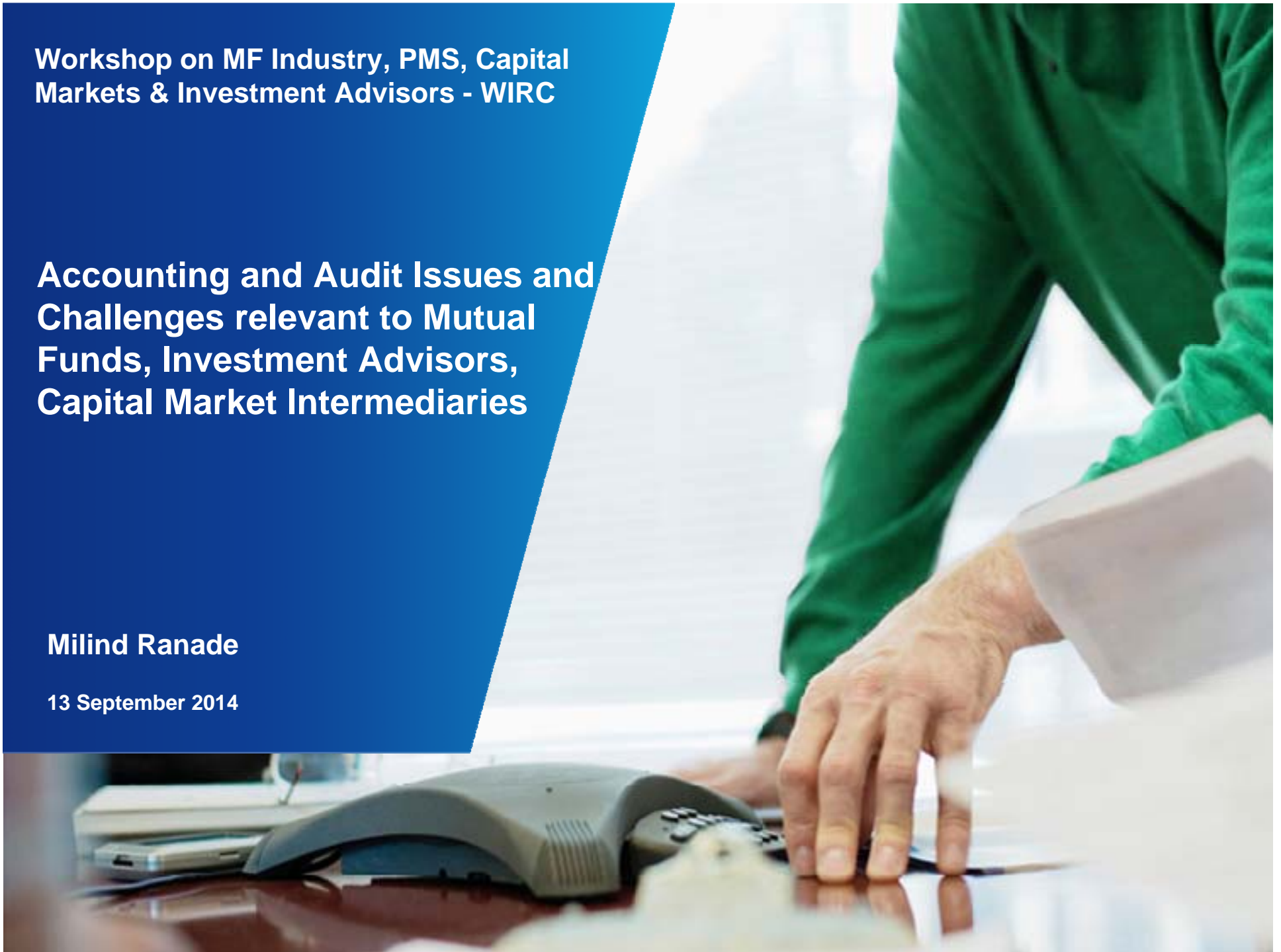


**Workshop on MF Industry, PMS, Capital  
Markets & Investment Advisors - WIRC**

**Accounting and Audit Issues and  
Challenges relevant to Mutual  
Funds, Investment Advisors,  
Capital Market Intermediaries**

