treasurer. However, the Act is of permissive nature in the sense that framing of scheme and vesting of scheme can only be done by the Government if application for that purpose.

2.20 Towards the beginning of the 20th century, many religious institutions had acquired considerable landed property and funds; often comparable to the holdings of a zamindari. It led to incidents of social tension and civil disputes.[*] There were constant complaints especially in the Madras Presidency, as to the inefficacy of The Religious Endowment Act, 1863 to prevent squandering and misappropriation of funds.[**] To deal with this situation, the government enacted a new law in the form of the 'Charitable and Religious Trusts Act, 1920' which recognised the existence of such religious bodies as entities different from Endowment Trusts formed for social and charitable purposes. It was meant to serve the twin purpose of simplifying the legal processes for obtaining information about these institutions as well as exercising control over the action of trustees. Trustees of such bodies were made accountable for disclosure of the income, values, management and application of the subject matter of the trust. Civil courts were given proactive powers with regard to management of the property bit there was no direct State intervention.

However, after independence many state governments enacted their own endowment acts. The state government has the control over management of temples in the states with exceptions being made for those owned by families and private boards. Some such acts are the Madras Hindu Religious and Charitable Endowments Act, 1951; the Travancore-Cochin Hindu Religious

[*] *www* arc.gov.in/9threport/ARC_9thReport_Ch3.pdf.

[**] Statement of object and reasons- The Charitable and Religious Trusts Act, 1920.

Institutions Act 1950; the Bodh Gaya Temple Act, 1949, the Andhra Pradesh Charitable and Hindu Religious Institutions and Endowments Act, 1987; and the Karnataka Hindu Religious Institutions and Charitable Endowments Act, 1997. The government appoints officials to the Board. In such a scenario , being a Hindu place of worship, in the state of Kerala, as a law and convention all temple board members as well as officials need to have sworn allegiance to Hindu faith and sworn to prime deity of each temple Board.

Wakf

2.21 “Wakf" means the permanent dedication by a person professing Islam, of any movable or immovable property for any purpose recognized by the Muslim law as pious, religious or charitable and includes:

(i) A Wakf by user but such Wakf shall not cease to be a Wakf by reason only of the user having ceased irrespective of the period of such cesser.

(ii) "Grants", including mushrut-ul-khidmat for any purpose recognized by the Muslim law as pious, religious or charitable.

(iii) A wakf-alal-aulad to the extent to which the property is dedicated for any purpose recognized by Muslim law as pious, religious or charitable. and "wakif" means any person making such dedication.*

2.22 The concept of Waqf is rooted to the Quranic injunctions, which deal with charity. The followers of Islam transformed this concept of charity into an institution known as Waqf. Literally, Waqf means endowment of moveable or immovable property dedicated to God by the Muslims for the welfare of needy. The Waqif (settler) in his deed appoints Mutawalli (Manager) for the administration of the Waqf. The Waqif is has authority to either appoint himself or any Muslim as Mutawalli. During Muslim rule, the rulers generously dedicated property such as land and its revenue rights to Waqf created with the purpose of maintaining mosques, tombs, orphanages (yatimkhanas), madrasas etc. In many cases, donations to a Waqf were made with the intent of promoting the tenets of Islam. During that period, Islamic courts overseen by Qazis kept a close eye on the Mutawallis. Any mismanagement of Waqf property was considered breach of the trust reposed in them for which they were duly punished. After the collapse of Muslim Empire, the British abolished the institution of Islamic courts headed by Kazis and deprived them of their supervisory control over Waqf. The Mutawallis

* Definition of wakf- http://mahawakf.com/

became more powerful as they had no fear from the harsh punishment under the provision of Islamic Law. This led to large-scale corruption in the administration of Waqf and they often indulged in favouritism, corruption and mal-administration. At that time, the British colonial administration did not interfere much in the religious matters of the natives. After 1857, when the British started expanding the Common law regime in the country, they began exercising control over Awaqf mostly where there were charges of corruption. The British Government confiscated several Waqf properties like Jama Masjid and the Fatehpuri Mosque in Delhi. These were restored to the Mutawallis only after the enactment of the Charitable and Religious Endowments Act by the government in 1863. Another practice which was started by some wealthy Muslims was to endow them to Waqf- al-Alaulad (Family Waqf) with the intention of saving their properties from irresponsible progeny. This kind of Waqf was opposed by a number of Muslim clerics as well as Amir Ali, the noted advocate of Calcutta and expert of Muslim Law. In 1894, the Privy Council maintained that it was "a concealed means for the aggrandizement of family" (Wakf Administration in India by S.Khalid Rasid, Vikas Publishing House, 1978, page127), which was contrary to the concept of charity the core spirit behind Waqf. It also said that in Waqf-al-Aulad "the provision for charity is so illusory that the poor are not entitled to receive a rupee till after total extinction of a family".[*] This decision led to a chain of events which finally led to the enactment of the Mussalman Waqf Validating Act in 1913. Thereafter, there were slew of acts passed on this matter. They are as follows:

(i) Mussalman Waqf Act, 1923

(ii) Bengal Waqf Act, 1934

(iii) The Hyderabad Endowment Regulation, 1939

(iv) U.P. Muslim Waqf Act, 1936

(v) Delhi Muslim Waqf Act, 1943

(vi) Bihar Waqf Act, 1947

(vii) Bombay Public Trusts Act, 1950

(viii) Dargah Khwaja Saheb Act, 1955

[*] Wakf background- http://www.southasiaanalysis.org/%5Cpapers12%5Cpaper1136.html

(ix) Central Waqf Act, 1954

(x) Waqf Amendment Act, 1959

(xi) U.P. Muslim Act, 1960

(xii) Dargah Kwaja Saheb Waqf Amendment Act, 1964

(xiii) Waqf Amendment Act, 1969

(xiv) Waqf Amendment Act, 1984 and

(xv) The Waqf Act, 1995

2.23 The Central Government is responsible for the implementation of the Wakf Act. The Wakf Act, 1954 had provisions for survey of Wakfs, constitution of Central Wakf Council and State Wakf Boards etc. For better management and adnminstration of Waqfs, the Wakf Act, 1954 was amended many times. Finally a comprehensive and land mark legislation, i.e., Wakf Act, 1995 was enacted by the Government of India which became effective from 01.01.1996. In contrast to the previous Act, this Act is applicable throughout the country except for Jammu & Kashmir and Dargah Khwaja Saheb, Ajmer. Currently, 300000 Waqfs in India are being administered under various provisions of the Waqf Act, 1995. The management structure under the Act consists of a Waqf Board as an apex body in each State. Every Waqf Board is a quasi-judicial body empowered to rule over Waqf-related disputes. At the national level, there is Central Waqf Council which acts in an advisory capacity. The Council consists of Chairperson, who is the Union Minister Incharge of Wakfs and such other members not exceeding 20 in numbers appointed by Government of India as stipulated in the Act. The Council derives its income from the contribution received by it from the various State Wakf Boards @ 1% (one per cent) of the net income of the Wakfs. All administrative and other expenses of the Council are met out of from this income. The Council advises the government pertaining to working of the State Wakf Boards and proper administration of the Wakfs in the country. The main functions of the State Wakf Boards can be described briefly as follows:

(i) Registration of Wakf Properties on due process.

(ii) Appointment & removal of Muttawalli.

(iii) Removal of Encroachment & illegal occupation on Wakf property.

(iv) Assessment of income, Issuance of Demand Notices of Wakf contribution & its collection.

(v) Preparation of Budget and scrutiny of Annual Accounts submitted by Muttawalli.

(vi) Maintenance of Wakf Fund & Fund of Wakf Estates.

(vii) Audit of Wakf Estates with income ₹ 10000/- and more by Govt. approved panel of Audit Firm.

(viii) Development of Wakf properties for Housing, marketing, educational institutions and other income generating purposes.

(ix) Management of Wakf Estates under Direct Management.

(x) Law matters and Court cases.

(xi) Preservation of Wakf Records like Deeds and other relevant papers.

(xii) Distribution of Stipend to poor and meritorious students.

(xiii) Organization of ―Urs□/ Melas/ fair under different Estates.

(xiv) Liaison with the Central Wakf Council, Delhi.

The Sikh Gurdwaras Act, 1925

2.24 This Act was enacted to provide for the better administration of certain Sikh Gurdwaras and for inquiries into matters and settlement of disputes connected therewith, and whereas the previous sanction of the Governor-General has been obtained to the passing of this Act. The Gurdwara Reform Movement, which led to the passing of the Sikh Gurdwaras Act in 1925, started because the Mahants were not duly recognizing the status and role of Sri Guru Granth Sahib in the Gurdwaras by placing other objects of worship alongwith. This remarkable piece of legislation is considered an achievement of Sikhs in the twentieth century. The Sikhs got not only their Gurdwaras but also the full freedom to manage them.

2.25 Scope of the Act is as follows:

(i) Petitions to State Government Relating to Gurdwaras - Chapter II (Section 3 To 11)

(ii) Appointment of, And Proceedings Before, A Tribunal - Chapter III (Section 12 To 37)

(iii) Application of Provisions of Part III to Gurdwaras Found to be Sikh Gurdwaras by Courts Other Than A Tribunal Under the Provisions of The Act - Chapter IV (Section 38)

(iv) Control of Sikh Gurdwaras - Chapter V (Section 39 To 41)

(v) The Board - Chapter VI (Section 42 To 69)

(vi) The Judicial Commission - Chapter VII (Section 70 To 84)

(vii) Committees of Gurdwaras - Chapter VIII(Section 85 To 105)

(viii) Finances - Chapter IX (Section 106 To 124)

(ix) Powers and Duties of The Board - Chapter X (Section 125 To 132)

(x) Powers and Duties of Committees - Chapter XI (Section 133 To 140)

(xi) Miscellaneous - Chapter XII (Section 141 To 148A)

(xii) Temporary and Transitional Provisions - Chapter XII-A (Section 148B To 148F)

(xiii) Electoral Offences - Chapter XIII (Section 149 To 161)

Section 25 of the Companies Act, 1956

2.26 Section 25 of the Companies Act, 1956 provides for a mechanism through which an Association can be registered as a Company with a limited liability, if such association is formed for promoting commerce, art, science, religion or any other useful object and intends to apply its profits/income in promoting its objects. The objective of this provision is to provide corporate personality to such Associations but at the same time exempting them from some of the cumbersome legal requirements.

This Section reads as:

"25(1) Where it is proved to the satisfaction of the Central Government that an association:

Is about to be formed as a limited company for promoting commerce, art, science, religion, charity or any other useful object,

Intends to apply its profits, if any, or other income in promoting its objects, and to prohibit the payment of any dividend to its members,

The Central Government may, by license, direct that the association may be registered as a company with limited liability, without addition to its name of the word "Limited" or the words 'Private Limited."

An Association registered under the above provision shall enjoy all the privileges and would be subject to all the obligations of limited companies.

Non-Trading Corporations

2.27 The list of State Non-trading Corporations Act is as follows:

(i) Andhra Pradesh Non-trading Companies Act, 1962

(ii) Bihar (Non-trading) Act, 1959

(iii) Kerala Non-trading Companies Act, 1961

(iv) Madhya Pradesh Non-trading Corporations Act, 1962

(v) Orissa (Non-trading) Companies Act, 1959

(vi) Punjab Non-trading Companies Act, 19601

(vii) Rajasthan Non-trading Companies Act, 1960

(viii) Tamil Nadu Non-trading Companies Act, 1972

(ix) West Bengal Non-trading Corporations Act, 1965

National Policy on the Voluntary Sector, 2007

2.28 This Policy is a commitment to encourage, enable and empower an independent, creative and effective voluntary sector, with diversity in form and function, so that it can contribute to the social, cultural and economic advancement of the people of India.

This policy recognizes the important role that the voluntary sector has to play in various areas and affirms the growing need for collaboration with the voluntary sector by the Government, as well as by the private sector, at the local, provincial and national levels.

Scope of the Policy

2.29 In the Policy, Voluntary Organisations (VOs) mean to include organization engaged in public service, based on ethical, cultural, social, economic, political, religious, spiritual, philanthropic or scientific & technological considerations. VOs include formal as well as information groups, such as:

Community-based organizations (CBOs); non-governmental development organizations (NGDOs); charitable organizations; support organizations; networks or federations of such organizations; as well as professional membership associations.

To be covered under the Policy, VOs should broadly have the following characteristics:

(i) They are private, i.e., separate from Government

(ii) They do not return profits generated to their owners or directors

(iii) They are self-governing, i.e., not controlled by Government

(iv) They are registered organizations or informal groups, with defined aims and objectives.

Objectives of the Policy

2.30 The specific objectives of the policy are as follows:

(i) To create an enabling environment for VOs that stimulates their enterprise and effectiveness, and safeguards their autonomy;

(ii) To enable VOs to legitimately mobilize necessary financial resources from India and abroad;

(iii) To identify systems by which the Government may work together with VOs, on the basis of the principles of mutual trust and respect, and with shared responsibility, and

(iv) To encourage VOs to adopt transparent and accountable systems of governance and management.

Establishing an Enabling Environment for the Voluntary Sector

2.31 The independence of VOs allows them to explore alternative paradigms of development to challenge social, economic and political forces that may work against public interest and to find new ways to combat poverty, deprivation and other social problems. It is, therefore, crucial that all laws, policies, rules and regulations relating to VOs categorically safeguard their autonomy, while simultaneously ensuring their accountability.

Partnership in Development

2.32 The voluntary sector can play an important role in the development process, particularly through community participation. It is, therefore, essential that the Government and the Voluntary Sector work together.

This Policy recognizes three instruments of partnership, *viz.,* (i) consultation, through a formal process of interaction at the Centre, State and District level; (ii) strategic collaboration to tackle complex interventions where sustained social mobilization is critical over the long-term; and (iii) project funding through standard schemes.

Strengthening the Voluntary Sector

2.33 The Indian society has a well-established tradition of philanthropy. While a regime f tax concession facilitates donations to charitable organizations, there is considerable untapped potential to channelise private wealth for public service. The Government will support and encourage existing, as well new, independent philanthropic institutions and private foundations to provide financial assistance to deserving VOs. It will also promote a dialogue among public and private grant makers so that they may take advantage of the best practices in grant making and fun-raising strategies.

This National Policy on the Voluntary Sector, 2007 is the beginning of a process to evolve a new working relationship between the Government and the Voluntary Sector, without affecting the autonomy and identity of VOs.

Grants-in-aid from the Government of India

2.34 Government of India allocates the grants-in-aid for carrying out the specific programmes as well as for block general purposes. These grants are made out to voluntary organizations who are involved in implementing these programmes. Grants-in-aid have been defined as the sum which a superior authority assigns to an inferior authority. For allocation of the financial resources, the Government of India has framed General Financial Rules for deciding the right agency. The terms and conditions governing these specific schemes are from the grants-in-aid rules mentioned in these schemes of the various ministries and departments.

It should have been engaged in social welfare/ development activities for a minimum period of 3 years prior to seeking the grant.

Government Schemes

2.35 There are various schemes sponsored by the various Central Government ministries, such as, Ministry of Social Justice and Empowerment, Ministry of Health and Family Welfare, Ministry of Human Resources Development. The applicant voluntary organizations applying for such grants in aid should file these through the relevant State level department. The recommendations made by these departments shall be considered while sanctioning these grants. Various schemes sponsored by the various Central Government ministries are given as Appendix 3.

Taxation

2.36 Though there exists a plethora of methods by which NPOs capable of being registered, as far as income tax is concerned, it makes no difference whether the organisation is formed by way of trust, a company or a society. The relative benefits would depend upon the way in which these organisations would be conducting its activities. The local laws of each state will also have relevance particularly in an area of compliances and state interferences in the activities.

2.37 The provisions regarding granting of exemption to a public charitable Trust, a company registered under Section 25 of the Companies Act, 1956 or a society registered under the Societies Registration Act, 1860, or any other institution is contained in one or more of the following sections of Act:

(i) Section 2(15);

(ii) Section 2(24) (iia);

(iii) Section 10

(iv) Sections 11, 12, 12A, 12AA and 13; and

(v) Sections 35(i)(ii) , 35(i)(iii), 35AC

Charitable Purpose [Section 2(15)]

2.38 Section 2(15) defines the expression "*charitable purpose*" in an inclusive manner to include,

(i) relief of the poor,

(ii) education,

(iii) medical relief,

(iv) preservation of environment, (including watersheds, forests and wildlife)

(v) preservation of monuments or places or objects of artistic or historic interest, and

(vi) any other object of general public utility.

The definition is not exhaustive and, therefore, purposes similar to the purposes mentioned in the definition will also constitute charitable purposes. The clause "any other object of general public utility" was increasingly being misused or being the subject of disputes. Finance Act, 2008 sought to limit the definition of "charitable purpose" by stating that if the "advancement of any other object of general public utility" involves undertaking any trade, commerce, or business activities, or rendering any related service for a fee or any other condition (irrespective of use, application, or retention of income arising from such activities), it will not be considered a "charitable purpose." The Finance Act 2010, retroactively effective from April 1, 2009, provided some relief by exempting the aggregate value of receipts from such activities up to ten lakh rupees that was further raised to ₹ twenty five lakhs by the Finance Act, 2011.

2.39 Section 12A states that provisions of section 11 and section 12, regarding exemption of income, will not be applicable to an institution etc., unless an application for its registration is made to the CIT within a period of one year from the date of its creation. Section 12A(b) also requires that if the total income of a trust etc. in any previous year exceeds the maximum amount not chargeable to income tax without giving effect to the provisions of section 11 and section 12, then its accounts are required to be audited by an accountant and his report in Form no. 10B has to be filed along with the return of income.

Income [Section 2(24(iia)]

2.40 This section defines what constitutes income for certain specified non profit organisations. Under section 2(24)(ii), voluntary contributions received by the following entities are considered as income:

(i) trust or institution created wholly or partly for religious or charitable purposes

(ii) scientific research association as specified in section 10(21) and Section 35(1)(ii)and(iii)

(iii) fund or trust or institution established for charitable purposes having special importance as specified under section 10 (23C)(iv)

(iv) trust or institution established for wholly for public religious or charitable purposes being administered in accordance with requirements of section 10 (23C)(v)

(v) any university or other educational institution referred to in section 10 (23C)(vi) or

(vi) any hospital or other institution referred to in section 10 (23C)(via).

2.41 Section 12 makes some changes in the aforesaid "income". Firstly, it excludes corpus donations from the ambit of income. Thus, voluntary contributions received with a specific direction that they shall form part of the corpus are to be excluded from the definition of the term income. It may be noted here that these contributions have to be used in accordance with the directions of the donor. And secondly, the value of any medical or educational service, by a trust etc. running an educational institution or a hospital, to a person referred to in section 13(3) of the Income Tax Act (author, founder, trustee, relative etc) will be deemed to be the income of the trust or institution. If the beneficiary has made any payment for such service, then such payment shall be deducted from the value of the service in arriving at the income.

Business Income

2.42 With respect to trust or institutions created or established wholly for religious or charitable purposes, income from a business that it operates that is incidental to the attainment of the objects of the organization, is exempt from income tax, provided the entity maintains separate books and accounts with respect to the business.

Application of Income

2.43 Section 11 deals with income from property held for charitable or religious purposes. It specifies the conditions on satisfaction of which the entity gets tax exemptions.

(i) The organization must spend 85% of its income in any financial year on the objects of the organization. The organization has until 12 months following the end of the financial year to comply with this requirement.

(ii) Surplus income may be accumulated for specific projects for a period ranging from 1 to 5 years.

(iii) The organization's income must be applied or accumulated in India. If for any reason income received falls short of 85% the entity has to apply in writing to get exemption and the funds have to be deposited as specified in section 11(5);

(iv) If due to circumstances beyond the control of the entity, the accumulated income cannot be applied for the purpose it was set up , the entity has to apply to the Assessing Officer and if permission is granted and other conditions set in the Act are met ,entity can apply the income for other charitable or religious purposes which are similar to its objects.

(v) If the organisation is dissolved, then Assessing officer may allow the income to be transferred to a trust or institution specified under section 11(3)(d).

Capital Gains

2.44 Treatment of capital gains is specified in Section 11(1A). Where the whole of the property is used for charitable and religious purposes and the whole of the net consideration (Consideration minus the expenditure incurred in connection with transfer) is applied towards acquiring a new capital asset, then, the capital gains is taken to have been applied for charitable or religious purpose. However, if only a part of the net consideration is applied for acquiring a new capital asset, then, the capital gains to the extent of differences between amount so applied and original cost of the asset is taken to be applied for religious or charitable purpose. The provision applies mutatis-mutandis where the capital asset is held partly for religious or charitable purpose.

Anonymous Donations

2.45 The organization must keep a basic record (name, address and other prescribed particulars) of voluntary contribution received. According to section 115BBC, introduced with the Finance Act, 2006, all anonymous donations to charitable organizations are taxable at the maximum marginal rate of 30%. Section 115BBC is applicable to following NPOs:

(i) Any university or other educational institution referred to in section 10(23C) (*iiiad*) or 10(23C) (*vi*)

(ii) any hospital or other institution referred to in section 10(23C) (*iiiae*) or 10(23C) (*via*)

(iii) any fund or institution referred to in section 10(23C) (*iv*)

(iv) any trust or institution referred to in section 10(23C) (*v*)

(v) any trust or institution referred to in section 11

2.46 Anonymous donations were taxable at the maximum marginal rate of 30%. However, Finance (No.2) Act, 2009, gave some relief and, w.e.f. 1-4-2010 the income-tax payable shall be the aggregate of:

(i) the amount of income-tax calculated at the rate of thirty per cent on the aggregate of anonymous donations received in excess of the higher of the following, namely:

  (A) five per cent of the total donations received by the assessee; or

  (B) one lakh rupees; and

(ii) the amount of income-tax with which the assessee would have been chargeable had his total income been reduced by the aggregate of anonymous donations received.

2.47 Additionally, the following entities are exempt from the provisions of this section:

(i) any trust or institution created or established wholly for religious purposes;

(ii) any trust or institution created or established wholly for religious and charitable purposes other than any anonymous donation made with a specific direction that such donation is for any university or other educational institution or any hospital or other medical institution run by such trust or institution.

Tax Deduction for Donors

Deductions under 80G

2.48 Though the internal auditor is auditing the NPO, the auditor should get acquainted with the tax impact to the donor as this can be useful in the audit. E.g. copies of receipts can serve as audit evidence for verifying donations received by the entity. More implications are discussed in chapter related to audit.

2.49 Section 80G of the Income Tax Act, 1961 sets forth the types of donations that are tax-deductible. Contributions to various funds, institutions, charitable institutions are exempt. The percentage of exemption differs for various types of entities. Donor get a 100% deduction for donations to entities listed under section 80G (2) which comprises mainly of funds set up by Central or State Government or local authority .For entities not specifically enumerated in section 80G, donors may deduct 50% of their contributions to such organizations, provided the following conditions are met.[Section 80G(5)]:

(i) The institution or fund was created for charitable purposes in India and provisions of section 11 and 12 apply to it ;

(ii) The institution or fund is tax-exempt;

(iii) The institution's governing documents do not permit the transfer or use of income or assets for any purpose other than a charitable purpose;

(iv) The institution or fund is not expressed to be for the benefit of any particular religious community or caste; and

(v) The institution or fund maintains regular accounts of its receipts and expenditures.

(vi) The institution is either a public charitable trust or a society or section 25 company or a specified educational institution or is an institution financed wholly or partly by the government or a local authority.

2.50 It should be remembered that:

(i) Total deductions available to a donor cannot exceed 10% of the donor's total gross income. Any amount in excess of 10% will not be exempt in the hands of donor.

(ii) Donations to institutions or funds "for the benefit of any particular religious community or caste" are not tax-deductible. A not-for-profit organization created exclusively for the benefit of a particular religious community or caste may, however, create a separate fund for the benefit of "Scheduled castes, backward classes, Scheduled Tribes or women and children" and those will be exempted [Section 80G Explanation 1].

(iii) For purpose of Section 80G, an association or institution related to sports or games and notified by the Central Government will be considered as charitable institution.

(iv) Tax deduction under section 80G are only allowed if the donation is a sum of money. Thus, in-kind donations are not recognised for exemption.

(v) Receipts issued to donors by not-for-profit organizations must bear the number and date of the 80G certificate.

Deductions for Projects, Schemes, etc.

2.51 The Income Tax Act, 1961 contains a number of other provisions permitting donors to deduct contributions related to various projects, schemes and programmes related to welfare and scientific research:

(i) Under section 35AC of the Act, donors may deduct 100% of contributions to various projects, carried out by approved funds or institutions including i) construction and maintenance of drinking water projects in rural areas and in urban slums; ii) construction of dwelling units for the economically disadvantaged; and iii) construction of school buildings, primarily for economically disadvantaged children.

(ii) Section 35CCA of the Act allows donors to deduct 100% of their contributions to associations and institutions (approved by prescribed authority) carrying out rural development programs and,

(iii) Under Section 35CCB of the Act, 100% of donations to associations and institutions (approved by prescribed authority) carrying out programs of conservation of natural resources is allowed as tax deduction.

(iv) A weighted deduction of 175% is also allowed for contributions to organizations approved under section 35(1)(ii) (i.e., a research association or a university, college, or other institution) specifically for "research," and 125% for contributions made under section 35(1)(iii) specifically for "research in social science or statistical research".

(v) Similar type of exemption is now available to donors of companies engaged in scientific research. Finance Act, 2008 introduced a weighted deduction of 125% for contributions made to a company registered in India, whose main objective is scientific research and development, when those contributions are approved by the prescribed authority and satisfy prescribed conditions. However, these companies will not be eligible for the weighted deduction of

200% available under section 35(2AB) to qualifying companies and manufacturers for expenditures incurred on scientific research or in-house research and development.

Foreign Contribution (Regulation) Act (FCRA), 2010

History of Foreign Contribution (Regulation) Act (FCRA), 1976

2.52 The Foreign Contribution (Regulation) Act was enacted by our Parliament in 1976 by virtue of Entry 36 of the Union list in schedule VII of the constitution dealing with currency, coinage and legal tender, foreign exchange. The FCRA bill, 1976 received the assent of the President on 31st March, 1976 and becomes an Act as published in the Gazette of India, Extraordinary, Part II, Section I, dated 31st March 1976 to serve as a component of the protective structure of our constitution and our cultural values. In order that funds from abroad do not subvert the integrity of the institutions that constitute the pillars of our secular democratic polity, the FCRA seeks to regulate the flow of funds into India from foreign sources by laying down a legal framework that enables the government to keep a vigil over undesirable foreign influence.

Object of Foreign Contribution (Regulation) Act (FCRA), 1976

2.53 The object and purpose of FCRA is to regulate the acceptance and utilization of foreign contribution or foreign hospitality by certain persons or associations and academic and other voluntary organizations as well as individual working in the important areas of national life may do so in a manner which is confident with the values of a sovereign democratic republic that India is.

As foreign money and hospitality at the material time was invading many institutions and organisations to destabilize the government in power, it was felt necessary to curb the receipts and usage of foreign contribution or foreign hospitality for nefarious or anti national purposes by all persons including Indian citizens or corporation operating within or outside India. The Ministry of Home Affairs has been made responsible for the implementation of the FCRA. The FCRA is a Framework for regulating and controlling the acceptance and utilization of foreign contribution and foreign hospitality.

History of Foreign Contribution (Regulation) Act (FCRA), 2010

2.54 Foreign Contribution Regulation Act and Rules 1976 is replaced by Foreign Contribution (Regulation) Act 2010 and Foreign Contribution (Regulation) Rules 2011.

2.55 Foreign Contribution (Regulation) Act (FCRA), 2010 received the assent of the President on the 26th September, 2010 and notification relating the Foreign Contribution (Regulation) Rules, 2011 published on 29th April, 2011. The FCRA, 2010 and Foreign Contribution (Regulation) Rules, 2011 is effective from 1st May 2011.

2.56 The FCRA, 2010 is an act to consolidate the law to regulate the acceptance and utilization of foreign contribution or foreign hospitality by certain individuals associations or companies and to prohibit acceptance and utilization of foreign contribution or foreign hospitality for any activities detrimental to the National interest and for matters connected therewith or incidental thereto.

2.57 The Act extends to whole of India and it shall also apply to:

(a) Citizens of India outside India and,

(b) Associate, branches or subsidiaries, outside India, of companies or bodies corporate registered or incorporated in India.

Expanded Scope of FCRA, 2010

2.58 The FCRA, 2010 has much broader applicability. It is applicable to individuals, HUF, association and a Section 25 company.

Similarly the object of act also changes from regulation to prohibiting. The object of FCRA, 1976 was to regulate the acceptance and utilization of foreign contribution or foreign hospitality by certain persons. Where as role of FCRA, 2010 is to regulate the acceptance and utilization of foreign contribution or foreign hospitality and to prohibit acceptance and utilization of foreign contribution or foreign hospitality for any activity detrimental to the national interest.

Provisions under FCRA, 2010

2.59 The new provisions introduced under FCRA, 2010 are as follows:

(a) Restriction to Utilize Foreign Contribution for Administrative Purpose

Every Person who is registered and granted a certificate or given prior permission under this act and received any foreign contribution shall not defray as far as possible such sum, not exceeding fifty percent of such contribution, received in a financial year, to meet administrative expenses.

Elements which shall be included in the administrative expenses and the manner in which the administrative expenses shall be calculated are prescribed in Rule 5 of FCRA Rules, 2011.

Administrative Expenses

The Following shall constitute administrative Expenses:

(i) Salaries, Wages, travel expenses or any remuneration realized by the members of the Executive Committee or Governing Council of the person;

(ii) All expenses towards hiring of personnel for management of the activities of the person and salaries, wages or any kind of remuneration paid, including cost of travel, to such personnel;

(iii) All expenses related to consumables like electricity and water charges, telephone charges, postal charges, repairs to premise(s) from where the organization or Association is functioning, stationery and printing charges, transport and travel charges by the Members of the Executive Committee or Governing Council and expenditure on office equipment;

(iv) Cost of accounting for and administering funds;

(v) Expenses towards running and maintenance of vehicles;

(vi) Cost of writing and filing reports;

(vii) Legal and professional charges; and

(viii) Rent of premises, repairs to premises and expenses on other utilities:

Provided that the expenditure incurred on salaries or remuneration of personnel engaged in training or for collection or analysis of field data of an association primarily engaged in research or training shall not be counted towards administrative expenses:

Provided further that the expenses incurred directly in furtherance of the stated objectives of the welfare oriented organisation shall be excluded from the administrative expenses, such as, salaries to doctors of hospital, salaries to teachers of school, etc.

(b) *Foreign Contribution or Any Income Arising out of It Shall Not Be Used for Speculative Business*

Rule 4 is specifying the activities or business which shall be construed as speculative business:

Speculative Activities

1. The following activities shall be treated as Speculative activities:

   (a) any activity or investment that has an element of risk of appreciation or depreciation of the original investment, linked to market forces, including investments in mutual funds or in shares;

   (b) participation in any scheme that promises high returns like investments in chits or land or similar assets not directly linked to the declared aims and objectives of the organisation or association.

2. A debt-based secure investments shall not be treated as speculative investment.

3. every association shall maintain a separate register of investments.

4. every register of investment maintained under sub-rule (3) shall be submitted for audit.

(c) *Validity for Certificate of Registration*

The certificate granted to accept foreign contribution shall be valid for a period of five years & the prior permission shall be valid for the specific purpose or specific amount of foreign contribution proposed to received, as the case may be.

(d) *Renewal of Certificate*

Every person who has been granted a certificate under Section 12 shall have such certificate renewed within six months before the expiry of the period of the certificate.

(e) *Application for Obtaining 'Registration' or 'Prior Registration' to Receive Foreign Contribution*

(i) An application for registration of a person for acceptance of foreign contribution shall be made electronically on line in form FC-3 and shall be followed by forwarding the hard copy of the on line application duly signed by the chief functionary of the association together with the required documents.

(ii) The hard copy shall reach within thirty days of the submission of the on line application.

(iii) An application for obtaining prior permission of the Central Government to receive foreign contribution shall be made electronically online in form FC-4 and shall be followed by forwarding the hard copy.

(iv) An application made for the Grant of the registration shall be accompanied by a fee of ₹ 2000 and for the grant of prior permission shall be with a fee of ₹ 1000.

(v) Every application made for registration or prior permission under the FCRA, 1976 but not disposed of before the date of commencements of the Foreign Contribution Regulation Rules 2011 shall be deemed to be an application for registration or prior permission, as the case may be under these rules, subject to condition that the applicant furnishes the prescribed fees for such registration or prior permission as the case may be.

(f) *Procedure for Renewal of Registration Certificate*

(i) Every person shall apply to the central Government in form FC-5 six moths before the date of expiry of the certificate of registration, for its renewal.

(ii) A person implementing an ongoing multi year project shall apply for renewal twelve month before the date of expiry of the certificate of registration.

(iii) An application made for renewal of the certificate of registration shall be accompanied by a fee of ₹ 500.

(iv) In case no application for renewal of registration is received or such application is not accompanied by the requisite fee, the validity of the certificate of registration of such person shall be deemed to have ceased from the date of completion of the period of five years from the date of the grant of registration.

(g) *Intimation of Foreign Contribution by the Recipient*

(i) Every person who receives foreign contribution under the act shall submit a report in form Fc-6, accompanied by an income and expenditure statement, receipt and Payment account, and balance sheet for every financial year beginning on the 1st day of April within nine months of the closure of the financial year, to the Secretary to the Government of India, ministry of home Affairs, New Delhi.

(ii) The annual return in form FC-6 shall reflect the foreign contribution received in the exclusive bank account and include the details in the respect of the funds transferred to other bank accounts for utilization.

(iii) If the foreign contribution relates only to articles, the intimation shall be submitted in form FC-7.

(iv) If the foreign contribution relates to foreign securities, the intimation shall be submitted in Form FC-8.

(v) Every report submitted under sub-rules (2) to (4) shall be duly certified by a chartered accountant.

(vi) Every such return in Form FC-6 shall also be accompanied by a copy of a statement of account from the bank where the exclusive foreign contribution account is maintained by the person, duly certified by an officer of such bank.

(vii) The accounting statements referred to above in the preceding sub-rule shall be preserved by the person for a period of six years.

(viii) A 'NIL' report shall be furnished even if no foreign contribution is received during a financial year.

(h) *Reporting by Banks of Receipt of Foreign Contribution*

The bank shall send a report to the Central Government within thirty days from the date of such last transaction in respect of receipt of any foreign contribution in excess of one crore rupees or equivalent thereto in a single transaction or in transactions within duration of thirty days, by any person, whether registered or not under the Act and such report shall include the following details:

(i) Name and address of the donor.

(ii) Name and address of the recipient.

(iii) Account number.

(iv) Name of the bank and branch.

(v) Amount of foreign contribution (in foreign currency as well as Indian rupees.)

(vi) Date of receipt.

(vii) manner of receipt of foreign contribution (Cash/ cheque/ electronic transfer, etc)

(i) *Receipts of Foreign Contribution in Excess of One Crore Rupees in Financial Year*

In case a person who has been granted a certificate of registration or prior permission receives foreign contribution in excess of one crore rupees, or equivalent thereto, in a financial year, he/it shall place the summary data on receipts and utilization of the foreign contribution pertaining to the year of receipt as well as for one year thereafter in the public domain. Besides, the Central Government shall also display or upload the summary data of such persons on its website for information of the general public.

(j) *Intimation of Receiving Foreign Contribution From Relatives*

Any person receiving foreign contribution in excess of one lakh rupees or equivalent thereto in a financial year from any of his relatives shall inform the Central Government in Form FC-1 within thirty days from the date of receipts of such contribution.

(k) *Guidelines For Declaration of An Organization to be of A Political Nature, Not Being A Political Party*

The Central Government may specify any organization as organization of political nature on one or more of the following grounds:

(i) Organization having allowed political objectives in its Memorandum of Association

(ii) or bylaws;

(iii) Any Trade Union whose objectives include activities for promoting political goals;

(iv) Any voluntary action group with objectives of a political nature or which participates in political activities;

(v) Front or mass organization like students Unions, Worker' Union, Youth Forums and women's wing of a political party;

(vi) Organization of farmers, workers, students, youth based on caste, community, religion, language or otherwise , which is not directly aligns to any political party but whose objectives, as stated in the Memorandum of Association, or activities gathered through other material evidence, include steps towards advancement of political interest of such groups;

(vii) Any organization, by whatever name called, which habitually engages itself in or employs common methods of political action like 'bandh' or 'hartal', 'rasta roko', 'rail rook' or 'jail bharo' in support of public causes.

(l) *Bank Account*

Every person who has been granted a certificate or given prior permission shall receive foreign contribution in a single account only through such one of the branches of a bank as he may specify in his application for grant of certificate.

Provided that such person may open one or more accounts in one or more banks for utilizing the foreign contribution received by him. Provided further that no funds other than foreign contribution shall be received or deposited in such account or accounts.

(m) *Prohibition to Transfer Foreign Contribution to Other Person*

No Person Who:

(a) is registered and granted a certificate or has obtained prior permission under this act; and

(b) receives any foreign contribution.

Shall transfer such foreign contribution to any other person unless such other person is also registered and had been granted the certificate or obtained the prior permission under this Act.

Provided that such person may transfer, with the prior approval of the Central Government, a part of such foreign contribution to any other person who has not been granted a certificate or obtained permission under this act in accordance with rules made by the Central Government.

(n) *Cancellation of Registration Certificate*

Under Section 14, the Central government may cancel the registration certificate for various records. However, no certificate shall be cancelled unless reasonable opportunities of being heard certificate are:

(i) Providing false information,

(ii) Violating any of the terms and conditions of the certificate or renewal there of, or

(iii) in the opinion of the central government, it is necessary in the public interest to cancel the certificate, or

(iv) the holder of certificate has certificate has violated any of the provisions of this Act or rules, or

(v) if the holder of the certificate has not been engaged in any reasonable activity in its chosen field for the benefit of the society for two consecutive years or has becomes defunct.

Any persons whose certificate has been cancelled under this section shall not be eligible for registration or grant of prior for a period of three years from the date of cancellation of such certificate.

(o) *Business/Consulting Income of an NGO*

The notable change in FCRA 201 is that foreign contribution does not include commercial receipts. Any consulting or commercial receipt from foreign source by NGO will not be included as foreign contribution.

(p) *Foreign Company and Foreign Source*

As per provisions of section 2 (j) which defines the form foreign source includes an Indian company under the category of foreign source if more than 50% of its equity is held by foreigners.

(q) *Panchayat has been Defined as Legislature*

Panchayat has been included under the definition of Legislature under section 2 (1) (k). The implications of this charged is that a member of a panchayat cannot receive any foreign contribution.

Definitions under FCRA, 2010

2.60 Some of the definitions under FCRA, 2010 are as follows:

Foreign Contribution

"Foreign Contribution" Means the donation, delivery or transfer made by any Foreign Source:

- of any article, not being an article given to a person as a gift for his personal use, if the market value, in India, of such article, on the date of such gift is not more than such sum as may be specified from time to time, by the Central Government by the rules made by it in this behalf;
- of any currency, whether Indian or foreign;
- of any security as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 and includes any foreign security as defined in clause (o) of section 2 of the Foreign Exchange Management Act, 1999.

Explanation 1 – A donation, delivery or transfer of any article, currency or foreign security referred to in this clause by any person who has received it from any foreign source, either directly or through one or more person, shall also be deemed to be foreign contribution within the meaning of this clause.

Explanation 2 – The interest accrued on the foreign contribution deposited in any bank refer to in sub-section (1) of section 17 or any other income derived from the foreign contribution or interest thereon shall also be deemed to be foreign contribution within the meaning of this clause.

Explanation 3 – Any amount received, by any person from any foreign source in India, by way of fee (Including fees charged by an educational institution in India from foreign student) or towards cost in lieu of goods or service rendered by such person in the ordinary course of his business, trade or commerce whether within India or outside India or any contribution received from an agent of a foreign source towards such fee or cost shall be excluded from the definition of foreign contribution within the meaning of this clause;

Foreign Source

"Foreign Source" Includes,

(i) The Government of any foreign country or territory and any agency of such Government;

(ii) Any international agency, not being the United nations or any of its specialized agencies, the World Bank, International monetary Fund or such other agency as the Central Government may, by notification, specify in this behalf;

(iii) a foreign company;

(iv) a corporation, not being a foreign company, incorporated in a foreign country or territory;

(v) a multi-national corporation referred to in sub-clause (iv) of clause (g);

(vi) a company within the meaning of the Companies Act, 1956, and more than one-half of the nominal value of its share capital is held, either singly or in the aggregate, by one or more of the following, namely:

  (a) the Government of a foreign country or territory;

  (b) the citizens of a foreign country or territory;

  (c) corporations incorporated in a foreign country or territory;

  (d) trust, societies or other associations of individual (Whether incorporated or not), formed or registered in a foreign country or territory;

  (e) foreign company.

(vii) a trade union in any foreign country or territory, whether or not registered in such foreign country or territory;

(viii) a foreign trust or a foreign foundation, by whatever name called, or such trust or foundation mainly financed by a foreign country or territory;

(ix) a society, club or other association of individuals formed or registered outside India;

(x) a citizen of a foreign country.

Person

Person includes:

(i) an individual,

(ii) a Hindu undivided family(HUF),

(iii) an association,

(iv) a company registered under section 25 of the Companies Act, 1956.

Account and Audit under FCRA, 2010

Rule 16 provide that annual return in prescribed form FC-6 accompanied by income & Expenditure Statement, Receipts & Payment accounts & Balance Sheet shall be submitted by 31st of December.

- Copy of bank statement certified by the bank has to be submitted.
- A nil return is required to be filed if there is no activity.

Method of Accounting

The FCRA 2010 and the rules there of do not specify any method of accounting. Section 19 of the FCRA 2010 provides that accounts with regard to FC receipt & utilization should be maintained. On a plain reading of section 19 of FCRA 2010, Rule 16 & form FC – 6, it seems that the requirement is to report FC Fund received and utilised during the year. In other words, the receipts of fund shall be on cash basis only. There is no specific direction regarding utilization on payment basis only.

FCRA 2010 does not prescribe any fixed method of accounting. Any method of accounting may be followed but the receipts of FC Funds should be reported on cash basis only.

Role of Chartered Accountants

2.61 Since the Foreign Contribution (Regulation) Act, 2010 (FCRA, 2010) is national security legislation; associations are required to exercise extreme care and caution in dealing with foreign contribution from the time of its receipt to its final utilization. As the Chartered Accountants audit the accounts of the associations and certify the accounts before submission to the Government, they are required to provide proper guidance to the associations who is either applying for grant of prior permission/ registration or who have been granted prior permission/registration under FCRA, 2010.

2.62 The Chartered Accountants are required to get themselves thoroughly acquainted with FCRA, 2010 and the Foreign Contribution (Regulation) Rules, 2011 (FCRR, 2011) so that they can help the associations:

(i) To verify whether the associations are eligible to receive foreign contribution.

(ii) To guide the applicant organization in submission of application for registration/ prior permission;

(iii) To ensure that the association receives and utilizes the foreign contributions through its bank account exclusively opened for the purpose in accordance with the provisions of FCRA, 2010 and FCRR, 2011 and that foreign contribution is not deposited or utilized from the bank account being used for domestic funds.

(iv) To assist in the proper maintenance of prescribed books of accounts in accordance with the provisions of FCRA, 2010 and FCRR, 2011;

(v) To ensure that the annual returns of an association have been prepared in accordance with the provisions of FC(R) Act, 2010 and FCRR, 2011.

Chapter 3
Key Concepts

3.1 While a for-profit and a not for profit organisation have a lot in common, there are some areas which require a different approach in case of not-for-profit activities. They are either distinctive to the not –for- profit organisation (NPO) or demand special attention from the management.

A for-profit enterprise focuses on profitability and maximizing shareholder value. A not-for-profit organization's primary goal is to provide some socially desirable need on an ongoing basis. However, since both involve running an organisation and providing goods or services, most for-profit accounting and financial management principles apply to not-for-profit organisations as well. But there are some areas which require a different approach in case of not-for-profit activities. Before going into details of internal audit, it is necessary to have knowledge of these significant concepts relating to these enterprises. This Chapter presents some key concepts relating functioning of NPOs. Major areas of internal audit significance would include:

Revenue

3.2 Most NPOs derive their income from non business transactions like donations, contributions, grants, programs or events contributions, fees or investment income. Revenue is not received as a part of exchange between the NPO and a third party in most cases. There are usually statutory and tax prohibitions on carrying out commercial activities. If the NPO carries out such business activities, the express condition is that either the entire revenue has to go toward meeting their objectives and should be related to their mission. However, it would be wrong to assume that all NPOs survive on contributions from a vast multitude of general public. Publicly-supported charities, form just a small segment of the non-profit sector in terms of assets or revenue. There are essentially three ways by which NPOs get revenues:

Public Support

(i) **No contribution from general public:** NPOs funded by private foundations like by wealthy individuals or corporate houses. E.g. Infosys Foundation, Bill and Melinda Gates Foundation.

(ii) **Direct public support:** Charitable donations by individuals, private foundations, and businesses each donation being limited to a small percentage of the total revenue. The amount comes from numerous individuals and businesses. Each contributing amounts forms small percentage of NPOs revenue. For e.g., CRY.

(iii) **Indirect public support:** Two major indirect sources are governments and publicly-supported granting agencies (including other publicly-supported NPOs and public foundations). In the second case, the support is through a general public, but *via* an intermediary. This form of public support is particularly useful to large charitable or religious organisations as they do not have to put in effort to use the full amount statutorily required to get tax exemption. They can give the money to smaller grassroots level NPO who find difficult to raise funds. For e.g., GIVE Foundation, CRY (supports 300 organisations).

Revenue from Commercial Activities

In many countries, the governing statutes or tax laws provide a list of revenue-generating activities which may be carried out by the NPOs. The tax authorities may also decide exempt based on the details of the organization's mission statement and description, and their past treatment. In India, Income Tax Act, 1961 provides exemptions to certain NPOs if their activities are for "charitable purpose" [which includes relief of the poor, education, medical relief and the advancement of any other object of general public utility.] There is also not tax on income from a business that is incidental to the attainment of the objects of the not-for-profit organization, provided the entity maintains separate books and accounts with respect to such business (Section 11 of the Income Tax Act, 1961). Furthermore, certain activities resulting in profit, such as, renting out auditoriums, are not treated as income from business. Of course, certain conditions need to be met which would covered in detail in chapter related to tax.

Other Revenue

A NPO may earn revenue from various other activities. For instance fundraising events, membership fees, interest, investment income (other than those exempted), unused capital gains and other unrelated business income. Unrelated business income is income from business activities that aren't considered to directly advance the mission of the organisation. Unlike other sources of revenue, unrelated business income is taxed at normal corporate income tax rates. It is essential however, that the NPO should ensure that the activities carried out are not prohibited by the statute under which the entity is formed. This may result in de-registration or loss of exemption.