**Milind Ranade**

**13 September 2014**



# Agenda

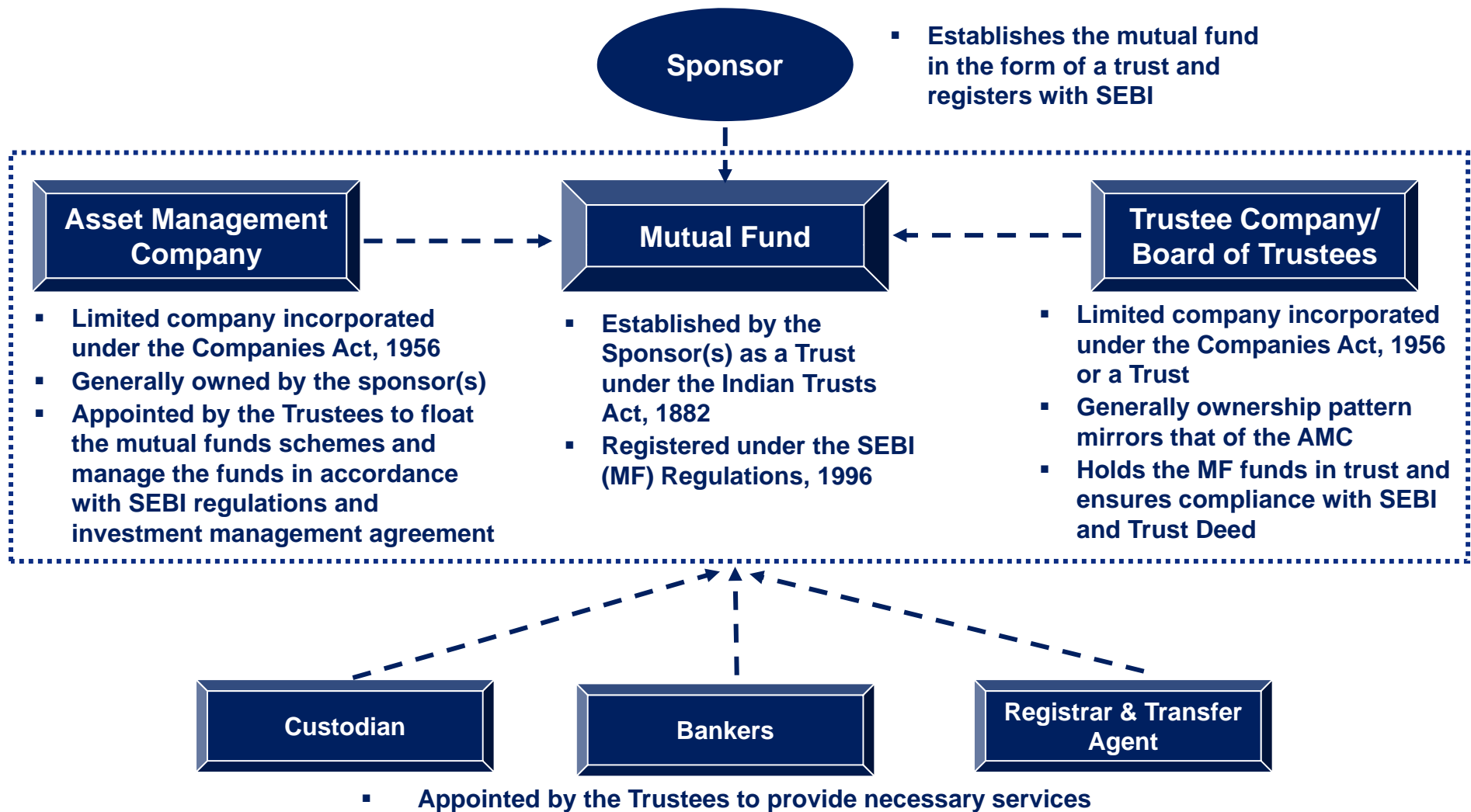
## **Mutual Funds and investment advisors**