Budgeting

3.3 A unique feature of NPO funding is that there is no exchange transaction with the resource providers. The resources provided are used for others. The organisation thus has to demonstrate its stewardship of donated resources — money donated for a specific purpose must be used for that purpose. That purpose is either specified by the donor or implied in the not-for-profit's stated mission or internal guidelines. The management and reporting activities should clearly demonstrate that the money was used as directed. Thus budgeting is a vital exercise for not-for-profit organizations.

3.4 Budget is an important tool to manage the financial health of an NPO. It serves as a benchmark for measuring current income and expense. A budget can also help in predicting tough financial times, and thus gives plenty of time for contingency planning if grants or other income sources fall through. Lastly, NPOs have to provide project and grant budgets to grant making agencies while applying for funds as well as progress reports.

3.5 New organizations may start the budgeting process by looking at potential income -- figuring out how much money they have to spend. Existing organizations can develop the budget as by reviewing its history of contributed income and stability of earned income. Ideally, the budgeting process should include those who are responsible for adhering to the budget and those who are responsible for achieving the organisation's objectives, i.e., both finance committee and senior staff.

3.6 The budgeting process should be documented, with tasks, responsibility and timelines clearly stated. A good budgeting process would incorporate strategic planning initiatives. With uncertain nature of income, the NPOs need to identify fixed costs and relate it to reliable revenue. They need to adopt policies that allow a balance between today's operating needs and maintaining the ability to provide for tomorrow's. Budgeting decisions are driven both by mission priorities and fiscal accountability.

3.7 Each organisation would have its own style of budgeting. The internal auditor can confirm whether good budgeting practices are being adhered to. Some good budgeting practices are as follows:

(i) Written: It is always recommended that the budget is written down. This creates a measurement tool against which progress can be monitored and creates a checklist to ensure thoroughness in the process.

(ii) **Timeline:** Many funding agencies require budget at the beginning of the fiscal year. Since NPO usually have a shortage of staff, the annual budget process should be integrated into the schedule such that the key persons have time to focus on it.

(iii) **Headings and title:** Ensure that proper headings are present. This would include name of organisation, programme details, budget period. To avoid unnecessary confusion, many organisations mark the approved budget as final budget and date of approval .

(iv) **Involvement:** While the executive directors and program directors play a significant role in the budget process, it is the departmental staff members who have responsibility for adhering to budgets. Hence, they should also have a role in creating those budgets. Staff members know more about operating details than board members, even the involved ones. With the limited manpower in most NPOs, it is probably more efficient for staff to create the early drafts of budgets and use the time of Finance Committee members to review and vet the proposed drafts.

(v) **Assignment of responsibility:** The major reason for success of a budget is proper delegation. Tasks need to be listed specifically to be done within a given timeline. Ideally, there should be a person who has the leadership responsibility to ensure that the assigned task is completed within dead timeline. When a person knows he or she will be held personally accountable to have completed the assigned task by the dead timeline, it is more likely to get done.

(vi) **Inflation:** The budget should take into account inflation. Many a time, there is time gap between the submission and approval of budget by the donor agency or funding agency. By implementation stage, the estimates may become useless. Items like salaries, audit fees, contractors' fees and taxes have a high probability of revision. For such items ensure whether there is provision for renegotiation. .

(vii) **Basis of Calculation:** The basis of calculation of each and every line item is available. This is especially, required for responding to any query from outside agencies and external reporting requirements. Effective comparisons can be made between budget and actuals if the budget line items are in sync with the financial statement line items. A mismatch would entail additional work to reconcile the two and may also lead to errors.

(viii) **Details:** The budget presented to the Board is a summary. But staff, Finance Committee members and Internal auditors would need the complete details. The details of budget components should be readily available. This could be done with the help of spreadsheet which has linked worksheets or worksheet tabs. Each line item in the Budget summary could be linked to a worksheet which would provide the breakup, e.g., insurance line item would be linked to a worksheet containing details of types of insurance, like, general liability, vehicle insurance, asset insurance, officers' liability etc. Revenue would include details of events, projects, concerts, prices, discounts. Details of Contributed revenue would include name and amount of donations. In-kind contributions can be included on this worksheet or on a separate one, depending on the quantity and complexity of such contributions. In a similar manner, details of Personnel and external consultants, business expenses (interest, licenses, office expenses etc.), rent, transportation, capital expenditure should be available.

Management of Contributions

3.8 *Corpus* is a Latin word, which means *body*. The term "corpus' in corporate usage denotes the sum and substance of an entity. For a NPO, corpus fund are of paramount importance Just like the capital of a commercial organisation – the funds generated and kept aside for the existence and sustenance of the organisation. It is a permanent fund kept for the basic expenditures needed for the administration and survival of the organisation. It is generally not allowed to be utilised for attainment of organisational objectives but interest/ dividend accrued on the corpus funds can be utilised or accumulated.

In case of a trust, the corpus is started by the settler. For other types of NPO, a donation is treated as corpus donation only if it is accompanied by a specific written direction of the donor. In the absence of any written direction of the donor, a contribution or grant cannot be transferred to corpus fund. Corpus fund is an unrestricted permanent fund. i.e.. there is no bar on the purpose for which the funds are used but its use should be restricted to preserve the financial base of the NPO. A corpus fund may be used in exceptional circumstances, when there is a serious financial emergency or the survival of the NPO is at stake.

However, a large corpus may also invite questions from donors and public as the creation of a corpus fund implies reduction of program activities to that extent. In the long run, an unprotected corpus may also attract undesirable people.

Creation of Corpus

3.9 As discussed above, corpus can be created in case of a trust by the settlor. In other types of NPOs corpus can be created only when a written consent is received from the donor. For instance, a NPO puts a donation box with the inscription "donations will be added to the corpus", the donation accumulated in the box will still not be considered corpus as there is no specific direction in writing. Corpus can also be created by the NPO out of its internal accrual and surpluses. These could be out of the current year's income or other available Unrestricted Funds. To create a corpus fund from the current year's income the prevailing legal provisions and the bye-laws of the organisation have to be kept in mind. For instance, for charitable trusts, the Income Tax Act requires that 85% of voluntary contribution received have to be applied for charitable purposes. In other words, a maximum of 15% of the income can be transferred to the corpus fund each year.

Management of Endowment Funds

3.10 Legally, an Endowment Fund is similar to a Corpus. The difference is only with respect to use of income from the Endowment Fund. Such a Fund is created under specific direction from the Donor. A donor *cannot* specify that funds donated for corpus should be used for a specified project whereas it can be done so in case of income from the Endowment Fund. Endowments can be earmarked for specific activities

The management of endowment funds –both principal and income are vital to a NPO. Getting funds is only half the story, the NPO should have the capacity to steward its endowment funds and maximize their impact. The fund management has following two aspects:

(i) Investment, oversight and reporting of Endowment fund.

(ii) Restrictions on spending of endowment fund interest and dividends.

3.11 The investment decisions would be based on allowable investments, investment performance reports, market practices etc. The statutory and tax prohibitions also have to be taken into account. The NPO should have specific guidelines and policies with regard to the above. Some restrictions imposed on the endowment funds are as follows:

(i) Donor Restrictions: The decision on spending endowment income or principal may not be in the hands of the organization's leadership. Most of the time NPOs try to raise money from donors on an unrestricted basis. This provides flexibility to use the funds and income in an optimum way across various projects and programmes. But many a time, donors specify that the contribution should be used for a specified purpose within the facing organization's scope of activities. For instance, X donates ₹ 2 lakh to be spent towards providing cycles to each girl student in 5 villages in Madhya Pradesh. Sometimes, a donor may require that the contribution not be used until a project has reached a predetermined goal or threshold. Thus, the concept of "unrestricted" and "restricted" comes in.

(ii) Endowment for "Perpetuity" but the Program is not: Many donors specify that the contribution is used for a specified project or program. In such a case, when the donor restriction expires, i.e., when a stipulated time restriction ends or purpose restriction is accomplished, the assets are reclassified as unrestricted net asset. In some cases, the donor stipulates that the contribution must be held by the non-profit in perpetuity (forever, not be used up), like, to provide a scholarship to the topper in the institution every year. The amount is to be recorded as a permanently restricted asset. The problem arises if the income is restricted to support a specific program or service of the organization—with an uncertain future. If there is any chance that such a "perpetually" endowed program or service could later be discontinued, there must be clear understanding and agreement with the donor at the time of the gift regarding an acceptable alternative application of such funds.

(iii) Utilisation of Endowment Funds and Income: For most organisations, there are two aspects of funds management-revenue from its business and management of investments and funds ploughed back. Revenue for a NPO would be the collection from events, programmes etc. which in most cases are not sufficient to run the organisation. The main source of funds is endowment funds. It has to pay special attention to proper utilization of its endowment income. .By establishing appropriate investment and endowment spending policies, institutions can judiciously place the spending fulcrum on the time continuum . An investment policy would state the appropriate asset mix based on the entity's needs and risk tolerance. It should include both a means of determining permissible current spending and a calculation of endowment principal.

The organization needs to decide how the income from endowment is handled, then attention must be given to the principal asset (the corpus).

Endowment Income

3.12 The NPO needs to make certain decisions regarding spending of endowment income. The first question is whether the organization will spend any of the income. If yes, what percentage of it? Then the question arises as to how it will spend it. If the organization decides to spend endowment income, it may direct this income toward annual operation expenses to provide some relief to Grant requests and/or because of a lack of sufficient other gifts and grants or it might rule that the income may be spent only to support specific ongoing, or new, programs, projects and services or, perhaps it might decide to pursue a combination of both these choices. To arrive at this decision, the organization needs to work out cost of current and imminent projects, programmes, etc., and prepared a budget for its short and long term expenses. However, if the donor restricts the use of income to a particular project these questions will not arise.

Endowment Principal

3.13 The Endowment Principal is supposed to be money required for working in perpetuity. Therefore, Not-for-Profit Organisations avoid depleting these assets which are intended to safeguard the future. It is inadvisable to dip into endowment principal for day to day activities. But there is so much uncertainty in NPOs that a situation may arise it has to choose between using the principal or going out of business. If the organization "today' sets an ironclad prohibition regarding any depletion of endowment principal for "tomorrow"—there be little or no other choice at a future time of dire need. It is much more practical that the organization first takes all possible steps to avoid such a situation. As a backup plan, it can define the circumstances and events under which the principal would spent. It can set a condition in the organization's financial policy that, should it be absolutely necessary to spend any endowment principal, those funds must be replaced by a designated date—the sooner the better.

Accounting Practices

3.14 The following paragraphs provide a brief overview of the accounting practices prevalent in the NPOs. It does not dwell on accounting and presentation of various items. For accounting practices prevalent in Not-for-Profit Organisations, please refer to ICAI's publication "*Technical Guide on Accounting for Not-for-Profit Organisations*".

3.15 The basic accounting principles which apply to commercial enterprises are applicable to NPOs also. There are certain differences in nomenclature, grouping and presentation on account of the non profit nature of their activities. The first element is profit. Though an NPO is not prohibited from making profits, if it generates a surplus, the surplus is referred as Excess of Revenues over Expenses" and it should be used to further the goals of the entity to avoid being mischaracterized as a profit-making organization. A net loss is called "Excess Expenses over Revenues". Another difference is the presentation and nomenclature for owner's interest. A for-profit organisation uses the term Equity. Equity is the worth of the organization usually expressed as the sum of the assets (what the entity owns), less the sum of its liabilities (what it owes). In a for-profit organisation, basically the company owns all the equity so there is no need to divide it up. A not- for-profit organization needs to separate the funds as they represent various pots of money that are meant for specific purposes. For example a NPO has a hospital building fund which can only be used for building the hospital or pay off the building loans. That money cannot be used to pay for medical equipment or salary of the hospital staff. Those would come out of a general operations fund or other designated funds. This necessitates Fund Accounting.

Fund Accounting

3.16 Under Fund Accounting, resources are segregated into various categories (or funds) and the source of funds and the use of each fund are shown. This segregation helps in controlling and monitoring resources and also ensures and demonstrates that legal/ administrative requirements are complied with. Take an example of an NPO involved in educational activity. It has received a grant from the State Government to support a computer education initiative, another grant from the central government for a free meal program, and an endowment from a business family for undertaking research projects. The NPO has to report Government about the special education program, the central government agency about the school lunch program, and the business family about the research program. Each of these donors has diverse reporting requirements and need to apprised about the related revenues and expenditures. This is achieved by establishing separate funds. The entity thus has maintain a number of general ledgers (or fund), so that reports can be produced detailing the expenditures and revenues for each individual funds, and reports that summarize the organization's financial activities across all of its funds.

Example 1: A NPO Gram Seva Trust maintains the following funds;

- Building Fund – For construction of ICU ward, children ward, new general wards, delivery rooms and dining hall.
- New Equipment Fund
- Poor Patient Relief Fund
- General Fund
- Children Fund
- In Memorium
- Eye Camp Sponsorship

Example 2: Excerpt from Balance sheet of World Vision UK (year ending 30th September 2010) showing break up of funds:

World Vision UK

	Notes	2010 £000	2009 £000
The funds of the charity			
Restricted funds	16	5,454	5,693
Unrestricted funds			
Tangible fixed asset fund	16	3,260	3,830
Strategic initiative funds	16	500	—
Emergency relief funds	16	500	1,000
General funds	16	7,616	5,649
Total funds	16	17,330	16,172

Source: http://www.worldvision.org.uk/upload/pdf/WV_annual_report_2010_v2.pdf

Restrictions on Funds

3.17 Fund accounting may not convey all the required information to users. The users of financial statements should be able to figure out whether the funds are restricted or unrestricted, what are the restrictions and whether the entity was following the restrictions set. The entity must also be able to demonstrate that it still holds assets belonging to restricted and endowment funds and has not used these for unauthorised purposes. It is a breach of trust to spend restricted funds for purposes other than for which they were given.

Statutory authorities in many countries (UK, USA, and Canada) now insist on reporting on "net assets" classification, rather than tracking each fund. *(*Net assets means more or less the same as owner's equity or net worth in a for-profit business.) Under this approach, the equity of the organization is presented with three classes of assets, i.e., Restricted Assets; Temporarily Restricted Assets; Unrestricted Assets.

(i) Unrestricted: Funds which are free from any external restrictions and available for general use are classified under this head. Usually individual contributions are unrestricted, as are general operating and unrestricted grants. It important to remember here that restrictions can only legally be placed on funds by the donors. The shape and form of the restrictions are defined in the "gift instrument."If the management designates some of the non profit's unrestricted assets for a specific purpose, those assets must continue to be reported as *unrestricted net assets.*

(ii) Temporarily Restricted: Sometimes the donors impose restrictions which are not perpetual. Such restrictions expire either with passage of a defined period of time (time restriction) or by performing specified activities (purpose restriction). Grant for a specific program or project or individual contributions given with the intent of supporting a particular program or campaign would fall under this category. An example of a *time-restricted* gift is a contribution of a trust, annuity, or term endowment where the principal of the gift is restricted for a certain term of time.

(iii) Permanently Restricted: These funds are gifts restricted by a donor for a designated purpose or time restriction that will never expire. An example is an endowment gift with the stipulation that the principal is permanently unavailable for spending, but the investment income from the principal may be used in current operations. The intent is that the principle balance of the contribution will remain as an investment forever, and the non-profit will utilize the interest and investment returns, such as with an endowment.

Excerpt from Balance sheet of Deepalaya (year ending 31st March 2010) showing break up of funds

Balance Sheet as on March 31,		2010	2009
Sources of Funds:	Sch.	Amount in Rupees	
Membership Funds		2,000	2,000
Corpus Fund		19,967,240	19,732,240
Unrestricted Project Funds	1	136,899,403	126,653,569
Restricted Project Funds	2	12,154,332	24,248,345
Total		169,022,975	170,636,354

3.18 Internal auditors need to pay special attention to the accounting practices of an NPO. The grant making entities, tax authorities and other watchdog agencies carefully analyze the accounting system of non-profit organizations. As tax-exempt entities, non-profit organisations must be extra careful to avoid incorrect accounting practices as this can prove to be very costly and endanger its existence, For detailed accounting methods, please refer to ICAI publication " *Technical Guide on Accounting for Not-for - Profit Organisations".*

Given below are some illustrations on accounting practices:

Illustration 1. If Mr. Patel gifts ₹ 10,00,000 to a non profit educational institution and stipulates only the interest on the ₹ 10,00,000 can be spent. There is a further condition that ₹ 15,000 is given to the person scoring highest in Physics every year. How is this be presented in annual accounts?

Solution: ₹ 10, 00,000 will be transferred to *permanently restricted net assets*. ₹ 15,000 has to be reported as *temporarily restricted net assets* until the restriction is released by the payment to the student.

Illustration 2: The board of directors of Akashdeep Services, a not-for-profit organization, approved the earmarking of ₹ 200,000 to upgrade facilities over the next four years. The ₹ 200, 000 of assets set aside for this purpose should be reported in which category of net assets?

Solution: Assets set aside by the board of directors are classified as *board-designated net assets*, which is still part of unrestricted net assets. Only donors can impose *restrictions* on how or when contributions will be used.

Illustration 3: A donor contributed ₹ 49,500 in 2010 but specified it to be for unrestricted use in 2011 . This amount was transferred from the temporarily restricted to the unrestricted net asset class in 2011.

Solution: The journal entry requires recording this transaction in 2011 is:

Net Assets Released—Expiration of Time Restrictions— Temporarily Restricted	49,500	
Net Assets Released—Expiration of Time Restrictions—Unrestricted		49,500

Illustration 4: The Manav Seva Prathisthan organised a charity fair to raise funds for an Employment Initiative for Disabled Persons. Direct costs of Rs 26,000, not incidental in nature, incurred for this event were paid in cash. The event yielded cash contributions of ₹ 1,50,000. What is (are) the required journal entry(ies)?

Cash	1,50,000	
Contributions—Temporarily Restricted—Program		1,50,000
Direct Costs— Employment Initiative	26,000	
Cash		26,000

Solution: It is recommended that all special event revenue and direct costs should be reported at their gross amounts. Cash could have been debited by1,24,000(1,50,000-26,000). However, it is likely that the costs and contributions are separate transactions occurring at different times. In fact, good internal controls suggest that contributions should be deposited when received and not held until all the costs are incurred.

Illustration 5: During the past year, 45 nurses volunteered numerous hours at the Institute of Mother and Baby, a nongovernmental NPO, providing immunizations to infants, children and pre natal and post natal care to women from disadvantaged families, as well as other health-related services. Otherwise, the entity would have to hire nurses to perform these tasks. The NPO records in kind contributions. What will be the journal entry to record these volunteer services?

Solution: The services "require specialized skills, are provided by individuals possessing those skills, and typically would need to be purchased if not provided by donation." The journal entry would debit to the appropriate program expense account and credit to contributed services revenue.

Classification of Expenses

3.19 Classification of expenses assumes a great deal of importance in not–for-profit entities. Many not-for-profit organisation cannot provide satisfactory information about their relative effectiveness in fulfilling their mission. In such a scenario, donors, funders, and watchdog of the organizations have to fall back on financial indicators. The principal financial indicators of effective utilisation of funds are the program-spending ratio (total program expenses ÷ total expenses) and the fund raising-efficiency ratio (fund raising costs ÷ total contributions). Many donors use these ratios as their primary basis for evaluating and ranking NPOs.

3.20 Classification by natural categories would not provide the information needed to arrive at these ratios. Natural categories, such as, salaries, rent, or electricity etc. shows what the money was spent for, but provide no indication of the purpose for which it was spent. Except in cases where the expenses clearly pertain to only one functional category like, the cost of printing a fundraising brochure is clearly a fundraising cost. However, the complexity arises when expenses benefit more than one function. In these cases, functional classification, which involves breaking down expenses based on the organization's major types of activities, becomes necessary. An NPO's major activities are usually program or mission based services, supporting services like, management/ general expenses and fundraising. Functional accounting helps in understanding who (provides the income /pays for the expense, what (type of income/expense) and why (program or purpose) of every rupee coming in and going out of the organization. Ideally, the functional areas are based on the mission. The tracking of 'why' is by the purpose of the organisation and not by the funder or contract. With proper functional accounting each rupee can be tracked through its journey through the organisation. Through functional accounting, the entity can know the real costs of program and supporting activities, making it an invaluable tool for decision-making. This helps the entity in understanding whether the fundraising for a program is enough to achieve its objectives or whether the entity should build, maintain or scale back a program and so forth.

3.21 The expenses are usually bifurcated as:

a. Program expenses

b. Supporting services expenses

a. Program Expenses

Program expenses (or program services expenses) are the amounts directly incurred by the not-for-profit organisations in carrying out its programs. Programs are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill objective or mission of the entity. A NPO may have several major programs. For example, an educational institution may have programs for student instruction, research, literacy programs for deprived, social welfare (providing basic infrastructure in rural areas)

b. Supporting Services Expenses

Supporting services are all activities of a not-for-profit organization other than program services. Supporting services expenses are reported in three subgroups:

- Management and general.
- Fundraising.
- membership-development activities.

3.22 Management and general activities include business management, general record keeping, budgeting, financing, and other administrative activities, except those directly incurred for program services or fund raising activities. Fund-raising activities include publicity and conducting fundraising campaigns; conducting fund-raising events; preparing and distributing fundraising manuals and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others. Membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities.

3.23 In order to accurately report the amount in each of these subgroups, it may be necessary to allocate some management and general salaries to fundraising based on the time spent by employees performing fundraising activities. For example, a management employee might be spending 30% of her time in fundraising activities but her entire salary has been recorded as management and general expenses.

Excerpt from Income and Expenditure Account 2010 of African Children's Mission

	2010	2009
Expenses and Losses:		
Program Services	330,339.58	223,357.26
Supporting Activities:		
Management and General	52,426.38	40,860.26
Fund Raising	0.00	14,032.05
Total Expenses and Losses	382,825.96	278,249.46

Source : http://africanchildrensmission.org/uploads/2010_Profit_Loss_Statement.pdf

3.24 Under the accrual method of accounting, expenses are reported in the accounting period in which they best match the related revenues. If that is not clear, then the expenses should be reported in the period in which they are used up. If there is uncertainty as to when an expense is matched or is used up, the amount spent should be reported as an expense in the current period.

In-Kind Contributions

3.25 Many NPOs, including funding agencies, receive a large amount of donations or support in the form of goods or services. Common examples of in-kind contributions include donated rent, utility payments, materials, and services, such as, advertising. They also receive assets as donations like vans or equipment which are also gifts in-kind. In some situations, NPOs are granted discounts for the purchase of certain items. There are certain tricky cases where it is difficult to estimate the value. For instance, an NPO decides to provide certain infrastructure facilities for the welfare of the local community .The local people might contribute in the following manner:

(i) They agree to provide labour at a lower cost or work without wages;

(ii) Allow free use of tractor-trolley for carrying stone, mud ,cement etc.;

(iii) Providing free saplings during tree plantation;

(iv) Allowing free use of personal shed for school / meetings.

Accounting for in–kind Contribution

3.26 Recognizing in-kind contributions paints a more complete picture of the activities of the NPO and the resources used to accomplish its mission. Additionally , In-kind contributions whose details need to be filed under Form FC 7 of Foreign Contribution (Regulation) Rules, 2011, have to be accounted for. However, these are not accounted by many NPOs. Some field level NPOs try to resolve this by showing them as receipt of money when actually they have received items or services. These go against sound accounting principles and raises questions and doubt.

3.27 The following issues need to be resolved for accounting for in–Kind contributions

(i) Estimating the money value of the material or services received;

(ii) Issue of supporting documents- vouchers/ receipts;

(iii) Making accounting entries;

(iv) Disclosure in Final Accounts.

3.28 Since the in-kind contribution received by many NPOs is substantial not accounting for them would mean:

(i) The assets constructed are shown at lower value in accounts - which is not the real value;

(ii) The community's economic participation is not reflected in the Income and Expenditure Account or ledger books.

(iii) It becomes difficult to have proper internal control over goods received from the community. This may lead to pilferage or wastage

3.29 In-kind contributions have been discussed in greater detail in later chapters.

Chapter 4
Accounting Standards and Standards on Internal Audit Relevant to NPOs

4.1 The basic accounting principles which apply to commercial enterprises apply to NPOs also. However, there are certain peculiar features which are discussed in brief. The accounting aspects and applicability of Accounting Standards are covered in detail in ICAI's publication "*Technical Guide on Accounting for Not-for-Profit Organisations.*"

Key Aspects

(i) Receipt of contributions and grants from resource providers restricted for specific purposes (temporarily and permanently).

(ii) Allocation of costs across functional areas (programs, management and general, and fundraising), across grantors, and identification by natural classification (i.e., line-item).

(iii) Reports to stakeholders (e.g., contributors, grantors, oversight bodies) according to needs, formats, and accounting periods.

(iv) Applicability of Standards on Internal Audit.

(v) Applicability of Accounting Standards.

Standards on Internal Audit (SIAs)

4.2 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 Board 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:

(i) Standard on Internal Audit (SIA) 1, Planning an Internal Audit

(ii) Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit

(iii) Standard on Internal Audit (SIA) 3, Documentation

(iv) Standard on Internal Audit (SIA) 4, Reporting

(v) Standard on Internal Audit (SIA) 5, Sampling

(vi) Standard on Internal Audit (SIA) 6, Analytical Procedures

(vii) Standard on Internal Audit (SIA) 7, Quality Assurance in Internal Audit

(viii) Standard on Internal Audit (SIA) 8, Terms of Internal Audit Engagement

(ix) Standard on Internal Audit (SIA) 9, Communication with Management

(x) Standard on Internal Audit (SIA) 10, Internal Audit Evidence

(xi) Standard on Internal Audit (SIA) 11, Consideration of Fraud in an Internal Audit

(xii) Standard on Internal Audit (SIA) 12, Internal Control Evaluation

(xiii) Standard on Internal Audit (SIA) 13, Enterprise Risk Management

(xiv) Standard on Internal Audit (SIA) 14, Internal Audit in an Information Technology Environment

(xv) Standard on Internal Audit (SIA) 15, Knowledge of the Entity and its Environment

(xvi) Standard on Internal Audit (SIA) 16, Using the Work of an Expert

(xvii) Standard on Internal Audit (SIA) 17, Consideration of Laws and Regulations in an Internal Audit

The application of standards on Internal Audit has been discussed in the chapter related to internal audit procedures.

Accounting Standards

4.3 The ICAI's publication "*Technical Guide on Accounting for Not-for-Profit Organisations*" states the following:

> "37. The ***'Preface to the Statements of Accounting Standards'***, issued by the Institute of Chartered Accountants of India, states the following:
>
> "3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are

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

38. From paragraph 37, It is apparent that the Accounting Standards formulated by the ICAI do not apply to an NPO *if no part of the activity of such entity is commercial, industrial or business in nature*. The Standards would apply even if a very small proportion of activities is considered to be commercial, industrial or business in nature. For example, where an NPO is engaged in the commercial activity of granting loans/credit to small entrepreneurs at nominal rates of interest or in the industrial activity of manufacturing clothes for the rural poor, Accounting Standards formulated by the ICAI would apply to such an NPO. It may be mentioned that since the Accounting Standards contain wholesome principles of accounting, these principles provide the most appropriate guidance even in case of those organisations to which Accounting Standards do not apply. It is, therefore, recommended that all NPOs, irrespective of the fact that no part of the activities is commercial, industrial or business in nature, should follow Accounting Standards. This is because following the Accounting Standards laid down by the ICAI would help NPOs to maintain uniformity in presentations of financial statements. However, while applying the Accounting Standards certain terms used in the Accounting Standards may need to be modified in the context of the corresponding appropriate terms

for NPOs. For instance, where an Accounting Standard refers to the term 'statement of profit and loss', in the context of NPOs, this Technical Guide uses the term 'income and expenditure account'.

39. NPOs incorporated under section 25 of the Companies Act, 1956, are required to comply with the Accounting Standards by virtue of sub-section (3A) of section 211 of the said Act. Sub- section (3B) of section 211 requires that where the profit and loss account (income and expenditure account) and balance sheet of a company do not comply with the Accounting Standards, the company shall disclose in its profit and loss statement (income and expenditure account) and balance sheet the fact of such deviation, the reason therefore and the financial effect, if any, arising due to such deviation. Further, section 227(3)(d) requires the auditor to state whether profit and loss account (income and expenditure account) and balance sheet comply with Accounting Standards referred to in sub-section (3C) of section 211. Sub- section (3C) of section 211 provides that for the purposes of this section, the expression 'accounting standards' means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under The Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS) established under sub-section (1) of section 210A. Proviso to sub-section (3C) of the section provides that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section. It may be noted that Accounting Standards 1 to 7 and 9 to 29 as formulated and recommended by the Institute of Chartered Accountants of India have been notified by the Central Government under Companies (Accounting Standards) Rules, 2006, in consultation with the NACAS, vide Notification dated December 7, 2006 in the Official Gazette.

40. As far as non-company NPOs (including trusts, societies registered under the Societies Registration Act, 1860) carrying on even a very small proportion of commercial, industrial or business activities are concerned, Accounting Standards, formulated by the Institute of Chartered Accountants of India, are mandatory for the members of the Institute in the performance of their attest functions

as per the relevant announcements made by the Institute of Chartered Accountants of India from time to time."

4.4 Keeping in view the nature of activities carried on by NPOs, some Accounting Standards may not be relevant to NPOs unless events or transactions of the nature covered by the Standard take place. Accounting

Standards, normally, not relevant to NPOs and accordingly not covered under the abovementioned Technical Guide are as follows:

(a) Accounting Standard (AS) 7, *Construction Contracts*

(b) Accounting Standard (AS) 14, *Accounting for Amalgamations*

(c) Accounting Standard (AS) 16, *Borrowing Costs*

(d) Accounting Standard (AS) 20, *Earnings Per Share*

(e) Accounting Standard (AS) 21, *Consolidated Financial Statements*

(f) Accounting Standard (AS) 22, *Accounting for Taxes on Income*

(g) Accounting Standard (AS) 23, *Accounting for Investments in Associates in Consolidated Financial Statements*

(h) Accounting Standard (AS) 24, *Discontinuing Operations*

(i) Accounting Standard (AS) 25, *Interim Financial Reporting*

(j) Accounting Standard (AS) 27, *Financial Reporting of Interests in Joint Ventures*

However, it may be mentioned that NPOs should follow these Accounting Standards as and when and to the extent these are applicable to them.

Report to Stakeholders

4.5 How to judge whether a non-profit organization is doing a good job? This is an important issue both for NPOs themselves and for donors. If the NPO is to retain donors it must convince them that their contributions are having a substantial and beneficial effect. The donor is not the only stakeholder with an interest in how NPOs do their job general public, revenue authorities, government and most importantly the people and communities who benefit from the services provided by an NPO need to be convinced. Few donors would be satisfied that the charity to which they've entrusted funds is honest, i.e., and will not misappropriate the money. Most donors want to be sure that the people or cause which motivated their gift in the first place does benefit from their generosity. Honesty, organizational efficiency and effectiveness (impact) are the three dimensions of NPOs in which they are interested.

Assessment

4.6 From an international perspective, donors often have to satisfy their own internal revenue authorities that the proposed recipient of their gift would be deemed 'charitable' if it were located in the donor's country. While there are usually some common requirements (official registration, board of trustees, governing document, etc), different countries have specific requirements too -- a winding up clause, exclusion of political activity, and so on. Also, some activities deemed charitable in one country may not be so classed in another.

4.7 To ensure this, most grantors undertake some form of organizational assessment prior to considering funding applications and these assessments can be extremely rigorous. Also, donors would like that as much of their contributions as possible goes into the actual charitable activity. Though individual donors may not have a say, grantors often state a maximum level of administration support within their grants. If the NPO has received foreign contribution, the Foreign Contribution (Regulation) Act, 2010 defines what consist administrative expenses and what does not. Also, the Act prohibits administrative expenses beyond 50%.

4.8 For assessing impact, grantors expect evaluations and reports, and most donors receive some type of communication illustrating effectiveness. They want to know how their investments made a difference – not just numbers to how many were helped but how lives were improved, how things have changed. This will need in-depth record keeping, research and interpretation, but need to become part of the process to secure funding from international agencies and large corporate donors. "No numbers without stories; no stories without numbers."

4.9 On its part, the NPO needs to provide information which is as far as possible be verifiable: references to grants received, reports produced, statistics in the public domain, registration documents. The information must also be sufficient to satisfy an international donor that further checks would verify that the NPO was eligible for a grant. The NPO can present additional information to demonstrate its effectiveness as an organization.

Types of Reports

4.10 The types of reports that may be useful to various financial information users/decision makers are as follows:

Financial Information Users/Decision Makers	Reports
Oversight bodies; external funding sources, and national organizations	Audited Annual Financial Statement (Audit Opinion letter, Balance Sheet, Statement of Cash Flow, Income & Expenditure Account , and accompanying Notes)
Central Government (CG)	All foreign contributions received within 30 days of the receipt of the contribution reported to CG File annual reports with the Home Ministry reporting the amount of the foreign contribution, its source, the manner in which it was received, the purpose for which it was intended, and the manner in which it was used.
Income Tax Authorities	NPOs claiming exemption under Section 11 and 12 to file audit report and annual return of income
Government and other Foundation funding sources	Grant Report (specific to the agency or foundation)
Management and Program Directors	Budget *vs.* Actual Statement of Activities (by month, quarter, year)
Service recipients/ clients	Performance measures
Public at large, and watchdog agencies	Performance measures

Chapter 5
Internal Audit - Concept and Objectives

5.1 From providing an independent assurance function, internal audit has become one of the core organizational governance elements. Many organisations which are not statutorily required to have internal audit functions have also established. The internal audit activity has become a key resource to the management in performing risk assessment and recommending improvements to an entity's governance, risk management, internal controls, Management Information System (MIS) and operations. An effective internal audit function helps the management in effectively discharging their duties towards the accomplishment of organisation's objectives by assessing the effectiveness of an organization's risk management processes, as well as using specialized data analysis in the audit, fraud detection and compliance arena.

Need for Internal Audit in NPO

5.2 In many ways not-for-profit organisations are no different from for-profit or commercial organisations. Their objectives and activities may be different but the day to day operations would more or less involve common activities like receipt and processing cash, tracking revenue and expenses, managing personnel, and financial reporting to stakeholders. Errors, misappropriations, frauds can happen in any organisation and the extent of its impact is more if it affects those key processes that contribute to the accomplishment of the organisational objectives. The uniqueness of not-for-profit organisations (at least those that are supported by donations) is that even a whiff of a scam can ruin it. An overwhelming majority of public still holds not-for-profit organisations to a high standard of integrity that the organization will use donations as promised. Thus, the greatest threat to the not-for-profit sector is the betrayal of public trust and the disappointment of public confidence. Additionally, they have to meet unique compliance requirements, especially, regarding tax exemptions and foreign contributions.

5.3 The most reliable method of meeting all these requirements is to have sound internal control. When controls are effective, there is high probability that key processes will function as designed and the organisation will achieve its objectives. Here, the internal auditor's objectivity, knowledge of the organization, and understanding and application of sound consulting and audit principles would be useful.

Methodology for Internal Audit

Terms of Internal Audit Engagement

5.4 The design and direction of the internal audit depends on the terms of engagement. These are usually finalized jointly by the client and the internal auditor. The internal auditor needs to take into account what kinds of issues are important to the management. It is also important to remember that the client may not have a deep understanding of the role and advantages of internal audit. Therefore, there is a need to assess what additional issues should be covered. The orientation of an internal audit may be more towards transactions verification, or system assurance. A third possible approach could be donor assurance, this would focus on whether justifiable expenses have been charged to correct budget heads.

(i) Transaction Testing and Verification

Transaction testing involves vouching and review of transactions to ensure that transactions are properly recorded and their data content with respect to internal application system is accurate. This would include

a) Reviews of the detail Transactions posted.

b) The transactions are accurate, valid and appropriate.

c) Corrective actions and closures of purchase orders have been initiated.

d) Payroll reports represent time worked by valid employees.

e) Amount shown in rupees and hours are correct and charged to the proper account.

Verification involves valuation and existence of assets like fixed assets, cash, equipment, etc. This orientation is, especially, useful for smaller organizations, where the accounts department is not fully developed and stable and there are a very few transactions but is not desirable or possible to do it in any other organisation. It is not internal audit's role to test every transaction and verify that it was handled properly (and function as a detective control). They should focus on the adequacy of processes and controls. Also, confirming that transactions are correct does not provide assurance that the controls are in place and effective.

(ii) System Assurance

Systems assurance is the planned and systematic set of activities that assure systems, processes and products conform with systems requirements for safety, reliability, availability, maintainability, standards, procedures, and regulations.

It involves system control and internal control. Whether it takes the form of system audit would depend upon the terms of engagement decided by the management and the internal auditor.

(iii) Donor Assurance

This approach is designed to reassure the donors that their funds are being spent properly. An internal audit could provide reasonable assurance that good stewardship is being used in handling and accounting for donor's money and other assets of the not-for-profit organization. It can be performed by external Accounting firms (or by an outside CA) or done internally-in which case the books are reviewed by selected non-related officers, or by prominent people in the not-for-profit organization who understand financial management. Under this approach, the focus is on looking at budgeting, budget monitoring, cost-effectiveness, distribution of assistance, internal transparency, governance, quality and timeliness of donor reporting, etc. Such audits encourages good habits of fiscal responsibility to among employees and will assure that contributions made to the organization with stipulations as to how the funds should be used, are consistently used in accordance with the donor's instructions, providing donors the assurance that their contributions are being used as intended.

Engagement Letter

5.5 Before commencement of the internal audit, the internal auditor has to obtain an engagement letter from the auditee. The engagement letter mainly outlines the terms and conditions of the engagement, scope of the work, assistance required from the management and the compensation terms. In case of a new assignment, the internal auditor visits the auditee and obtains information to determine the audit scope, audit objective, time schedules, audit dates and in a continuing assignment the earlier letter has to be modified depending on the changed circumstances. The engagement letter is prepared by the internal auditor and has to be approved by the appropriate authority of the auditee which could be Board of Directors or Board of Trustees or Audit Committee. Briefly, the engagement letter would include:

(i) Scope of internal audit: this could include internal audit of financial statements, Supplemental information, Compliance reports, Tax filings, FCRA filings etc.

(ii) Provide for an agreed-upon process for changes in the scope of work.

(iii) A timetable for the internal audit work including dates for fieldwork, number of staff, date of delivery of draft reports, Delivery of management letter, if applicable, meetings with audit committee, if any.

(iv) Information that is expected to be provided during the internal audit by the organization's personnel: this typically include various information to be provided by the organization, such as permanent file documents and schedules prepared by the organization's staff in connection with the internal audit engagement.

(v) Discuss how adjustments below the internal auditor's materiality threshold will be handled. (For example, does it address how they will be communicated to management for possible recording in the subsequent year's financial statements?)

(vi) Identify the persons or entities that will use the internal audit report and for what purpose. Usually, the report states that report is intended for the information and use of the audit committee, management, specific legislative or regulatory bodies, grant making agencies and is not intended to be and should not be used by anyone other than these specified parties without the internal auditor's permission.

(vii) Address the internal auditor's record retention policy stating the minimum period for which internal audit documentation is retained and conditions (dispute, disagreement) under which the timeframe may be increased.

(viii) Internal Auditor's privacy policy regarding the organization's financial information.

(ix) Include basis of compilation of the professional fees to be charged for the engagement and make provision for the handling of out-of-pocket expenses.

5.6 It is recommended that the letter clarifies that the internal audit engagement ends on delivery of the internal audit report and state that the any follow-up (such as representing the client before taxation authorities) will be deemed to be a separate engagement and will be governed by the terms and conditions of a subsequent engagement letter. The Standard on Internal Audit (SIA) 8, Terms of Internal Audit Engagement provides detailed guidance related to terms of engagement.

Planning an Internal Audit

5.7 The internal auditor needs to develop an audit plan for each internal audit engagement so that the internal audit can be completed in an efficient and effective manner. Adequate planning ensures that appropriate attention is given to every significant area so that weaknesses can be identified and errors can be rectified. Once deficiencies are found the entity can take preventives steps by enhancing policies, procedures, and operations. NPOs usually have budgetary constraints, so the internal auditor has to also plan that frequency and depth of the audit is based on the entity's needs and budgetary constraints and focuses on the most important areas. The Standard on Internal Audit (SIA) 1, *Planning an Internal Audit* provides indepth guidance on planning an internal audit.

5.8 A significant characteristic of not-for-profit organisations which affects internal control is the presence of volunteers across various levels of the organisation. The nature and degree of influence of volunteers varies across NPOs depending on size, purpose, nature of NPO's activities and its corporate culture. Volunteer presence the following forms:

(i) Volunteer presence on the governing board

(ii) Inadequate amount of staff for administrative purposes affecting segregation of duties.

(iii) Both Volunteers and paid staff are involved in day-to-day operations including finance function.

5.9 This could affect the management and internal control of these organisations significantly. The altruistic nature of their activities and absence of an owner group could mean lesser understanding and interest in having a strong corporate culture. The focus is on allocating resources to further the mission of the entity than on segregation of duties. Deep involvement of volunteers in operations and management performing accounting functions, control or supervisory positions may affect the control system, especially, in areas, like, personnel management, authorisation procedures, establishment of priorities, accountability and control over data. Again, some NPOs may not have resource constraints or may have a strong corporate culture.

The internal auditor must take these into consideration and take additional safeguards while conducting internal audit of NPOs.

Knowledge of the Business

5.10 The internal auditor should have knowledge of client business to obtain an understanding of the events, transactions and practices. At the planning level, this knowledge will enable them to determine materiality level, identify components of internal audit risk, identify areas which need special attention and draw conclusions. The internal auditor needs to have specific knowledge of the following:

(i) Legal form

(ii) NPO's mission and objectives

(iii) Organisational structure

(iv) Nature and mix of its main activities

(v) Major sources of funding, donors, etc.

(vi) Chart of accounts and accounting methods

(vii) Policy and procedures

(viii) Major risks

(ix) Tax status

(x) Main characteristics of recipients of its services

(xi) Related parties

5.11 If the entity has a well documented service provision and outcomes it would help in understanding the type of work undertaken by NPO. This usually contains:

(i) The mission statement and details of all the services the organization provides to the community.

(ii) Scope of those services; this answers questions like, how large is the service area? Is the organization state, county or citywide? The population the organization serves; is it a specific population, such as individuals with disabilities, homeless or battered women, or children with criminal backgrounds

(iii) Documentation on outcomes, or how the NPO's services affect the population it serves, numbers of people affected and length of time individuals utilize the services of the NPO.

5.12 For internal audit, it is vital that the internal auditor gain knowledge about the field of activity, economic, tax and legal environment. For an NPO audit, it becomes all the more vital to gain an understanding of the working of the entity from diverse resources as there might be inadequate availability of information. The internal auditor can obtain sufficient knowledge through:

(i) Financial information, like, previous annual reports and budgets. Prior year comparative reports and narrative explanations of significant changes or unusual balances would reveal critical information about cash balances, investments, receivables, payables, and the overall financial health of the organization.

(ii) Reports of statutory auditors required under Section 10 and 12 of the Income Tax Act.

(iii) Monthly or quarterly report generated for the management, like, the Statement of Financial Position, the Statement of Financial Activities (sometimes called the profit and loss report, income and expense report, or budget report). If possible, go through specific detail reports, like, income and expense (profit and loss) line items by activity, cash flow projection, fundraising progress, and program or project reports.

(iv) Enquire about the accounting policies for various items, like, capital assets, fund accounting, contribution in kind.

(v) Study the documents, like, periodicals, survey results and financial statements of similar entities.

(vi) Visit various offices and meet management.

Standard on Internal Audit (SIA) 15, Knowledge of the Entity and its Environment provides detailed guidance in this regard.

Audit Planning, Materiality and Sampling

5.13 During the initial stages, the internal auditor needs to formulate the internal audit program and thereafter modifications may be made as necessary. The opening conference with the client would aim at discussing the overall plans of the audit before the fieldwork starts. During the opening conference the internal auditor would:

(i) Explain the scope of the planned audit, the internal audit objectives, and the general approach to the internal audit;

(ii) Clarify that the auditee understands the commitment needed from the auditee to support the internal audit and respond to internal audit requests;

(iii) Review organizational charts and job descriptions and the nature of the auditee's activities and functions;

(iv) Inquire about current developments relating to the entity function, activity, department, or unit under audit;

(v) Inquire about problem areas that would be reviewed;

(vi) Make arrangements with the auditee for the preparation of the data which will be needed during the internal audit, like, management plans, objectives, or other documents that may have a material impact on the audit outcome;

(vii) Develop a list of key personnel in the auditee department to be contacted for meetings or information;

(viii) Develop preliminary estimates of materiality levels and acceptable error rates.

Standard on Internal Audit (SIA) 1, Planning an Internal Audit provides detailed guidance in this regard.

5.14 The magnitude of a misstatement in quantitative terms is but the first step in evaluating materiality and there is a need for full analysis of all relevant considerations. Materiality needs to be considered when there is "substantial likelihood" that a reasonable person would consider it important. Materiality must be judged within the "total mix" of information.

The assessment of materiality in planning and completing an internal audit of a not-for-profit organization is inherently difficult. The for-profit world's rules of thumb for materiality thresholds, such as, calculating a percentage of net income, do not easily apply to charitable organizations. Instead, auditors apply various percentages to total assets, total revenues, or some other measure of an organization's size. The assessments of materiality involve both quantitative and qualitative judgments. Auditors can consider "other measures" for assessing planning materiality, such as unrestricted contributions, total program expenses, the ratio of program expenses to total expenses, and the ratio of fund-raising expenses to contributions.

5.15 Audit sampling is used when the internal auditor has to obtain evidence on a selective basis, i.e. to audit less than 100% of the items within an account balance or class of transactions to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. Audit sampling can be used as part of a test of control or as part of a substantive procedure. They have to follow the procedure in Standard on Internal Audit (SIA) 5, *"Sampling".* When using either statistical or non-statistical sampling methods, internal auditors should design and select an audit sample, perform audit procedures thereon and evaluate sample results so as to provide sufficient appropriate audit evidence.

Risk Assessment

5.16 Every organization faces a variety of business risks from external and internal sources that must be assessed. Risk assessment involves the identification and analysis of relevant risks that may prevent the achievement of established objectives. Internal auditors typically conduct an overall risk assessment of the organization to understand overall strategy and objectives, and then within the framework of strategy, understand the key processes that drive and support accomplishment of strategy and the inherent risks to the accomplishment of objectives. Once the areas of high risk (areas susceptible to error or fraud) have been identified, different types of procedures (agreed upon procedures, reviews, audits) are performed to identify the strength of controls in the high risk areas. Risk Assessment aids the auditor in deciding audit timing, audit intensity and audit frequency

5.17 Risk analysis usually takes the following form

(i) Define the audit universe and identify the auditable units within the entity for which these analyses will be carried out.

(ii) Identify appropriate risk factors designed to reflect management's concerns.

(iii) Select an appropriate format for evaluating risk factors.