- Overview
- Financial reporting framework
- Accounting and Auditing Challenges

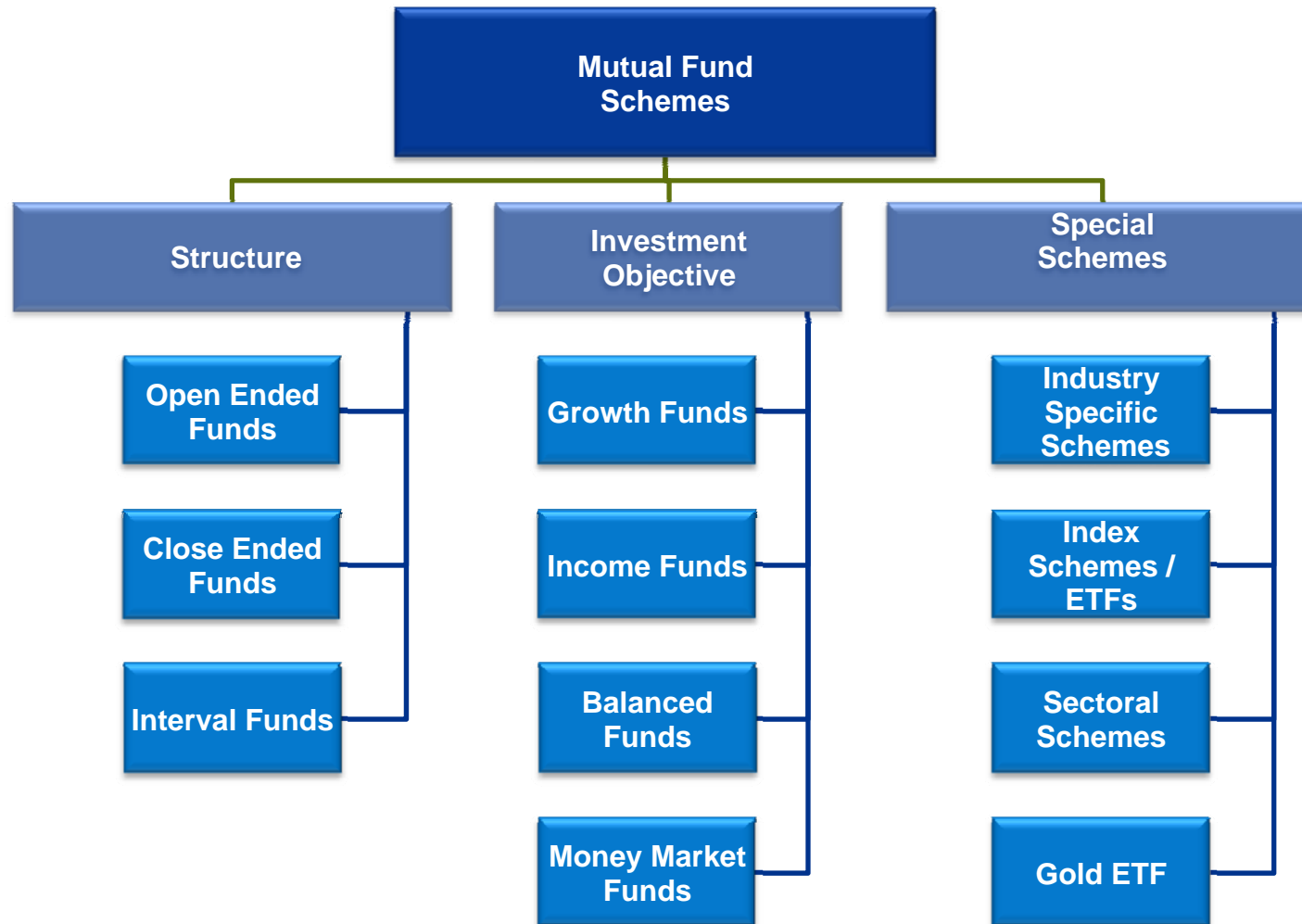
## **Portfolio Managers**

- Overview
- Financial reporting framework
- Accounting and Auditing Challenges

# Legal structure of Indian mutual funds



# Types of Mutual Fund Schemes



## Financial reporting framework

### Accounts and audit

**Regulation 50 (3)** - “The asset management company shall follow the accounting policies and standards as specified in **Ninth Schedule** so as to provide appropriate details of the schemewise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unitholder in a fair and true manner.