(iv) Develop a combination rule for each audit unit which will properly reflect its riskiness over several risk factors that have been identified and a method of setting audit priorities for the audit units.

(v) Once audit units have been rated according to their risk, assign them various audit frequency categories; that is, to identify frequency of audit and, a mechanism for applying variable audit scope or intensity of auditing commensurate with the importance of the audit unit.

(vi) Have an audit coverage plan which indicates which audits will be conducted at what times throughout the planning horizon and the expected costs associated with those audits. This will help in staff and other resource scheduling.

Risk Types

5.18 The internal auditor should try to limit audit risk, which is the product of inherent risk, control risk and detection risk.

Inherent Risk

Inherent risk is the risk that a financial assertion is susceptible to a material misstatement. The assertion could be about a class of transactions, account balances or disclosures about significant company events. Examples include double counting funds received, incorrectly valuing inventory and failing to disclose significant accounting changes.

The internal auditor has to assess inherent risk for each account head or class of transaction. One high risk area is cash donations. The restrictions on use of certain funds will impact the risks as wrong use of those assets could mean that the donor might refuse to provide further funding.

Control Risk

Control risk is the risk that one or more material misstatements might not be prevented or detected on a timely basis by the organization's internal control systems. For example, if the revenue is misstated on an organisation’s income statement, control risk means that the organisation’s internal auditing processes may not be able to catch it. As stated earlier, the use of volunteers for accounting and day to day management might be a major factor to consider.

Detection Risk

Detection risk is the risk that an audit might not be able to detect a material misstatement. For example, if there are revenue or cost misstatements on a company's income statement, detection risk refers to the possibility that an audit fails to detect these misstatements and, consequently, expresses an inappropriate favourable opinion.

Assessment

The Internal auditors are required to assess inherent risk and control risk on three levels: maximum or high risk, moderate or medium risk and low risk. If the inherent and control risks are high, the detection risk must be low in order to have a low overall audit risk. Therefore, the internal auditor has to carry out more detection procedures to be reasonably assured that the financial statements are free of material misstatements.

Significance

A low audit risk is important because it is not possible for internal auditors to verify all transactions. Auditors tend to focus on key risk areas -- for example, overstated revenues or understated costs, where it is more likely that errors will lead to material misstatements on the financial statements. Standards on Internal Audit require internal auditors to plan and perform audits with professional skepticism because there is always the possibility that the financial statements are materially misstated. Professional skepticism involves a questioning mind and a critical evaluation.

Understanding and Evaluation of Internal Control

5.19 At the planning stage, the internal auditor has to analyse the internal controls in the organisation. The issue with NPOs is that there are limited number of staff personnel, there is a mix of paid staff and volunteers .The internal audit team should be look into the following aspects:

(i) The adequacy of internal control.

(ii) The accuracy of the records and the reports to the governing body (usually. the board of directors).

(iii) The proper authorization of activities and expenditures.

(iv) The determination of the physical existence of assets.

(v) A review of the tax-exempt status and identification of any activities that may endanger it.

(vi) Ascertaining that TDS, licenses, sales taxes, other taxes and corporate reports are properly filed in a timely manner.

In developing the audit program, the adequacy of the internal accounting controls is an influencing factor. The internal audit team should satisfy itself that the internal control procedures outlined above actually were being followed.

5.20 The involvement of volunteers and limited staff may affect the segregation of duties. The responsibility and authority delegation varies from one NPO to another. This involvement of volunteers influence the management and internal controls these organisations greatly:

5.21 The internal auditor needs to pay special attention to:

(i) Nature and extent of volunteer involvement.

(ii) Attitude of management, staff and volunteers with regard to internal control, budgets, etc.

(iii) Assignment of authority and responsibility.

(iv) Nature of external influences which may affect the internal control environment.

(v) Personnel policies.

5.22 A system of internal control can be evaluated by assessing its ability to achieve seven commonly accepted control objectives:

Authorization: All transactions are pre-approved by responsible personnel.

Completeness: All valid transactions are included in the accounting records.

Accuracy: All valid transactions are accurate, consistent with the originating transaction data, and information is recorded in a timely manner.

Validity: All recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's authorization.

Physical Safeguards and Security: Access to physical assets and information systems are controlled and properly restricted to authorized personnel.

Error Handling: Errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.

Segregation of Duties: Duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing a transaction.

Standard on Internal Audit (SIA) 12, Internal Control Evaluation provides detail guidance in this regard.

Chapter 6
Major Areas of Internal Audit Significance

6.1 Just as with accounting, internal auditing considerations for a not-for-profit organization are similar to those of a profit-making entity. However, there are a number of special challenges that are faced by the internal auditors of not-for-profit organizations. Donation receipts, grant management, limited resources, use of volunteers, and expenditure control give rise to unique internal control and risk management issues. Completeness of contributions — particularly as related to donations and other fundraising activities — is also an area of exposure. There is also a question of whether or not to value non-cash contributions and services and how to value them. Key focus areas for internal audit would include:

(i) Revenue completeness assertion.

(ii) Internal controls over receipts and revenues.

(iii) Accounting of restricted fund transactions.

(iv) Valuation of non-monetary transactions.

(v) Dealing with variations of budgets to actual results.

(vi) Risks caused by absence of detailed chart of accounts.

(vii) Problems associated with accounting for multiple programs, grants or contracts that have year-ends different from the fiscal year-end of the not-for-profit organization.

(viii) Internal Audit restrictions imposed by funding sources.

(ix) Risks associated with the use of volunteer personnel and volunteer board of trustees.

(x) Tax considerations resulting from unrelated business income.

6.2 Once internal audit strategy is formed, it should be revaluated every year as resource outflow, inflow, funding sources may change drastically from one year to another. This could mean changes in restrictions or requirements imposed by donors which has to be taken into account to design internal audit procedures to detect non-compliances, if any. All items of noncompliance (no matter how small) should be summarized by the auditors, evaluated, and brought to the attention of management.

Receipts

6.3 Revenues are recognized by a NPO for resources received in reciprocal or *exchange* transactions; i.e., those in which the other party receives benefits in exchange for the resources provided.

6.4 During any given accounting period, Revenues and Expenses are the two primary sections where summarized transaction amounts will be reported.

6.5 Revenues that may be listed in the statement of activities include:

(i) Contribution, gifts and legacies

(ii) Membership fees

(iii) Program fees

(iv) Fundraising events

(v) Institutional grants

(vi) Donated goods and services

(vii) Investment income from endowments

(viii) Gain on sale of investments

(ix) Interest from other investments

(x) Interest from earmarked funds

(xi) Transfer from project funds - reclassifications when net assets are released from restrictions (a negative amount in the temporarily restricted column and a positive amount in the unrestricted column)

(xii) income derived from economic undertakings specified in the charter/mission

6.6 There are various direct and indirect ways to determine amount of receipts in such cases. Complications arise in ascertaining income from non-business transactions, like, donations, contributions and grants.

6.7 It is recommended that the entity should document all private, individual donations, regardless of how small or large the monetary amount.

Donations that are specified for a particular purpose should be accounted separately. Pre-numbered receipts should be given for contributions, gifts, etc. "Anonymous" donations should be to a minimum. If a donor wishes to be anonymous, the NPO can issue a receipt to the individual with the details and agree to keep the information confidential and list the donations as anonymous in public documents such as brochures and financial information.

6.8 Anonymous donations may also result in disallowance under Income Tax. Under Section 115BBC, all anonymous donations to charitable organizations are taxable. Finance (No.2) Act, 2009, has provided some relief by stating anonymous donations aggregating up to 5% of the total income of the organization or a sum of ₹ 100,000, whichever is higher, will not be taxed. Additionally, religious organizations (e.g., temples, churches, mosques, etc) are exempt from the provisions of this section.

Donation or Exchange

6.9 Income received could be contribution or exchange. Contribution is an *unconditional* and *non-reciprocal* transfer of cash or other assets from one entity to another. Assets could be land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services In other word, someone is making a donation to an organization without the expectation of receiving anything in return besides a possible tax deduction. Mr. A's cheque of ₹ 600 to Wellness Foundation in response to its fundraising appeal would be called a contribution as he expects nothing in return.

In contrast, an exchange transaction is a *reciprocal* transfer between two entities where each party receives something of approximately equal value. So, using the same example Mr. A gives ₹ 600 and in exchange the foundation gives him a medical check-up package (worth ₹ 600) .In most cases , there is a partial donation and a partial exchange Using the example, when Mr. A gives ₹ 600 , he is given a t –shirt valued at ₹ 150. In this instance, of the ₹ 600 of value, part of it (₹ 450) would be a contribution and the other half (₹ 150) would be an exchange transaction.

Internal Control over Donations

6.10 The inherent risk with respect to cash donations is quite high. It is quite difficult sometimes impossible to verify that all amounts given by donors were effectively recorded. NPOs use a wide variety of methods to raise funds. Not only that, several methods are used concurrently. These include door to door solicitation, corporate fundraising strategies, organisation of fundraising events, TV campaigns endorsed by stars, etc. The internal auditor has to gather at the planning stage, information about the various methods used during the year to devise an audit strategy. The most important are gathering information about the internal control over cash and cheque receipts.

Cash Receipts

NPOs usually have shortage of staff. This may result in a single person having multiple responsibilities. This may be acceptable for some areas but certain duties need to be segregated. The following simple techniques would go a long way in having effective internal control:

(i) Cash receipts should be recorded immediately and deposited in the bank daily.

(ii) A person with no access to cash should compare cash receipts records and authenticate deposit slips.

(iii) Individuals handling cash should not make entries to the general ledger or subsidiary ledgers.

(iv) A petty cash fund should be entrusted to a single custodian and used for all payments other than those made by cheque.

(v) Individuals handling cash should be bonded.

Cheque Receipts and Issued

(i) Incoming mail should be opened and recorded by persons other than those with access to cash receipts journals and accounts receivable records. If there is no donation form with the Cheque, one should be prepared. All information on the Cheque should be captured on the donation form.

(ii) A person with no access to cash should compare cheque receipts records and authenticate deposit slips with mail listing.

(iii) Cheques should be pre-numbered, used in sequence with adequate controls over supplies of blank Cheques. All Cheque numbers, even destroyed Cheques, should be entered into the accounting program.

(iv) Cheques should be prepared by persons other than those who approve invoices. The supporting organizational invoices should be signed by the responsible committee chair for that type of funding.

(v) Cheques should be entered in the disbursement journal exactly as they have been prepared.

(vi) Cheques to vendors should be issued only in payment of approved invoices, and the supporting documents should then be cancelled.

(vii) Cheques should be prepared from original organizational invoices with attached copies of purchase orders, vendor invoices and receiving reports and presented for signature with these attached. The organizational invoices should be numbered (by the treasurer after receipt), include the originals of all receipts, and be retained in numerical order.

(viii) Bank accounts should be reconciled periodically by someone other than the person who signs the cheques.

(ix) The person who is responsible for the physical custody of an asset should not also have responsibility for keeping the records related to that asset.

(x) The best bank accounts will link each evening with the organization's accounting system, and update the accounts with that day's bank transactions.

(xi) The governing board should authorize all Cheque signers. All Cheques more than a certain amount should be signed by two persons.

(xii) Signing of blank Cheques should not be permitted.

(xiii) An officer or executive director should receive the unopened bank statement before turning it over to a person, other than one who handles the receipt and disbursement of cash, for reconciliation. This officer should review the bank reconciliation, then date and initial it. The reconciliation should be retained for the internal audit team.

(xiv) The person who has authority for placing employees on the payroll and establishing wage rates should not be the same person who signs the checks.

Internal Audit of Donations

6.11 Similar to other areas, the internal audit objectives would be to ascertain completeness, measurement and presentation, ownership and existence of the receipts which would be achieved by ensuring:

(i) Value of donations received during the year is appropriate (measurement).

(ii) Donation recorded during the year were in fact received by and belong to the organisation (occurrence, ownership and existence).

(iii) Value of donations received in kind, where value could be reasonably estimated were recorded (completeness).

(iv) Cash donations during the year were recorded (completeness).

(v) Donations during the year were adequately disclosed in the Financial Statements (presentation).

6.12 The internal auditor needs to understand the process of issuing of donation receipts by the entity. They assume importance as these are the only official documents issued to third parties attesting to donations received. The internal audit of the receipt issuing process is an integral part of the internal control examination performed by the auditor with respect to donations. In case of a registered entity, the auditor can rely on receipts to donors for claiming income tax exemptions. Where the donation is motivated by allowance of tax deductions, donors would insist on receipts thus ensuring records are available. Difficulty arises where:

(i) The donation is not tax deductible.

(ii) Donors do not insist on a receipt

(iii) The amount contribute is below the minimum limit for which the entity issues receipts.

(iv) Donation is anonymous.

6.13 It has been estimated that most organisations receipts are not issued for upto to 20% of donations. Thus, the internal auditor may not be able to express an opinion on completeness, measurement and existence of all donations. The internal audit process would mainly help the internal auditor to determine to what extent policies and procedures of the entity can be relied upon. An internal audit strategy for donations will be based on the auditor's understanding of the receipt issuing process and of internal control on donation receipts.

6.14 The internal auditor should enquire about the following policies and procedures to ensure reliability of receipts:

(i) Control over numerical sequence.

(ii) Procedures to ensure amount mentioned in receipts is correct.

(iii) Control over date of issuance of receipt and date of donation.

(iv) Details of entity name, address and registration number.

(v) Presence of name and address of donor.

(vi) In case of property, description of property is correct, consistent use of appraisal method competence of persons.

(vii) Authorised signatories.

(viii) Controls over issuing of duplicates.

6.15 Given the importance of donation receipts and unavailability of proper records, the internal audit would not be complete without some substantive testing. Procedures selected could include:

(i) Review of receipts issued during the year to detect unusual or substantial donations which need to be audited in detail.

(ii) Internal Audit of cash donations – Donation receipts can be used as internal audit evidence. One way is to compare records of donations in accounting system with the bank deposit slips for the day. This can be done where the internal control ensures that cash received is deposited daily as it is. Alternatively match the total receipts issued with total donation revenues recorded and with total revenues deposited in bank. This would ensure that donations received where actually recorded. But it does not provided reasonable assurance that all donations were recorded so should be used in conjunction with other procedures.

When there are differences in total amount of receipts and donation revenue shown in the books, the internal auditor should get a satisfactory explanation from the organisation . Many a time the difference is due to the different cut off dates for accounting and tax purposes or due to the fact that the donors did not ask for receipt. For donations in kind, no corresponding receipts may have been issued.

The internal auditor should analyse differences is and no satisfactory explanation would necessitate increase in internal audit procedures for donations. It would mean looking into the receipt issuing process to find, if there is any weaknesses in the internal control system, paying special attention to receipts issued late, duplicate receipts, etc.

Internal Audit of Funds

6.16 The internal auditor should ensure the following:

(i) The organization's financial policy addresses the circumstances and restrictions attached to funds.

(ii) Though fair and reasonable requirements connected to restricted, or designated, endowment funds from donors are acceptable, the internal auditor should verify that organization carefully reviews with donors, limits, conditions, and expectations of such gift—taking special care to avoid conditions set forth by any donor which could cause the organization to stray from its basic mission.

(iii) In case of donor restrictions, whether the not-for-profit organisations to segregate these contributions as temporarily restricted assets until the specified conditions have been met.

(iv) When a donor restriction expires, whether the temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions. If material, the components of temporarily restricted net assets and the amounts released are disclosed in the footnotes of the financial statements.

(v) When the contribution must be held by the not-for-profit organisations in perpetuity whether the amount is recorded as an asset and as permanently restricted contribution revenues. Permanently restricted contribution revenues (reported on the statement of activities) also cause the amount of permanently restricted net assets to increase.

Utilization of Endowment Funds

The internal auditor can ensure these policies, which usually are set by Board or their investment committees and, have been reviewed in conjunction with state laws.

Restricted Funds

For restricted funds following should be kept in mind by the internal auditor:

(i) The principal amount of the permanently restricted assets is invested to generate income. Unless otherwise stated, the income earned belongs to the fund and has the same restrictions and must be accounted for as part of the fund to which it belongs.

(ii) For investment purposes, based on conditions of the donation assets are not pooled with others, but instead, are held in separate accounts. Activity and investment performance are reported periodically. Where the assets can be pooled for investment purpose, the income is attributed to each fund, based on the amounts invested and the time for which they were invested. The amount of interest credited at the end of the investment period will be determined by the average rate of return received by the entity on investments during that period

(iii) If a restricted fund consists of assets (e.g. a property or investments) and any are sold, the proceeds of sale must be held within the same restricted fund.

(iv) The only exceptions to the above are: (i) where the donor has expressly provided for some other use for the income; (ii) where the asset is part of a permanent endowment held for general purposes. In this case, the capital is restricted in an endowment fund (because it cannot be spent) but the income is unrestricted and can be spent for general purposes. E.g., Millionaire Foundation awards ₹ 5,00,000 for use over twenty years for general operating support.

Donated Property, Plant and Equipment

6.17 One of the primary issues in accounting for donated goods is their valuation in the NPO's financial statements. Since in kind contributions are recognised by the Income tax authorities in Canada and USA, the internal auditors can review the receipts issued for tax purposes with accounting records but in India since Section 80 G provides exemption only for monetary donations auditors cannot use that method.

6.18 Though the transactions is non-monetary in nature the inherent risk in determining their value remains high, particularly for used assets not recently involved in a business transaction. Donated property, plant and equipment may be recorded by the organisation when an estimate of fair value can be reasonably made. Both the Canadian standards and US SFAS 157 talk of fair value. Fair value would be "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". During internal audit , the internal auditor should review the documents, invoice or appraisal reports in supporting the market value attributed to these assets.

6.19 In many circumstances, the organisation is likely to receive bulk quantities of the donated items (for example, manufacturers and/or retailers donating packaged foods, new toys, new blankets, stationery etc.). In such cases, the entity can use wholesale values for the items received.

Internal Audit of Small or Used Items

6.20 The completeness of donations often presets a high inherent risk, especially in case of small furniture or equipment belonging to organisations that do not capitalise their assets.

The reasons could range from NPO not valuing its low value assets at all due to difficulty involved or it might estimate their value. If the NPO is using estimates, the internal auditors should ensure that if, the methods are being applied consistently and the results obtained are reasonably expected not to be materially different from detailed measurements. The internal auditors should obtain sufficient appropriate evidence to enable them to evaluate whether management accounting estimates are reasonable within the context of the financial statements as a whole.

6.21 Valuation of used items also needs to be considered. For example, if the NPO received donated office furniture from a business, how would it value it? Here the concept of "exit price" comes into the picture. The recipient charity should consider the market that would be most advantageous for the asset. It would need to identify the market where it would get the best price for the items. In case of used furniture, because of the volume and condition of the items the organization could not sell them to users directly, the best market could be the price that a used furniture outlet store would pay an office for such items.

Donated Services

6.22 Contributed services are a significant activity for many non profit organizations However, most of the time it is difficult to place a monetary value on donated services, and the NPO may also not have control over the time and effort put in, so such services are generally not recorded as contributions and expense. Then again, there are some services which if not recorded would not show a correct picture of the entity position on the financial statements. Some such services would include:

(i) Legal, accounting, and other professional services,

(ii) Donation of office space,

(iii) Providing free use of equipment such as computers, printing equipment.

6.23 The thumb rule for recognition would be to recognise services, only if they:

(i) can be easily measured,

(ii) create or enhance non-financial assets (e.g., constructing a building), or

(iii) require specialized skills, are provided by individuals possessing those skills (e.g., carpenters, doctors, and accountants), and

(iv) would typically need to be purchased if not provided by donation.

Illustrations

What constitutes donated service?

a. A lawyer on the NPO board reviews the organization's contracts and receives the handicrafts made at the NPO in appreciation of her services.

   The lawyer's services are within the scope of her voluntary service on the board which is not compensated and not recognized.

b. A local accountant volunteers 10 hours of service a week to set up the information system and helps in recording transactions. His professional services are valued at ₹ 350 an hour.

   The accountant's services should be recognized as donated service because he is providing specialized services that would otherwise have had to be purchased.

c. The executive director is a salaried employee.

   The director is compensated so it does not constitute donation.

d. Several local citizens were at the counter at the fun fair organised by the NPO and were noting the name of the participants at the contest.

   There was no specialised services provided.

Grant Management

6.24 Funders expect not-for-profit organisations to justify the request for funding and its capability to use it in an effective fashion. The grant proposal should be able to bring out how the applicant’s research has determined, and demonstrate, that the project being presented is central to the funder's agenda. Strong proposals offer compelling solutions to be carried out by competent, solvent applicants. Grant management thus involves researching grant sources, planning projects, preparing proposals and budgets and managing funded programs and evaluating them. In short, the entity has to be able to develop funders' interest in the organization's mission/services, developing in them a passion for the mission and a commitment to the organization's future, getting them to make-the-gift, and maintaining the relationship so that they will continue to support the mission and continue to give.

6.25 It has been found that a high number of funding requests, estimated at 90 percent, are declined as they fall outside a funder's stated interest areas or because they are inadequately prepared and do not reflect an organisation's strengths and its ability to carry out a proposal's objectives. Also , if grants are not utilized as per decided terms or periodic reports are not sent, the funder will not make any further disbursements. It thus becomes essential for the internal auditor to review the proposals and management of grant and contribution programs.

6.26 The internal auditor has to first gain an understanding of the process and then go into details of management of project under grant:

First Step: Details of Grants

The Internal auditor should obtain:

(i) A list of all grants procured by the organization, including the amount of grant, time frame for fund usage, and the specific program, service or project the money has been designated for. get copies of any specific financial arrangements or contracts required by the grant-making organization.

(ii) Documentation on entity's goals and its strategy to achieve them. The entity would have a plan on amount of money required and use of the money along with detailed procedures for executing the plan.

Second Step: Service Provision and Outcomes

A well documented service provision and outcomes should have the following details:

(i) the mission statement and listing of all the services the organization provides to the community under the umbrella of the mission.

(ii) Documentation of the scope of those services; how large is the service area? Is the organization state, county or citywide? List the population the organization serves; is it a specific population, such as individuals with disabilities, homeless or battered women, or children?

(iii) Documentation of outcomes, or how the NPO's services positively affect the population it serves, numbers of people affected and length of time individuals utilize the services of the NPO.

Third Step: Information on Project

Obtain knowledge of the policy history, the program results desired, critical success factors, risks, known weaknesses, as well as matters specific to the program under review. At the core of internal auditing, grants and contributions is the determination of whether financial management and control is adequate. There should be clear evidence for the following:

(i) Support for appropriate decision-making at all levels;

(ii) Availability of timely, relevant and reliable management information, both financial and non-financial;

(iii) Management of risk;

(iv) Efficient, effective and economical use of resources;

(v) Accountability for the use of resources;

(vi) A compliance with authorities and safeguarding of assets; and

(vii) Monitoring and reporting of actual results.

In short, auditing grants and contributions programs amounts to the determination of an appropriate level of due diligence in the management of funds.

Fourth Step: Project Management, Implementation

(i) Has the management reviewed the program design to ensure that it provided for effective control?

(ii) Are the results expected from the program clear, measurable, directly related to objectives?

(iii) Do the eligibility and assessment criteria, and any associated direction, directly address and contribute to these expected results?

(iv) Does the program design address relevant risks?

(v) Is there a centre of expertise/central review group for grants and contributions in the organization to assist program management?

(vi) Are responsibilities well defined – in particular, those of people who are not program staff but are involved in funding decisions?

(vii) Do available resources (human, physical, financial and other) match the workload for the program?

(viii) Are responsibilities among staff supportive and clear?