**Regulation 55 (1)** Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company.

**Accounting Standards issued by ICAI  
also applicable to Mutual Funds**

# Significant Accounts

## Balance Sheet

- **Unit Capital and Liabilities:**
  - Unit Capital
  - Reserves and Surplus
  - Current Liabilities
- **Assets:**
  - Investments
  - Deposits
  - Current Assets

## Revenue Account

- **Income:**
  - Interest / Dividend income
  - Profit on sale of investments (inter-scheme / others)
- **Expenses:**
  - Management fees
  - Brokerage expenses
  - Loss on sale of investments (inter-scheme / others)
  - Other expenses (custodian, registrar, audit fees etc.)
- **Income distribution**

# Accounting and Auditing Challenges

## Fungibility in Total Expense Ratio

Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"><li>▪ Monitoring of actual expenditure incurred against the accruals on a periodic basis to achieve correct accruals and adjustments to overall TER at an early stage, if any</li><li>▪ Absence of periodic monitoring may lead to year-end adjustments / write back under various expense heads and could potentially impact NAV</li></ul>	<ul style="list-style-type: none"><li>▪ Validating the appropriateness of daily expense accrual</li><li>▪ Adequacy of control framework around expense accrual</li></ul>



## Additional expense for inflow form beyond top 15 cities (B-15 Cities)

Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"><li>▪ Setting-up appropriate system for periodical review of actual additional expenditure incurred against the accruals</li></ul>	<ul style="list-style-type: none"><li>▪ Verification of appropriateness and relevance of expenditure incurred for generating additional inflow form B-15 cities</li></ul> <p>For example - Establishment cost, branch expenses set up in B-15 locations</p>

Commission to Distributors	
Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"> <li>▪ Allowability of amortization of upfront commission</li> <li>▪ Determination of appropriate period over which the upfront commission paid by schemes or AMC to be apportioned</li> </ul>	<ul style="list-style-type: none"> <li>▪ Appropriateness and adequacy of evidences / support provided by management for availing distributors' services                             <ul style="list-style-type: none"> <li>• Contractual obligation with distributor</li> <li>• Nature and timeframe of services</li> <li>• Cost and revenue matching concept</li> <li>• Other terms of commission e.g.- Clawback</li> </ul> </li> </ul>

## Investors' education and awareness expenses

Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"><li>▪ Unspent accruals of Investors' education and awareness in case of closed ended / fixed maturity schemes, after maturity</li><li>▪ Tracking of such unspent accruals post maturity date</li></ul>	<ul style="list-style-type: none"><li>▪ Closed schemes with unspent provisions if not subjected to audit – potential threat of inappropriate use of unspent provisions</li><li>▪ Thin line between differentiation of expenditure on investors education and awareness and corporate advertisements / brand promotion expenditures</li></ul>

Inter-scheme transfers	
Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"><li>▪ Setting-up appropriate policies and procedures for determination of price for inter-scheme transfers</li><li>▪ Appropriateness of rationale for inter-scheme transfers</li></ul>	<ul style="list-style-type: none"><li>▪ Appropriateness of justification for inter-scheme transfers from the selling and buying schemes perspective</li><li>▪ Adequate documentation of rationale for inter-scheme transfers</li></ul>

## AMC's Net-Worth computation

Accounting Challenges	Auditing Challenges
<ul style="list-style-type: none"><li>▪ Exclusion of Securities Premium from computation of Net-Worth under Companies Act 2013 having impact on compliance with Net-Worth norms</li></ul>	<ul style="list-style-type: none"><li>▪ Verification of compliance by fund houses to AMC's Net-Worth norms</li></ul>

## Unpaid Brokerage

### Accounting Challenges

- Setting-up of appropriate review mechanism for long outstanding unpaid brokerages (pending KYC / code of conduct com)
- Absence of accounting policies to deal with such long outstandings

### Auditing Challenges

- Lack of appropriate review mechanism for long outstanding unpaid brokerages increases the risk of misappropriations