(ix) Does staff have the time and means to enforce the rules and carry out their responsibilities?

(x) Does staff have information, tools and essential resources to do their jobs well?

(xi) Does staff know how to assess an application under the program, and how to monitor a project with due diligence?

Fifth Step: Project Reporting

(i) Are actual project results measured and rolled-up?

(ii) Is there on-going program information on achievement of expected results?

(iii) Are there compliance audits/reviews of projects?

Chapter 7
Illustrative Internal Audit Checklist

This chapter contains detailed internal audit checklist on various aspects of non-for-profit organisations. The checklist is general in nature, which can be customized according to nature and size of the organisation:

A. Knowledge of Business

S. No.	Particulars	Y/N N/A	Notes
1.	What are the documents available about the NPO's activities: • Articles of incorporation • Regulations • Major contracts • Minutes of meetings • Brochures, newsletters or reports distributed to members or donors.		
2.	What information is available about the NPO's external environment: • Tax, legal, regulatory and contractual obligations • Manuals, periodicals, financial information about similar organisations.		
3.	Which of the following sources for financial information are available: • Working papers of previous engagements • Annual reports • Budgets		
4.	What accounting policies are adopted by the organisation for: • Capital assets • Donated materials • Donated services • Fund accounting • restricted assets and funds		

S. No.	Particulars	Y/N N/A	Notes
5.	What are the NPO's main sources of income? • Obtain information on major sources of funding and names of main contributors. • Methods to collect donations.		
6.	What are the characteristics of the recipients of NPO's services: • Physically challenged • Economically deprived • Homeless children, etc.		
7.	Who are the related parties? *The income tax exemption available to NPO would not be available on the portion of income or property if it is used for the benefit of certain specified persons (Section 13). These include:* • *Author of the trust or founder of the institution* • *Trustee or manager of the trust* • *Person who has made a substantial contribution to the trust or institution, that is to say, any person whose total contribution up to the end of the relevant previous year exceeds [fifty thousand] rupees.* • *Any relative of any such author, founder, trustee , manager, or member as aforesaid.* • *Where such author, founder or person is a Hindu undivided family, a member of the family.* • *Any concern in which any of the person, mentioned above, has substantial interest.*		

B. Budgeting

S. No.	Particulars	Y/N N/A	Notes
1.	Which of the following budgets does the organisation have: • project /program budgets. (e.g. those relating to one activity or donor-funded project) • core costs (administration/overheads) budget. • comprehensive operating budget (organisation-wide budgets consolidating all activities like cost of programs ,management and fundraising). • Others.[specify] *Try to get copies or go through the most recent budgets available, noting the period they refer to.*		
2.	Whether the organization prepares cash flow projections.		
3.	What process is used to produce the organisation's budgets. • *Find out who is involved(executive staff / finance committee)* • *When they are produced (year end or quarterly)* • *Is there a link to the organisation's mission and objectives?*		
4.	What method is used to produce the organisation's budgets: • Based on historical figures and projections made? • Periodically year -end revenue is forecast and budget adjusted		

S. No.	Particulars	Y/N N/A	Notes
5.	Is there provision for contingencies to deal with emergency or unexpected expenses: • unexpected repairs and maintenance. • Personnel expenses due to retirement or maternity leave. • changes in tax rates, fringe benefits, allocations of rents, auditing fees, etc.		
6.	Is the organisation's annual budget formally approved by the Board and entered in the minutes: Are significant changes to the budget approved by the Board.		
7.	Whether the organisation prepares budget report comparing the actual to budgeted amounts: *For actual the organization needs to monitor unit costs of programs and services through the documentation of staff time and direct expenses and allocate the management , general and fundraising expenses.*		
8.	Whether the organization has established a plan identifying actions to take in the event of a reduction or loss in funding.		
9.	Whether The organization has established, or is actively trying to develop, a reserve of funds to cover at least three months of operating expenses.		

C. Internal Control

S. No.	Particulars	Y/N N/A	Notes
1.	Does the organisation have an up-to-date Organisation Chart? *If not, enquire about admin structure and management responsibilities.*		
2.	What are the roles of various levels of management? *Note the job profiles and hours spent in various activities like fundraising, program management , admin etc.*		
3.	Does the organisation have approved policies outlining its expectations in: • Financial management practices • Personnel management practices • Conflict of interest • Fundraising practices • Quality of services to users, clients, consumers, or the public • Safety of staff, volunteers, and clients *Find out about the nature and extent of entity's reliance on volunteers and its impact.* *Training provided to staff*		
4.	What are the policies and procedures in various activities? Are they written down? Are they communicated to executive staff? • Delegation of authority • Cash handling • Procurement • Payment		
5.	Are the above policies and procedures implemented ?		

S. No.	Particulars	Y/N N/A	Notes
6.	Is there proper segregation of duties in critical activities: • Finance and book-keeping ? • Procurement and payment • Invoice approval and cheque signing		
7.	What controls are in place for handling cash. • Cash receipts recorded immediately and deposited in the bank? • A person with no access to cash compares cash receipts records and authenticate deposit slips? • All incoming money banked and no amounts held over for petty cash "feeding"? • Numbered duplicate receipts issued for all incoming cash and cheques? • Segregation of duties between Individuals handling cash and person recording in the ledgers? *Variations should be explained*		
8.	What controls are in place for cheques received and issued. • Rules for authorisation of payment? • Cheques never signed in blank? • Cheques are issued in sequence, blank cheques safeguarded and all Cheque numbers, even destroyed Cheques are entered into the accounting program. • Segregation of duty- cheque signing and invoice approval; person deciding salary amount and signatory • Cheques issued only for approved invoices and never signed without proper documentary evidence of the nature of the payment?		

S. No.	Particulars	Y/N N/A	Notes
	• Authorised signatories approved by the governing board		
9.	• What controls are in place for bank accounts. • All bank accounts held in the name of the NPO, not individuals. • Authorisations for bank operations and cheque signatories done yearly. • Bank notified of the amounts beyond which counter-signatures are required. • Instructions to open or close accounts properly authorised and / or reported to Trustees/Board. • Secure records held for all bank accounts. • Regular bank reconciliations carried out by someone other than the person who signs the cheques. • Bank statements regularly inspected by the Board.		
10.	• Which of the following controls over purchases are followed: • Competitive quotations are considered wherever applicable. • Supporting documentation held for all items of expenditure (i.e. invoices, vouchers, receipts). • All expenditure properly authorised. • Invoices checked against orders made. • The quality and quantity of goods supplied checked against orders made. • Payments only made against original invoices (i.e. not on monthly statements or photocopies).		

S. No.	Particulars	Y/N N/A	Notes
11.	Whether Organizations take periodic inventories? • monitors the inventory against theft. • reconciles general ledger inventory information. • maintains an adequate inventory level.		
12.	Whether Organizations has an effective contracting or tendering system: • Complies with the requirements of procurement legislation; • is open and fair; • meets all the requirements of each contract or tender.		

D. Finance

S.No.	Particulars	Y/N N/A	Notes
1.	Whether the organisation has set up appropriate financial systems.		
2.	Whether the organisation has employed qualified persons, either full-time part-time or voluntarily to administer and manage the systems.		
3.	Whether the organisation has financial policies and procedures manual which includes: • Financial statement presentation • distribution of financial statements • system of accounting codes • investment policies • cheque signing procedures • bank statement reconciliation procedures		

S.No.	Particulars	Y/N N/A	Notes
	• travel expense and other policies • revenue collection and recording • payroll policy, • insurance policies, • controls over fixed assets, • controls over inventories (if applicable), budgeting procedures • tax procedures (if applicable) and • conflicts of interest		
4.	Whether capital needs are at least reviewed annually.		
5.	Whether the organization has insurance coverage. • insurance coverage is adequate. • which is periodically reviewed to ensure the appropriate levels and types of coverages are in place.		
6.	Whether the organization has clear policies on loans and staff advances.		
7.	Whether the organization has a policy regarding the receipt of outside honoraria and/or remuneration in order to avoid 'duplicate' or inappropriate payment.		
8.	Whether employees, board members and volunteers who handle cash and investments are bonded to help assure the safeguarding of assets.		
9.	Whether the organization has a written policy related to investments.		
10.	Whether Training is made available for board and appropriate staff on relevant accounting topics.		

E. Donation and Grants Received

S.No.	Particulars	Y/N N/A	Notes
1.	What controls are in place for donation receipts: • control over numerical sequence • Procedures to ensure amount on receipts ins correct • Control over date of issuance of receipt and date of donation • Details of entity name , address and registration number present • Presence of name and address of donor. • In case of property, description of property is correct , consistent use of appraisal method competence of persons • Authorised signatories Controls over issuing of duplicates		
2.	What are the different methods to collect donations:		
3.	Review receipts to detect substantial or unusual donations.		
4.	Whether total receipts issued match donation revenues and amount deposited in bank. *Variations to be explained*		
5.	Whether relevant details of grants received maintained: • list of all grants procured by the organization with details of amount of grant, time frame for fund usage, and the specific program, service or project the money has been designated for. • any specific financial arrangements or contracts required by the grant-making organization		
6.	What is the effect of non compliance with restrictions • Penalties and sanctions		

S.No.	Particulars	Y/N N/A	Notes
	• Financial impact		
7.	Enquire on the reasons for non compliance with conditions or restrictions.		
8.	Whether the organisation has designated ratios and standards to keep control of fundraising and administration costs.		
9.	Whether the organisation has developed a diversified funding base to reduce the risk of financial dependency.		

F. In-kind Contribution

S. no.	Particulars	Y/N N/A	Notes
1.	How is the valuation of Donated property carried out: • Method used • Supporting documents which are evidence of the value attributed • Presentation in financial statements		
2.	What is the policy of the organisation for valuation of donated material and services. • Method used • Method used consistently • Audit the estimated value • Presentation in financial statements • Compare with earlier years data		

G. Compliances- FCRA 2010

Sr.No.	Particular	Y/N N.A.	Note
1.	Whether any foreign contribution is received by the organization during the period: If yes, • organisation has obtained the certificate of registration from the central govt. or • has taken the prior permission from the CG.		
2.	Whether receipt of contribution has been reported to the Central Government within 30 days of receipt with the following details: • amount of the foreign contribution • its source • the manner in which it was received • the purpose for which it was intended, and • the manner in which it was used.		
3.	Verification of registration documents as per FCRA • to verify registration certified issued by Ministry of Home Affairs • to verify the designated bank account mentioned in certificate • to verify the nature of organization in certificate.		
4.	Documents in support of receipts of foreign contribution: • to verify the donor letter & purpose there of. • whether the purpose mentioned in donor letter is in accordance with the object & registration certificate.		

	• whether the source is a foreign source • whether interest & other incidental income generated out of foreign contribution is accounted properly in FC books. • whether such foreign contribution deposited in designated bank account mentioned in registration certificate. • To counter check total foreign contributions with total cr in designated bank account.		
5.	Document in support of utilization of foreign contribution: • to verify the purpose of utilization. • to verify whether such utilization is in accordance to donor instruction • to verify whether the utilization reached to end user. • To verify supporting for such utilization		
6.	Utilisation of foreign contribution by way of donation to other trust: • to verify the registration status of donee organisation under FCRA. • to verify the purpose for which such donation made. • to verify supporting for such transaction. • to verify application/ proposal from donee.		
7.	Whether organisations is complying with donor restrictions, if any: • Financial managers have copies of relevant documentation to know the restrictions set forth. • Are the funds being utilised in accordance with the donor's wishes.		

8.	Whether utilisation of foreign contribution as per the FCRA Act: • Verify whether FC is used for speculative business. If it has been so used, this should be included in the report. • Administration expenses amount to not more than 50% of the total amount of foreign contribution.		
9.	In case, there is transfer of foreign contribution to another entity, it complies with provisions of FCRA, 2010. • other person is also granted certificate of registration. • If transfer to unregistered entity should get prior permission and total amount of transfer to unregistered organisations should not exceed 10% of the total foreign contribution received.		
10.	<u>Administrative Expenditure.</u> (i) Section 8 of the FCRA 2010 provides that the administrative expenditure shall not exceed 50% of the total utilization of funds out of FCRA receipts. Further, it states that any expenditure of administrative nature in excess of 50% shall be defrayed with prior approval of the central government. (ii) The rule further provides that any type of expenditure expended directly on programme activities shall not be considered as administrative in nature. • to verify for the overall expenditure of organization towards administrative expenditure. • to verify direct cost for projects and other administrative expenditure. • to verify overall budget of the organization.		

11.	<u>Change in member of executive committee/Governing council</u> (i) FCR Rules through its Forms require prior permission for change of more than 50% of members of Executive Committee of an NGO. (ii) Form FC-3 pursuant to FCR rule 9(1)(a) of 1976 and Form FC-4 pursuant to FCR rule 9(2)(a) of 2010 includes 'Declaration and undertaking' by the Chief Functionary of the applicant organization which in point (ii) specifies obtaining of prior permission for the changes causing replacement of 50% or more members of the Executive committee/Governing Council. (iii) There is no corresponding provision in FCR Act 1976 or 2010 which provides for the above and so forms in rules takes the effect of superseding the Act. The rules are made under the power conferred by the Act itself and cannot have any provision which stretches beyond the Act. • to verify the present status of governing body and to ensure there is no substantial change in the overall composition. • In case of change in excess of prescribed limit to ensure for necessary approval has been obtained from ministry of home affairs.		
12.	<u>Consultancy income of an NPO</u> (i) FCRA, 2010 excludes 'the professional/ consultancy fees paid to NGOs from Foreign Source' from the definition of		

	Foreign Contribution. (ii) Explanation 3 to Section 2(1)(h) of FCRA 2010 states that any amount received, by any person from any foreign source in India by way of fee or cost against business, trade or commerce shall not be considered as foreign contribution. In other words, such receipts shall be kept outside the FCRA account. • to verify whether any of such transaction is recorded in FC accounts. • to verify such similar type of contract with donor agency.		
13.	<u>Information on Public domain</u> (i) Rule 13 provides for requirement of keeping the information regarding receipt and utilization in public Domain. (ii) The Rule provides that if the contribution received during the year exceed ₹ 10 million, then the organisation has to keep in the public domain all data of receipts and utilization during the year and also in the subsequent year. The rule also states that the Central Government will also upload such summary data through its website. (iii) The manner of disclosure or meaning of 'public domain' has not been explained. It seems that all such organizations are required to have their own website where such data should be uploaded. • to ask for web site and to verify that the information as required by the rule is kept on it and is accessible to all.		

14.	<u>Speculative investment</u> (i) The new law does not permit investment of surplus funds in risky or speculative assets. Rule 4(1)(a) prohibits investment in shares & stocks even through mutual fund. (ii) Rule 4(1)(b) prohibits investment in high return schemes or in land if it is not directly linked to the declared aims and objectives of organisation. Basically the idea is to prevent investment of short term funds into risk bearing instruments or assets. • to verify the details of investments to ensue no investment is made in such speculative investment.		
15.	<u>Prohibited Sources.</u> The Act provides power to the Central Government under section 11(3) (iv) to notify such source(s) from which foreign contribution shall be accepted with prior permission only. It implies that the Central Govt. may notify specific donors or countries from which foreign funds could not be received or shall be received with prior permission only. • To verify sources of all foreign contribution and to ensue that no fund is received from such prohibited sources.		
16.	<u>Contribution received in kind.</u> (i) The new FCRA Rules under form FC-7 requires a certificate from a Chartered Accountant with regard to the foreign contribution received in kind there was no such requirement in the earlier Act and Rules. A Chartered Accountant normally certifies only objective valuations. In case of contribution		

	received in kind from foreign sources the authentic valuation in India is not normally available which may cause problems for the Chartered Accountant in certifying such valuations. In this regard, it is important that the FCRA department issues guidelines on the valuation of contributions received in kind and thereafter the Chartered Accountant can certify whether such processes were followed or not. Further, when FC assets are given by one FC registered organization to another FC registered organization. The written down value of the donor organization may be considered as a basis for valuations.		
17.	Make sure that the foreign contribution has been received only in single bank account.		

Appendix 1

Laws for Societies, Trusts, Wakfs and other Endowments*

S. No.	Legislation	Purpose of the Act	Organisations Covered	Coverage	Measures for Purpose Compliance	Strength	Limitations
1.	Societies Registration Act, 1860 Modelled on the English Literary and Scientific Institutions Act, 1854 Basic aim was (i) to maintain a register of such Associations functioning in the State	Regulation, incorporation, improving the legal condition of Societies	Societies registered for the promotion of literature, science, fine arts, diffusion of knowledge, education, charity, political education, libraries. -Non-profit Bodies	-requirements for registrations. -annual returns about Governing Body. -legal personality of	-purpose should be lawful. -alteration of purpose or dissolution only by General Body by special vote.	Least intervention by the State. -facilitative role of law recognized.	-loosely refers to democratic framework. -purpose compliance mechanism and financial discipline scheme ineffective.

* Source: www.asianphilanthropy.org.

	and (ii) to make them a legal entity; (iii)element of any control / regulation was absent in the original Act. After Independence the subject came under the State list of Schedule 7. Under Indian Adaptations Order this legislation became virtually a Model Act which could be amended only by the State Government. In subsequent years many of the governments went on adding different degrees of teeth to this Act in form of (a) palcing annual audit and other reports before the General			Society.			

	Body as well as to the government; (b) Registrar's power of enquiry and investigation; (c) power of supersation; (d) take over of management.						
	Andhra Pradesh Societies Registration (SR)Act,1959 Karnataka SR Act, 1960 -M.P. SR Act,1973 -Meghalaya SR Act,1983 -Rajasthan SR Act,1958 -Tamil Nadu SR Act, 1975	Regulation, incorporation, improving the legal condition of Societies within the State.	Societies established for promotion of charity, education, science, literature, fine arts, sports, foundation or maintenance of libraries, reading room, collection of natural history. -Non-profit Bodies	-requirement for registration. -democratic framework of Managing Committee. -Authority vested with General Body. -control over transfer of property or	-General Bodies control and Committees accountability. -annual audit and other reports to be placed before General Body. -Registrar's power of enquiry, investigation, surcharge and actions like superseding	-systematic democratic organisation. -well conceived financial discipline. -effective scheme for purpose compliance. -laws role both facilitative and regulative	-excessive governmental intervention amounting to regimentation. -freedom to disassociate is difficult to exercise.

	-Travancore-Cochin Literary, Scientific & Charitable Societies Act, 1955 -U.P. SR Act,1976 -W.B.SR Act,1963			use of funds. -extensive power of Registrar - financial discipline.	appointment of administrator. -Court's or Registrar's power of dissolution and cancellation of registration.		
2.	Religious Endowments Act,1863 Basically a Private Endowment Act which placed the property under the management of Trustee/Trustees under a Will for religious and charitable purposes. It was some sort of a contract between the Will maker and the	Management was solely in the hands of the Trustees.	Endowments of Mosques, Temples and other religious establishments.	Rights of Trustees; appointment of Regional Committees; members of Regional Committees; Duties of the Trustees.	-Trustees to give accounts. -committee to supervise. Since it was a contract between the Will maker and the Trustees, the only intervention possible was through filing of a civil suit in a court	-autonomy to Endowment. -concept of elected Body of the Committee. -control over Trustee.	-life tenure of Committee Member.

	Trustee.				of law. -suits for breach of trust.		
3.	Charitable and Religious Trusts Act,1920 Concept of Public Trust came to be established firmly. Trustees were made accountable for disclosure of the income and the value of the Trust. Civil courts given sue-motto powers to pass orders relating to proper management of Trust. But direct intervention of the government was not at all intended. After Independence, the	Effective control over charitable and religious Trusts.	Charitable and Religious Trusts.	-Trustee under an obligation to disclose object, income and value of Trust. -court to pass orders relating to proper management.	-Court's interference for proper administration. -Remedies under civil procedure code for breach of trust.	-Transparency is ensured by disclosure of particulars. -Courts regulative role.	-Extensive institutional or administrative control is absent. -preventive mechanism is not adequate.

	situation changed drastically. Many of the State Government enacted their own Religious and Charitable Endowments Act in the areas of temple management. State Government officials (State Government appointed Trustees and functionaries) given widespread administrative and supervisory powers.						
	a) Madras Hindu Religious and Charitable Endowments Act,1951 b) Travancore-Cochin Hindu Religious	Administration and governance of all Hindu public religious institutions and endowments in the concerned State.	Hindu public religious institutions and endowments including Matths.	Formation, rights and duties of Trustees, powers of Authorities	-supervising powers of authorities. -religious qualifications and duties of Trustee	-systematization in temple administration. -wide-ranging powers of State Authorities to ensure	-lack of democratic framework for devotees participation.

	Institutions Act, 1950			such as - Commissioner, Deputy Commissioner, Assistant Commissioner, Accounts Committee etc.	and servants. -financial accountability for proper use.	purpose compliance.	
	c) Andhra Pradesh Charitable and Hindu Religious Institutions and Endowments Act,1966	Administration and governance of all Hindu Public Religious Institution and Endowments in the State.	Hindu public religious institutions and endowments including Matths.	-registration. -vesting of property in the institution. -appointment of Board of Trustees, rights, powers, duties,	-requirement of giving accounts, audit, budget. -regulation on investment of funds and use of surplus funds.	-Chairman of the Board of Trustee is elected by the Board of Trustees. -elaborate measures about Tirupati Temple.	-lack of democratic framework for devotees'participation

				disqualifications of Trustees. -Powers of Authorities.			
	d) Karnataka Hindu Religious Institutions and Charitable Endowments Act,1997	Administration and governance of Hindu public religious institutions and endowments in Karnataka other than Matths and Institutions of religious denominations.	Hindu religious institutions and Charitable Endowments other than Matths and denomination institutions.	-formation of Committee of Management for each notified institution. -Advisory Committee at State level. -Powers of Authorities.	-requirement of giving accounts, audit, budget. -regulation on investment of funds and use of surplus funds. -power to suspend improperly Working Committee. -proper administration of common pool fund.	Extensive measures for financial discipline.	-exclusion of Matths and religious denominations. -lack of democratic participation of devotees.

4.	Wakf Act,1995 Special kind of Charitable and Religious Endowments Act. To manage Muslim Trust properties (Wakf). This again guided by a Will. Little regulatory powers of the government. In case of any dispute, it could be settled only by a Civil Court.	Better administration of Wakfs, superintendence and control of Wakfs.	Wakfs or permanent dedication by a Muslim, of any property for any purpose recognized by the Muslim law as pious, religious or charitable.	-formation of Wakf Board. -distribution of power between Wakf Board and Wakf Commissioner -appointment of Executive Officer. -strengthening finance of Wakf Board. -restrictions on powers of Muttawalli -Wakf Tribunal. -prevention of	-restraints on powers of muttawalli. -restriction on misuse of property -Executive Officer's role. -Wakf Tribunal's interference	Semi-democratic composition of Wakf Board. -protection against misuse of mechanism for purpose compliance is effective.	Beneficiaries are not given any opportunity in decision making.

				misuse of improper transfer of property			
5.	Charitable Endowments Act,1890 The government introduced some elements of regulation by instituting a post of treasurer in each State to oversee the functioning of such charitable endowments. It was the first step towards State intervention in the field of charity.	Vesting administration of property held in Trust for charitable purpose	Public Trusts for charitable purpose.	-defines charitable purpose. -constitutes treasurer for charitable purpose. -vesting and administration of property.	Treasurer has the responsibility of using Trust's property for the purpose mentioned in the Trust Deed.	State's involvement in ensuring proper use of Trust property.	Skeleton like legislation without elaboration for peoples' participation.
6.	Indian Trusts Act, 1882 beginning of charity	Registration/ incorporation. Rights	Private Trustseither for charitable or	Creation of Trust, duties,	Beneficiaries can compel Trustee	facilitates creation of	Lack of remedies outside the

	laws in the country. Basically for management of a Private Trust created by a person through a Will, in the form of a contract between the Will-maker and the Trustees. The intended benefit was only for the family members as mentioned in the Will. The intervention could only be through Civil Court.	and duties of Trustees and beneficiaries.	other lawful purposes.	liabilities, rights and powers of Trustees. Rights and liabilities of beneficiaries.	through legal proceeding to execute the trust and avoid breach of trust.	Trusts. -codifies rights and duties of Trusts and beneficiaries -does not involve extensive State control	courts. -lack of State supervision.
	a) Bombay Public Trusts Act, 1950: The first Act for Public Endowments; Firmly established strong regulatory presence of the State Government (Charity	Detailed measures for governance of Public Trusts in the State of Maharashtra.	Public Trusts	-superintendence of Public Trusts by Charity Commissioner. -quasi-judicial	-suspension or dismissal of Trustee by Charity Commissioner for injurious acts. -prevention of waste, damage or	-transparency. -in-built checks by Charity Commissioner. -purpose compliance is effective. -economically more	-not much insistence on democratic governance. -over work on Charity Commissioner. -over dependence on Charity Commissioner.

	Commissioner). Provision for suspension and dismissal of Trustees, special audit of accounts.			adjudication by Charity Commissioner .	improper transfer of Trust property. -special audit of accounts and inquiry about laws.	effective.	
7.	Trade Unions Act, 1926	Registration, rights and liabilities of Trade Unions.	Trade Unions	-arrangements and requirements about registration of Trade Unions. -immunity from civil suits and from criminal liability. -funds, amalgamation dissolution.	-Registrar's power to cancel registration - annual returns. -access to Registrar.	-scope for election of office bearers. and democratic framework. -competence to involve in collective bargaining.	-no check against outside /political interferences - purpose clause usually vague

8.	Indian Companies Act, 1956, Section 25	Registration of Nonprofit Companies/ Institutions	Not-for profit Companies	-arrangement and requirement about registration. -corporate entity - privileges of a Limited Company.	Acts done in violation of Memorandum of Associations are invalid, Directors are answerable	-enables a corporate personality. -General Body meetings controls, policies and leadership.	

Appendix 2
Comparative Analysis between Various State Legislations on Societies

1. Purpose for Formation of Societies

(a) Societies Registration Act, 1860 provides for formation of a Society for any literary, scientific, or charitable purpose, or for any such purpose as is described under Section 20 of the Act. In terms of Section 20, the following Societiesmay be registered under this Act:

> "Charitable Societies, the military orphan funds or Societies established at the several presidencies of India, Societies established for the promotion of science, literature, or the fine arts for instruction, the diffusion of useful knowledge, [the diffusion of political education], the foundation or maintenance of libraries or reading-rooms for general use among the members or open to the public, or public museums and galleries of paintings and other works of art, collections of natural history, mechanical and philosophical inventions, instruments, or designs."

(b) State Amendments –

(i) Andhra Pradesh - A Society can be registered for promotion of art, fine art, charity, crafts, religion, sports, literature, culture, science, political education, philosophy or diffusion of any knowledge, or any public purpose.

(ii) Karnataka – Societies can be established for promotion of charity, education, science, literature, fine arts, or sports, diffusion of knowledge relating to commerce or industry or of any other useful knowledge, diffusion of political education, foundation or maintenance of libraries, reading rooms, public museums and galleries, the promotion of conservation and proper use of natural resources and scarce infrastructural facilities like – land, power, water, forest, etc. and the collection of natural history, mechanical and philosophical inventions, instruments or designs. This is subject to the provision that such Societies would intend to apply their profits or other income in promoting their objects and prohibit the payment of any dividend or distribution of any income or profits among their members.

(iii) Madhya Pradesh – Societies may be formed for promotion of science, education, literature or fine arts, diffusion of useful knowledge or political education, foundation or maintenance of libraries, galleries of paintings and arts, public museums, collection of natural history, mechanical and philosophical inventions, instruments or designs, promotion or social welfare, promotion or religious or charitable purpose including establishment of funds for welfare of military orphans, political sufferers and welfare of the like, promotion of gymnastics, promotion and implementation of the different schemes sponsored by the State Government or the Union Government and promotion of commerce, industries and khadi.

(iv) Rajasthan – For any literary, scientific or charitable purpose, military orphan funds, promotion of literary, science or fine arts, diffusion of knowledge or political education, foundation or maintenance, libraries, reading rooms, museums, galleries, collections of natural history and for mechanical and philosophical inventions, instruments or designs.

(v) Tamil Nadu – The objects for formation of a Society are interests of consumers in the supply and distribution of essential articles, interests of passengers using buses, taxies and similar public conveyance, welfare of the physical handicap, working women and the unemployed, interests of residents in the matter of provision of civic amenities, interest of pilgrims and tourists, welfare of animals, beards and similar living beings, welfare of displaced persons and downtrodden economically and socially backward classes.

(vi) West Bengal – Promotion of literature, arts, science or religion; any charitable purpose, including the care or relief or orphans, or of aged, sick, helpless or indigent persons; the alleviation of the sufferings of the animals; the diffusion of knowledge; the dissemination of social, political or economic education; establishment and maintenance of libraries or reading-rooms for the members or for the public; the collection and preservation of manuscripts, paintings, sculptures, works of art, antiquities, natural history specimens, mechanical and scientific instruments and designs; any other object as may be notified by the State Government as being beneficial to the public or to a section of the public.

(vii) Uttar Pradesh – In addition to the objectives listed in the Societies Registration Act, Societies can also be formed for Khadi and Village Industry and Rural Development.

1. Registration

(a) In terms of the Societies Registration Act, 1860, the Registrar will register a Society after the Memorandum of Association and certified copy of Rules and Regulations are filed with him.

(b) State Amendments:

(i) Andhra Pradesh – A Society can be registered after the Memorandum of Association and Bye-laws are filed with the Registrar. If an application for registration complying with all the provisions of the Act is not disposed of within 60 days, the Society is deemed to have been registered and the Registrar shall issue a certificate to that effect. In case of refusal of registration, an appeal shall lie to the Registrar General.

(ii) Karnataka – Registration to be given on the basis of MOU and the Rules and Regulations filed with the Registrar. In case of refusal, an appeal shall lie to the Karnataka Appellate Tribunal.

(iii) Madhya Pradesh – Registration certificate to be issued on the basis of a copy of MOU and the Rules and Regulations.

(iv) Rajasthan – Registration is done on the basis of the certified copy of MOU.

(v) Tamil Nadu – Registration certificate to be issued on the basis of a copy of MOU and the Rules and Regulations.

(vi) West Bengal – Registration certificate to be issued on the basis of a copy of MOU and the Rules and Regulation. An appeal shall lie to the State Government against an order of the Registrar refusing to certify the registration and the decision on such appeal shall be final.

(vii) Uttar Pradesh – The certificate of registration shall remain enforce for a period of two years from the date of issue and will have to be renewed thereafter. If any question arises regarding entitlement of the Society for registration, the matter shall be referred to the State Government and the decision of the State Government shall be final.

2. Changes in the Memorandum of Association and Bye-laws

(i) Gujarat – The MOU can be altered by special resolution passed by a majority of not less than 3/5th of the total membership of the Society and such alteration is sanctioned by the Registrar.

(ii) Andhra Pradesh – By a "Special Resolution", a Society may alter the provisions of the memorandum with respect to –

(a) Change of objectives of the Society;

(b) To amalgamate itself with any other Society; or

(c) To divide itself into two or more Society.

"Special resolution" means a resolution passed by a majority of the total members of the Society and not less than 3/5th of the members present and voting in a meeting.

The Bye-laws can be altered by an ordinary resolution passed by not less than half of the members present and voting.

(iii) Karnataka – The MOU can be altered by a proposal agreed to by the votes caste in favour of the proposal and such votes are not less than three times the number of the votes, if any, caste against the resolution. The resolution will need to be confirmed by a simple majority of votes at a second special general meeting convened after an interval of thirty days after the former meeting.

(iv) Madhya Pradesh – Any amendment to the MOU or Regulations of a registered Society will have to be registered with the Registrar.

Alternately, if the Registrar considers that any such amendment is necessary, he will direct the Society to make the amendments within such time as may be specified in such order. If a Society fails to make such amendment within the specified time, the Registrar will himself register such amendment and these amendments shall be binding on the Society and its members.

(v) Tamil Nadu – The MOU and Bye-laws can be amended by a special resolution by the Society and such amendments will have to be registered by the Registrar.

(vi) West Bengal – A Society shall not alter its Memorandum except with the previous permission of the Registrar in writing and the votes of 3/4th of its members. The regulation of a Society can be altered by the votes of 3/4th of the members subject to the provisions of the Act and its Memorandum.

3. Filing of Annual Return

(a) In terms of the Societies Registration Act, 1860, an annual list is supposed to be filed with the Registrar containing the names, addresses and occupations of the Governors, Councils, Directors, Committee or other Governing Body entrusted with the management affairs of the Society.

(b) State Amendments:

 (i) Karnataka – Along with the list indicated above, a society has to file a copy of the Balance Sheet and Income & Expenditure Account audited by a person authorized under Section 226 of the Companies Act to act as an auditor of companies registered in Karnataka.

 (ii) Madhya Pradesh – In addition to the annual list of the Governing Body, every society shall send to the Registrar a statement of Income and Expenditure with full particulars duly audited by its auditor, audit report and balance sheet of the previous year along with details of all financial activities. Accounts of such Society having annual transaction exceeding ₹ 1 lakh shall be submitted to the Registrar duly audited by Chartered Accountant. The Registrar is empowered to undertake a special audit of the account of a Society either himself or by a person authorized by him.

(iii) West Bengal – In addition to the list of the Governing Body, every Society shall file an annual report by the Governing Body on the working of the Society for the previous year and a copy of the balance sheet and the auditors report certified by a duly qualified auditor which means a Chartered Accountant or a person approved by the Registrar in this behalf.

(iv) In almost all the States the Registrar has been empowered to call for any information from the Society, if he so desires.

4. Property of the Society

(a) In terms of Section 5 of the Societies Registration Act, 1860, the property belonging to a Society, if not vested in Trustees, shall be deemed to be vested in the Governing Body of such Society.

(b) State Amendments:

(i) Uttar Pradesh – It shall not be lawful for the Governing Body of a Society or any of its members to transfer without the previous approval of the Court, any immoveable property belonging to such Society.

(ii) Madhya Pradesh – No immoveable property shall be acquired or transferred by the Society without the prior permission of the Registrar and such property will not be used for any object other than the object of the Society without prior permission from the Registrar and in case of gift, written consent of the donor.

5. Amalgamation and Dissolution of Society

(a) Under the Societies Registration Act, the dissolution of a Society shall be decided by not less than 3/5th of the members and the subsequent settlement of the property would be done according to the rules of the Society applicable thereto. In case no such rules are in existence, it may be done as per the decision of the Governing Body. In case of any dispute between the Governing Body and the members, the matter shall be referred to the Civil Court. Subsequent assent will be required by vote of 3/5th of the members present in the general meeting convened for this purpose. Also, if the Government is a member or a contributor or otherwise interested in other Society, such Society shall not be dissolved without the consent of the government.

Upon dissolution, any property left after discharging debts and liabilities of the Society, the same shall not be paid or distributed among the members of the Society but shall be given to some other Society to be determined by the votes of not less than 3/5th of the members. However, this shall not apply to any Society which has been founded or established by the contribution of share holders in the nature of a Joint-Stock Company.

(b) State Amendments:

(i) Uttar Pradesh – Apart from proposing the dissolution of a Society by its Governing Body, the Registrar or not less than 1/10th of the members may also move the Court seeking an order for dissolution on the grounds of contravention of the provisions of the Act, number of the members is reduced below seven, the Society has ceased to function for more than three years, the Society is unable to pay its debts or liability and the registration of the Society has been cancelled on the grounds that the activities of the Society constitute a public nuisance or are otherwise opposed to public policy.

(ii) Karnataka – The proposal for amalgamation of Societies needs to be approved by votes of the members which are not less than three times the number of votes cast against the resolution. The proposal needs to be reconfirmed at a second special general meeting convened by Governing Body after an interval of thirty days. The dissolution requires approval of 3/4th of the members of a Society. However, if the State Government is a member or a contributor or otherwise interested in any Society, such Society shall not be dissolved without the consent of the State Government.

The property which remains with the Society after the satisfaction of its debts and liabilities, shall be given to some other Society to be determined by the votes of not less than 3/5th of the members. The majority of the members may also decide to give such property to the State Government to be utilized for the purpose of formation of other Society.

(iii) Madhya Pradesh – The dissolution to be decided by 3/5th of the members and to be confirmed by voting of equal number of members at a general meeting convened for the purpose. The provisions regarding property are the same as applicable in Karnataka, discussed above. However, the Registrar has also been given powers to cancel the registration on being satisfied that no useful purpose is likely to be served by continuing the Society and consequently the Society been deemed to have been dissolved. In such situation, the moveable and immoveable assets of the society shall vest in the State Governments to the extent of assistance/grant that the Society may have received from the Union or State Government or any of the statutory Bodies. It shall be the duty of the Collector of a District where the property is situated to take charge of the same on intimation of cancellation by the Registrar.

(iv) Tamil Nadu – The amalgamation, division and dissolution of the registered Societies can be done by special dissolution and as per the Bye-laws. However, for amalgamation and division, prior approval of the registrar is required.

(v) West Bengal – Two or more Societies can be amalgamated if so decided by the Governing Body of each such Society, if the proposal is approved by the votes of 3/4th of the Members of each of the Societies concerned and confirmed by like votes at a subsequent general meeting. However, prior approval of the Registrar would be required who can also order for modifications to be carried out in the proposal. An appeal against such orders of the Registrar lies with the State Government.

A Society may be dissolved by the votes of the 3/4th of the members at a general meeting convened for this purpose. No member to receive any profit upon dissolution and 3/4th of the members or in default thereof, by the Registrar, with the approval of the State Government can decide giving the surplus property to some other Society. The dissolution may also be ordered by the court on application of the Registrar or by not less than 1/10th of the members in case the Society contravenes any of the provisions of the Act, if the number of members is less than seven, if the society has ceased to function for more than three years, if the Society is unable to pay its debt or meet its liabilities and if it is proper that the Society should be dissolved.

Also, where in the opinion of the Registrar, there are reasonable grounds to believe that a Society is not managing its affairs properly or is not functioning the Registrar may move the court for making an order for the dissolution of the Society.

6. Other Powers of the State Government and the Registrar

(i) Karnataka – (a) The Registrar may on his own motion and shall on the application of the majority of the members of the Governing Body or of not less than 1/3rd of the members of the Society, hold an inquiry or direct some persons authorized by him to hold an inquiry into the constitution, working and financial condition of a registered Society. While doing so, he will have all the powers regarding inspection of the documents, issuing summons to any person, calling general meeting, etc. During the course of such enquiry if any person related to Society has been found guilty of misfeasance or breach of trust, the Registrar can make an order requiring him to repay or property along with the interest or to contribute such sum to the assets of the Society by way of compensation. This will be in addition to the criminal liability incurred under the Act.

(b) The Registrar can also order for cancellation of registration and dissolution of certain societies if he satisfied that such society has been carrying on any unlawful activity or has allowed any unlawful activities within their premises.

(c) The State Government is empowered to appoint an Administrator for such period not exceeding six months at a time (the aggregate period shall not extend beyond four years) in case a Society is unable to hold the General Meeting, the Governing Body has not been constituted and whether it is in the public interest to do so. The Administrator shall perform all duties and functions of the

Society. He shall take necessary action to hold elections for the constitution of the Governing Body and convene the General Body meeting but for the reason beyond his control if is not able to do so, the State Government may order dissolution on his recommendations.

(ii) Madhya Pradesh – (a) The Registrar has been given the powers to seize records, documents of the Society in case he is satisfied that these are likely to be tampered with or destroyed.

(b) The Registrar may his own motion or an application made by a majority of the members of the Governing Body of the society or not less than 1/3rd of the total number members of the Society, either by himself or by a person authorized by him hold an enquiry into the constitution, working an financial condition of a Society.

(c) The State Government may make order for supersession of Governing Body of any State aided society if it is not functioning properly or commits acts which are prejudicial to the interest of Society and appoint a person or persons to manage the affairs of the Society for a specified period not exceeding two years in the first instance. The period however can be extended from time to time at the discretion of the State level.

(iii) Tamil Nadu – (a) The State Government has the power to order supersession of committee of any Society and appoint a person as the special officer to manage the affairs of the Society for a specified period not exceeding one year. The time period is extendable upto three years at the discretion of the State Government.

(b) As is the case with the other States, the Registrar has the power to enquire into the constitution, working and financial conditions of a registered Society. Such enquiry can also be ordered on the basis an application moved by the District Collector. The Registrar has authority to cancel the registration on the basis of outcome of such enquiry.

(c) The Registrar can also order cancellation of registration if any society is carrying on any unlawful activity or allow unlawful activity within its premises. After cancellation of registration, the society will be dissolved by special resolution and in case of failure to do so, the Registrar can appoint a liquidator to wind up the Society.

(d) The Registrar also has the power to remove the names of the defunct Societies from the register.

7. Offences and Penalties

Unlike the Societies Registration Act, almost all the State Acts contain provisions regarding offences and penalty on the office bearers and members of the society for contravention of the provisions of these Acts.

8. Appeal

Few State Acts such as Tamil Nadu and Madhya Pradesh contain the provisions regarding appeal against the order of the Registrar. In Madhya Pradesh, the appeal against the order of the Registrar lies with the State Government and appeal against the order of the subordinate officers lies with the Registrar. In case of Tamil Nadu, the appeal against the order of the Inspector General of Registration can be filed before the State Government. In case of the orders of any other person, the appeal would lie with the Inspector General of Registration and any person aggrieved by any order made by liquidator may appeal to the Court.

Appendix 3
Various Schemes as Sponsored by Various Central Government Ministries

Various Schemes as sponsored by various Central Government Ministries are as follows:

I. Schemes Sponsored by the Ministry of Social Justice and Empowerment, Shastri Bhawan, New Delhi

S.No.	Name of the Scheme	Purposes and the eligibility
1.	Scheme for Welfare of Children in need of care and Protection	The main purpose of the scheme is to rehabilitate destitute children as normal citizens of the country. The scheme seeks to provide individualized and personal care to destitute children with the help of institutional and non-institutional care. The scheme is implemented through registered voluntary (national level) organisation.
2.	Scheme for Foster Care Services.	The objective of the scheme is welfare of the destitute children by providing the homely atmosphere to those who become destitute at an early age. It is made available to reputed V.O. working in the field of promoting foster care services in India.
3.	Organizational Assistance to Voluntary Social Welfare Organisations.	The objective is to provide assistance to voluntary organizations with a view of developing their organizational efficiency.
4.	Scheme for Assistance to disabled persons for purchases/ fittings of aids/ appliances.	The main objective is to assist needy physically handicapped persons in procuring quality and modern aids and appliances that can promote their physical rehabilitation.

		The eligible are the individuals who are physically handicapped.
5.	Grants-in-aid for sponsoring research on rehabilitation of the handicapped.	The projects are intended to help in finding the solutions to the problems of the handicapped and facilitate their effective rehabilitation. The projects under this sponsoring shall be of an applied nature and result and action oriented.
6.	Scheme of Assistance to organizations for disabled persons.	The scheme seeks to provide financial assistance mainly for developing services in the area of prevention of disabilities, early detection and intervention; education, training and rehabilitation.
7.	Assistance to Voluntary agencies for prevention, detection and management of childhood disabilities	This scheme is jointly promoted by the Government of India and UNICEF. It seeks projects of Non-Governmental Organisations having a focus on preventive and early detection of disability among children. Projects eligible for this assistance would include community and family based rehabilitation programmes for disabled children; efforts aimed at creating awareness among families and community leaders; innovative programmes of training in early detection/ intervention methods for families etc.
8.	Grants-in-aid rules for sponsoring research.	The scheme provides assistance for conducting research in the field of social welfare, social policy and social development. Priorities within these broad areas will be given to projects of an applied nature keeping in view plan policies and programmes.
9.	Grants-in-aid rules for sponsoring publications	Grants for provided for publication of studies and documentation in the field of social welfare and policy development.
10.	Grants-in-aid for Workshops/	The Ministry also provides financial assistance for organising workshops/

	seminars.	seminars which will help disseminate research findings, identify problem areas, discuss problems and identify research needs etc. in the broad field of social welfare, social policy and social development.
11.	Grants-in-aid rules for supporting projects (Tribal Development) of all India or Inter-State nature	The scheme aims at supporting action oriented studies on problems of scheduled tribes particularly in the field of economic development for generation of necessary data to improve formulations and implementations of tribal developmental programmes.

II. Schemes Sponsored by the Ministry of Human Resource and Development, Shastri Bhawan, New Delhi

S.No.	Name of the Scheme	Purposes and the eligibility
1.	Scheme of Assistance for construction/ extension of Hostel buildings for working women with a day care centre.	The scheme seeks to provide suitable accommodation in healthy environment for the working women and day-care centres.
2.	Scheme for short stay homes for women and girls.	
3.	Scheme for setting up women's training centres/ institutes for rehabilitation of women in distress	The main objective is to rehabilitate destitute women through vocational trainings and residential care.
4.	Scheme for organizational assistance to voluntary organizations for women and child development.	The scheme seeks to support and help the V.O. for women and children to maintain their central offices, a vital input in the running of their activities.

5.	Scheme of Nutrition programmes through Bal-wadis and Day-care centres for pre-school children in the age group of 3 to 5 years.	The programme seeks to provide supplementary for children in the age of 3-5 years and envisage that it would form a basis for the development of other services like health, education and welfare.
6.	Scheme for Assistance to V.O. working in the field of adult education	Promotion of adult education and eradication of mass illiteracy.
7.	Scheme of Assistance to V.O. for early childhood education. (Universalisation of education)	Early Childhood education programmes.

III. Schemes Sponsored by the Ministry of Health and Family Welfare, New Delhi

1.	Scheme for improvement of health services	The scheme seeks to provide the medical care to rural and high density urban slums for expansion and improvement of existing nursing facilities.
2.	Schemes for sanctioning grants-in-aid for promoting the voluntary blood donation camps.	The scheme seeks to promote intensive and extensive education of the pubic and motivate them to donate the blood
3.	Grants to Under-graduate college of Indian Systems of Medicines and Homeopathy run by the V.O.	The scheme seeks to provide the financial assistance with a view to improve the standard of education in the under-graduate ISM and Homeopathy colleges for the purchase of lab equipment and setting up of the book banks.
4.	Grants-in-aid to the V.O. engaged in the Family welfare programmes.	The scheme seeks to encourage V.O. to take up the family welfare programmes by running the family welfare centres.

IV. Other Schemes Sponsored by Various Ministries

Concerned Department/ Board	Scheme	Purposes
National Wasteland Development Board Lok Nayak Bhawan, New Delhi	Scheme for Grant of Financial Assistance to V.O.	The objective under the scheme is to bring under productive uses the wastelands in the country through a massive programme of afforestation and tree planting. The major steps include identification of lands, motivation of villagers, assisting the villagers either as a group in obtaining trees, rights on lands etc. The Board shall emphasise on the issues relating to laying of nurseries, forestry and Pasteur development activities and development of culturable wasteland including improvement of land.
National Fund for Rural Development (Department for Rural Development), Krishi Bhawan, New Delhi	Scheme for Rural Development	The Govt. accords highest priority to programmes of rural development for attaining the objectives of increasing agricultural production, creating employment, eradicating poverty and bringing overall improvement in the rural economy. Projects qualifying for these assistance: • Construction and maintenance of rural link road • Construction and maintenance of drinking water projects • Construction and maintenance of hospitals and dispensaries

		• Establishment of rural industries and animal product units for generating employment in rural areas.

V. Ministry of Home Affairs

Provides grants-in-aid to voluntary organizations to undertake activities for the cause of national integration and communal harmony, such as, inter-community celebration of National Days and festivals, cultural shows, essays and painting competitions, inter-regional camps, exchange of visits, public meetings, exhibitions

Appendix 4
Frequently Asked Questions (FAQs) Related to FCRA, 2010

Following are the Frequently Asked Questions (FAQs) related to FCRA, 2010:

1. What will be the status of existing registered trust under FCRA, 1976?

Any Association registered with the Central Government under Section 6 of the FCRA, 1976, as it stood immediately before the commencement of this Act, shall be deemed to have been registered under this act and such registration shall be valid for a period of five years from the date from which this section comes into force.

2. Whether organization can invest foreign contribution in M.F and what will be the status of existing investment?

No organization can invest foreign contribution in mutual funds. It is advisable to withdraw the existing investment in mutual funds.

3. Can Association have multiple bank accounts?

Yes, association can have multiple bank accounts for utilizing the foreign contribution. It is important to note here that it is obligatory for all associations to receive the foreign contribution in one bank account designated for the purpose and in no other bank account.

4. What is the last date for submission of annual accounts?

Every person who receives foreign contribution under the act shall submit a report in form Fc-6, accompanied by an income and expenditure statement, receipt and Payment account, and balance sheet for every financial year beginning on the 1st day of April within nine months of the closure of the financial year i.e. before 31st of December every year.

5. What are the documents required to be submitted with annual accounts?

Form FC 6/ FC 7/ FC8 as the case may be to be accompanied with statement of receipt and payment of foreign contribution, income and expenditure accounts and balance sheet. Every such return in Form FC-6 shall also be accompanied by a copy of a statement of account from the bank where the exclusive foreign contribution account is maintained by person, duly certified by an officer of such bank.

6. What are the differences in from FC 3 (FCRA, 1976,) and FC – 6 (FCRA 2010)?

Bifurcation of cash and in kind is required for opening and closing balance. In form FC 6. New column is introduced to include details of places with addresses of specific activities carried out during year.

7. Whether donation given by a NRI (Non Resident Indian) is treated as Foreign Contribution?

It is important to note here that any donation received from foreign source will constitute to be a foreign contribution. In case of NRI if he/she posses the Indian Passport (i.e. holding Indian Nationality) than such donation will not be treated as foreign contribution.

8. Can foreign contribution be received in Rupees?

Yes, donation from foreign source in any currency will constitute to be foreign contribution.

9. Who can receive foreign contribution?

Person having definite cultural, economic, educational, religious or social programmed shall accept foreign contribution subject to condition that such person obtains a certificate of registration from central government.

10. Who cannot receive foreign contribution?

No foreign contribution shall be accepted by any:

(a) candidate for election;

(b) correspondent, columnist, cartoonist, editor. Owner, printer or publisher of a registered newspaper;

(c) Judge, Government servant or employee of any corporation or any other body controlled or owned by the Government;

(d) Member of any Legislature;

(e) Political party or office-bearer thereof;

(f) Organization of a political nature as may be specified under sub-section (1) of section 5 by the Central Government;

(g) Association or company engaged in the production or broadcast of audio news or audio visual news or current affairs programmes through any electronic mode, or any other electronic form as defined in clause (r) of sub-section (1) of section 2 of the information Technology Act, 2000 or any other mode of mass communication;

(h) Correspondent or columnist, cartoonist, editor, owner of the association or company referred to in clause (g).

Explanation - In clause (c) and section 6, the expression "corporation" means a corporation owned or controlled by the Government and includes a Government company as defined in section 617 of the Companies Act, 1956.

11. Which are the purposes where provisions of Section 3 will not apply?

Nothing contained in section 3 shall apply to the acceptance, by any person specified in that section, of any foreign contribution where such contribution is accepted by him subject to the provisions of section 10:

(a) by way of salary, wages or other remuneration due to him or to any group of persons working under him, from any foreign source or by way of payment in the ordinary course of business transacted in India by such foreign source; or

(b) by way payment, in the course of international trade or commerce, or in the ordinary course of business transacted by him outside India; or

(c) as an agent of a foreign source in relation to any transaction made by such foreign source with the Central Government or state Government; or

(d) by way of a gift or presentation made to him as a member of any Indian delegation, provided that such gift or present was accepted in accordance with the rules made by the Central Government with regard to the acceptance or retention of such gift or presentation; or

(e) from his relative; or

(f) by way of remittance received, in the ordinary course of business through any official channel, post office, or any authorized person in foreign exchange under the foreign Exchange management Act, 1999; or

(g) by way of any scholarship, stipend or any payment of like nature.

Provided that in case any foreign contribution received by any person specified under section 3, for any of the purposes other than those specified under this section, such contribution shall be deemed to have been accepted in contravention of the provisions of section 3.

12. Is it necessary to submit form FC 6 in case no foreign contribution is received during year?

Yes, even NIL FC6 is required to submit every year.

13. What will be the status of application made for registration or prior permission under FCRA 1976 but not disposed of before the date of commencement of Foreign Contribution (Regulation) Rules, 2011?

It shall be deemed to be an application for registration or prior permission, as the case may be, under FCR Rules 2011, subject to condition that the applicant furnishes the prescribed fees for such registration or prior permission, as the case may be.

14. Whether a Company incorporated in India under the Companies Act, 1956 having its operations in two or more countries is to be treated as an MNC under FCRA, 2010?

No. However, the definition of 'foreign source' under section 2(j) (vi) may be seen.

15. Whether foreigners can be appointed as Executive Committee members?

Organizations having foreign nationals as members of their executive committees or governing bodies are generally not permitted to receive foreign contribution. However, foreign nationals, fulfilling the following conditions, may be appointed as Executive Committee members, after obtaining prior permission of the Central Government:

(i) the foreigner is married to an Indian citizen;

(ii) the foreigner has been living and working in India for at least five years;

(iii) the foreigner has made available his/her specialized knowledge, especially in the medical and health related fields on a voluntary basis in India, in the past;

(iv) the foreigner is part of the Board of Trustees/Executive Committee in terms of the provisions in an inter- governmental agreement;

(v) the foreigner is part of the Board of Trustee/Executive Committee, in an ex-officio capacity representing a multilateral body which is exempted from the definition of

(vi) Foreign source. The need for such an appointment should, however, be adequately justified.

16. Whether Government servants, Judges and employees of a Government owned/controlled company/body can be on the executive committees/boards of an association?

Yes. The legal entity of a 'person' under FCRA, 2010 is distinct from am individual person. Therefore, individuals who cannot receive foreign contribution may happen to be on the executive committees/boards of such an association.

17. Whether foreign remittances received from a relative are to be treated as foreign contribution as per FCRA, 2010?

The position in this regard as given in Section 4(e) of FCRA, 2010 and Rule 6 of FCRR, 2011 are as under:

Subject to the provisions of section 10 of the FCRA, 2010, nothing contained in section 3 of the Act shall apply to the acceptance, by any person specified in that section, of any foreign contribution where such contribution is accepted by him from his relative. However, in terms of Rule 6 of FCRR, 2011, any person receiving foreign contribution in excess of one lakh rupees or equivalent thereto in a financial year from any of his relatives shall inform the Central Government in Form FC-1 within thirty days from the date of receipt of such contribution. Available on the website http://mha.nic.in/fcra/forms/fc-1.pdf.

18. What is the procedure for change of designated Bank Account?

For change of the bank account, an application in prescribed form mentioning the details of the old bank account and the proposed new bank account along with justification for change of designated bank, name/ address of the society, copy of registration under FCRA, copy of fresh resolution of the executive committee (in English or Hindi) for change of designated back account, certificate from the proposed bank (copy of Bank Pass Book is not acceptable) that the account is being opened exclusively for FCRA, may be submitted to MHA. This form is available on website http://mha.nic.in/fcra/forms/chng_name_addr.pdf.

19. What are the eligibility criteria for registration?

For grant of registration, the association should:

(i) be registered under the Societies Registration Act, 186 or the Indian Trusts Act, 1882 or section 25 of the Companies Act, 1956;

(ii) normally be in existence for at least three years and has undertaken reasonable activity in its chosen field for the benefit of the society for which the foreign contribution is proposed to be utilized. For this purpose, the association should have spent at least ₹ 6,00,000 over last three years on its activities, excluding administrative expenditure. Statement of Income & Expenditure duly audited by Chartered Accountant for last three years may be enclosed to substantiate that it meets the financial parameter.

(iii) meet the following conditions:

(a) The person making an application for registration or grant of prior permission under sub-section

1. Sec.12 (4) (a) (1) is not fictitious or benami;

2. has not been prosecuted or convicted for indulging in activities aimed at conversion through inducement or force, either directly or indirectly, from one religious faith to another;

3. has not been prosecuted or convicted for creating communal tension or disharmony in any specified district or any other part of the country;

4. has not been found guilty of diversion or mis-utilisation of its funds;

5. is not engaged or likely to engage in propagation of sedition or advocate violent methods to achieve its ends;

6. is not likely to use the foreign contribution for personal gains or divert it for undesirable purposes;

7. has not contravened any of the provisions of this Act;

8. has not been prohibited from accepting foreign contribution;

9. the person and/or any of its directors or office bearers has neither been convicted under any law for the time being in neither force nor any prosecution for any offence is pending against him.

(iv) the acceptance of foreign contribution by the association/ person is not likely to affect prejudicially:

   (i) the sovereignty and integrity of India; or

   (ii) the security, strategic, scientific or economic interest of the State; or

   (iii) the public interest; or

   (iv) freedom or fairness of election to any Legislature; or

   (v) friendly relation with any foreign State; or

   (vi) harmony between religious, racial, social, linguistic, regional groups, castes or communities.

(v) the acceptance of foreign contribution:

   (i) shall not lead to incitement of an offence;

(ii) shall not endanger the life or physical safety of any person.

20. What are the eligibility criteria for grant of prior permission?

An organisation in formative stage is not eligible for registration. Such organisation may apply for grant of prior permission under the law.

Prior permission is granted for receipt of specific amount from specific donor for carrying out specific activities/projects. For this purpose, the association should:

(i) be registered under the Societies Registration Act, 1860 or the Indian Trusts Act, 1882 or section 25 of the Companies Act, 1956;

(ii) submit a specific commitment letter from the donor; and

(iii) submit copy of a reasonable project for the benefit of the society for which the foreign contribution is proposed to be utilized.

(iv) should meet all the conditions for the grant of registration.

21. Is recommendation of District Collector or District Commissioner or District Magistrate mandatory?

No. Submission of verification certificate from the District Collector or District Commissioner or District Magistrate is not mandatory. However, in certain cases, if the amount applied for prior permission is less than ₹ 50 lakh,submission of such a certificate assists in speedy clearance of the application.

22. If an application for registration or prior permission is submitted online by an association, does it need to submit that application in physical form also?

Yes. When an application is filed online, a printout of the same may be taken after submission and thereafter, it should be submitted, duly signed, along with the requisite documents to the Ministry of Home Affairs. The prescribed forms for submission of application for grant of Registration and Prior Permission are FC-3 and FC-4 respectively. Available at MHA website http://mha.nic.in/fcra/forms/fc-3.pdf and http://mha.nic.in/fcra/forms/fc-4.pdf, respectively.

23. What are the documents to be enclosed with the application?

(a) Following documents should be enclosed with the application for grant of Registration:

- (i) Hard-copy of the online application, duly signed by the Chief Functionary of the association;
- (ii) Certified copy of registration certificate or Trust deed, as the case may be;
- (iii) Details of activities during the last three years;
- (iv) Copies of audited statement of accounts for the past three years (Asset and Liabilities, Receipt and Payment, Income and Expenditure);
- (v) If functioning as editor, owner, printer or publisher of a publication registered under the Press and Registration of Books Act, 1867, a certificate from the Registrar of Newspaper for India that the publication is not a newspaper in terms of section 1(1) of the said Act.
- (vi) Fee of by means of demand draft or banker's cheque of ₹ 2000/- in favor of the "Pay and Accounts Officer, Ministry of Home Affairs", payable at New Delhi.

(b) Following documents should be enclosed with the application for grant of Prior Permission:

- (i) Hard-copy of the online application, duly signed by the Chief Functionary of the association;
- (ii) Certified copy of registration certificate or Trust deed, as the case may be;

(iii) Commitment letter from foreign donor specifying the amount of foreign contribution;

(iv) Copy of the project report for which foreign contribution is solicited/being offered;

(v) If functioning as editor, owner, printer or publisher of a publication registered under the Press and Registration of Books Act, 1867, a certificate from the Registrar of Newspaper for India that the publication is not a newspaper in terms of section 1(1) of the said Act.

(vi) Fee of by means of demand draft or banker's cheque of ₹ 1000/- in favor of the "Pay and Accounts Officer, Ministry of Home Affairs", payable at New Delhi.

Note: The hard copy of the on-line application along with all the documents mentioned above must reach the Ministry of Home Affairs, Foreigners Division (FCRA Wing) within thirty days of the submission of the on-line application, failing which the request of the person for grant of registration or prior permission, as the case may be, shall be deemed to have ceased.

24. How to find the status of pending application for registration/prior permission?

Status of pending applications for grant of registration or prior permission may be checked on-line from the Ministry of Home Affairs web-site http://mha.nic.in/fcra.htm. One needs to fill in the numbers on acknowledgement letter or any correspondence from MHA (Foreigners Division) in the blank format which pops up on the screen after selection of status enquiry icon (registration/prior permission, as the case may be)

25. Is there any restrictions on transfer of funds to other organisations?

Yes. Section 7 of FCRA, 2010 states:-

"No person who :

(a) is registered and granted a certificate or has obtained prior permission under this Act; and

(b) receives any foreign contribution, shall transfer such foreign contribution to any other person unless such other person is also registered and had been granted the certificate or obtained the prior permission under this Act:

Provided that such person may transfer, with the prior approval of the Central Government, a part of such foreign contribution to any other person who has not been granted a certificate or obtained permission under this Act in accordance with the rules made by the Central Government."

It may further be noted that Rule 24 of FCRR, 2011 prescribes the procedure for transferring foreign contribution as under:

"Rule 24: "Procedure for transferring foreign contribution to other registered or unregistered persons:

(1) Any person intending to transfer the foreign contribution may make an application to the Central Government in Form FC-10.

http://mha.nic.in/fcra/forms/fc-10.pdf

(2) The Central Government may permit the transfer in respect of a person who has been granted the certificate of registration or prior permission under section 11 of the Act, in case the recipient person has not been proceeded against under any provision of the Act.

(3) Any transfer of foreign contribution shall be reflected in the returns in Form FC-6 http://mha.nic.in/fcra/forms/fc-6.pdf as well as in Form FC 10http://mha.nic.in/fcra/forms/fc-4.pdf by the transferor and the recipient.

(4) In case the foreign contribution is proposed to be transferred to a person who has not been granted a certificate of registration or prior permission by the Central Government, the person concerned may apply for permission to the Central Government to transfer a part of the foreign contribution, not exceeding ten per cent, of the total value of the foreign contribution received. The application shall be countersigned by the District Magistrate having jurisdiction in the place where the transferred funds are sought to be utilized. The District Magistrate concerned shall take an appropriate decision in the matter within sixty days of the receipt of such request from the person. The donor shall not transfer any foreign contribution until the Central Government has approved the transfer."

26. How would an organisation that is registered or has obtained prior permission under FCRA and intends to transfer a part of the foreign contribution received by it to another organisation registered under FCRA would know whether the recipient organisation has been proceeded against under FCRA?

Where any organisation is proceeded against under FCRA, it is done with due intimation to the organisation concerned. Therefore, the donor organisation is advised to insist on a written undertaking from the intending recipient organisation.

27. What is the procedure for filing Annual Returns?

An association permitted to accept foreign contribution is required under law to maintain separate set of accounts and records exclusively for the foreign contribution received and utilized and submit an annual return, duly certified by a Chartered Accountant, giving details of the receipt and purpose-wise utilization of the foreign contribution. The return is to be filed for every financial year (1st April to 31st March) within a period of nine months from the closure of the year i.e. by 31st December each year. Submission of a 'Nil' return, even if there is no receipt/utilization of foreign contribution during the year, is mandatory. The return is to be submitted, in prescribed Form FC -6, duly accompanied with the balance sheet and statement of receipt and payment, which is certified by a Chartered Accountant. The form is available on MHA's web-site - http://mha.nic.in/fcra/forms/fc-6.pdf For further details, please refer to Sections 17, 18 and 19 of FCRA, 2010 and Rule 17 of FCRR, 2011.

Note: It may be noted that the annual return for the financial year 2010 - 2011 is to be filed by the 31st December, 2011 in Form FC-3, i.e., as per FCRA, 1976.

28. What is foreign hospitality?

Foreign Hospitality means any offer, not being a purely casual one, made in cash or kind by a foreign source for providing a person with the costs of travel to any foreign country or territory or with free board, lodging, transport or medical treatment.

29. Who cannot accept foreign hospitality without prior approval of the Ministry of Home Affairs?

No member of a Legislature or office bearer of a political party or Judge or Government servant or employee of any corporation or any other body owned or controlled by the Government shall, while visiting any country or territory outside India, accept, except with the prior permission of the Central Government any foreign hospitality.

Provided that it shall not be necessary to obtain any such permission for an emergent medical aide needed on account of sudden illness contracted during a visit outside India, but, where such foreign hospitality has been received, the person receiving such hospitality shall give, within one month from the date of receipt of such hospitality an intimation to the Central Government as to the receipt of such hospitality, and the source from which, and the manner in which, such hospitality was received by him.

30. How one can seek permission of the Government for receiving foreign hospitality?

Application form (Form FC-2) for this purpose is available on MHA's web-site - http://mha.nic.in/fcra/forms/fc-2.pdf. In terms of Rule 7 of FCRR, 2011:

(i) Every application for acceptance of foreign hospitality shall be accompanied by an invitation letter from the host or the host country, as the case may be, and administrative clearance of the Ministry or department concerned in case of visits sponsored by a Ministry or department of the Government.

(ii) The application for grant of permission to accept foreign hospitality must reach the appropriate authority ordinarily two weeks before the proposed date of onward journey.

(iii) In case of emergent medical aid needed on account of sudden illness during a visit abroad, the acceptance of foreign hospitality shall be required to be intimated to the Central Government within sixty days of such receipt giving full details including the source, approximate value in Indian Rupees, and the purpose for which and the manner in which it was utilized.

Provided that no such intimation is required if the value of such hospitality in emergent medical aid is up to one lakh rupees or equivalent thereto.

31. What is the procedure for seeking change in the name/address of the association?

For seeking change in the name/address of the association, one should use the prescribed form available on MHA's website http://mha.nic.in/fcra/forms/chng_name_addr.pdf and submit the same along with the requisite documents specified therein.

32. Can an organization, whose violation under FCRA has been condoned, apply for registration/prior permission?

After the violation committed by an association has been condoned, the association can apply for prior permission (PP) only by submitting an application in form FC-4 http://mha.nic.in/fcra/forms/fc-4.pdf. Once the PP has been granted and foreign contribution received for specific purpose has been fully/partially utilized and organisation has submitted annual FC-6 http://mha.nic.in/fcra/forms/fc-6.pdf returns and accounts in prescribed format pertaining to the PP, it becomes eligible for consideration of registration under FCRA. Registration would be granted under FCRA, if other parameters are fulfilled by the association.

33. Can an association invest the foreign contribution received by it in profitable ventures and proceeds can be utilized for welfare activities?

No. The association should utilize such funds for the welfare purpose or activities for which it is received. The utilization should be in line with the objectives of the association. However, foreign contributions can be utilized for self-sustaining activities, not meant for commercial purposes.

34. Whether interest earned out of foreign contributions be shown as fresh foreign contribution receipt during that year or not?

Yes. The interest earned out of such deposit should be shown as second / subsequent foreign contribution receipt in the annual return during the year in which it is earned.

35. Can the fee paid by the foreign delegates/participants attending/participating in a conference/seminar etc. be termed as foreign contribution and thus require permission from FCRA?

Foreign delegates/participants paying “delegate/participation Fees” in foreign currency for participation in a conference/seminar which is utilized for the purpose of meeting the expenditure of hosting the conference/seminar and is not treated as foreign contribution and as such no permission under FCRA is required.

Create a Budget that Looks For You	http://www.snpo.org/samples/V150446.pdf
Checklist to Assess Financial Activities in Non-profit Organisations	http://managementhelp.org/organizationalperformance/nonprofits/finances.htm
First Official Estimates – an NGO for Every 400 People in India	http://www.indianexpress.com/news/first-official-estimate-an-ngo-for-every-400-people-in-india/643302/1
Section 25 Companies under Companies Act, 1956	http://www.legalindia.in/section-25-companies-under-companies-act-1956
Assessment of Charitable Trusts and Institutions	http://www.incometaxindia.gov.in/Archive/Assessment_CharitableTrusts_Institutions.pdf
National All-India Legislation Governing not-for-profit Organizations in India	http://www.usig.org/countryinfo/india.asp
The Budgeting Process	http://www.nonprofitaccountingbasics.org/reproting-operations/budgeting-process
Non-Profit Organizations	http://www.reallifeaccounting.com/pubs/Article_Theme_Non_Profit_Organizations.pdf
How to do Fund Accounting in Quick Books	http://community.intuit.com/posts/how-to-do-fund-accounting-in-quickbooks
UCSB Campus Information and Procedure Manual- Fund Accounting	http://www.controller.ucsb.edu/ResourcesandPresentations/pdf/deskmanual/fund_accounting.pdf
Fund Accounting	http://en.wikipedia.org/wiki/Fund_Accounting
Accounting for Different Types of Funds	http://www.parishresources.org.uk/treasurers/difffunds.htm
Using Fund Accounting	http://www.freechurchaccounting.com/fundaccounting.html
Functional Accounting	http://www.notforprofitaccounting.net/2009/10/14/functional-accounting/
The Statements of Functional Expenses: Measuring Nor Profit Efficiency	http://www.understand-accounting.net/StatementofFunctionalExpense.html

Accreditation – a Kite Mark for the Non-Profit Sector	http://www.alliancemagazine.org/en/content/accreditation-%E2%80%93-a-kitemark-non-profit-sector
NGO - Internal Audit	http://uttardayee.freewebspace.com/AuditableAuditAble1.pdf
Not-for-Profit Organizations – Audit Checklist	http://www.ehow.com/list_7343774_not_for_profit-organizations-audit-checklist.html
Risk Assessment Do's and Don'ts	http://www.jebcl.com/riskdo/riskdo.htm
Internal Control- The Key to Good Business Practices	http://www.cafm.vt.edu/dbmg/internal_controls.php
Financial Management Guide for Non-Profit Organizations	http://www.nea.gov/about/oig/fmgnpo.pdf
A Guide for Not-for-Profit Organizations (Official Donations Receipt for Canadian Registered Charities)	http://www.deloitte.com/view/en_ca/07fbe55cd21fb110VgnVCM100000ba42f00aRCRD.htm
Grant Readiness	http://managementhelp.org/blogs/fundraising-for-nonprofits/2010/04/08/development-is-not-a-synonym-for-fundraising/
Audit of Grant or Contribution Programs	http://www.oag-bvg.gc.ca/internet/docs/grant_cont.pdf