## Other Auditing Challenges

- Reliance placed on SAS-70 report in cases where fund accounting function (Intermediary) is outsourced by AMC (Intermediary)
- Lack of availability of SAS-70 report from fund accounting service organization (Intermediary) covering the entire length of audit period
- Need for Robust control testing on:
  - investments transaction and valuation (being significant component)
  - common expenses allocation
  - cash and cash equivalents – Balance confirmations
- Heavy reliance on ITGC and application IT controls

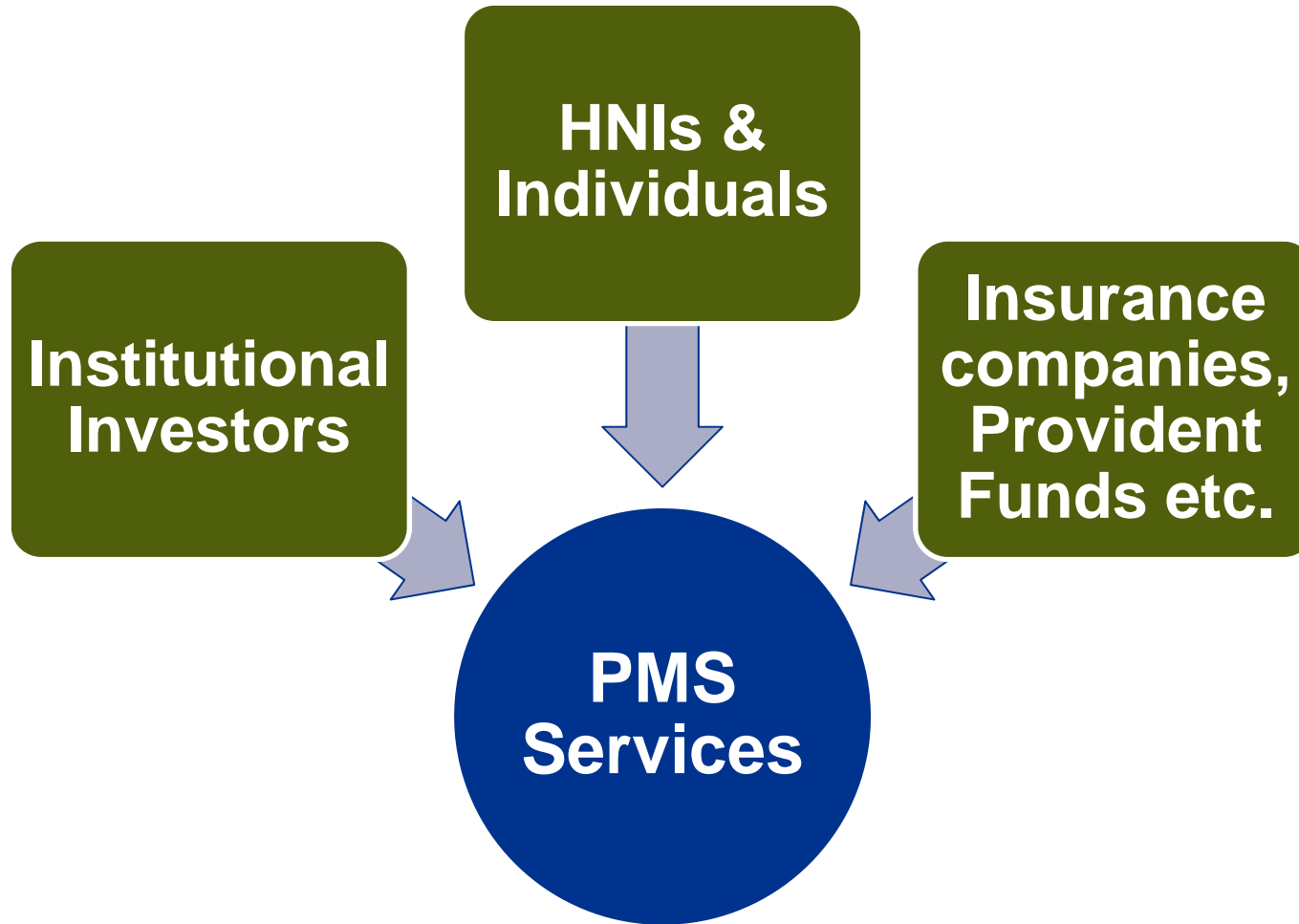
# Challenges relevant for Portfolio Managers



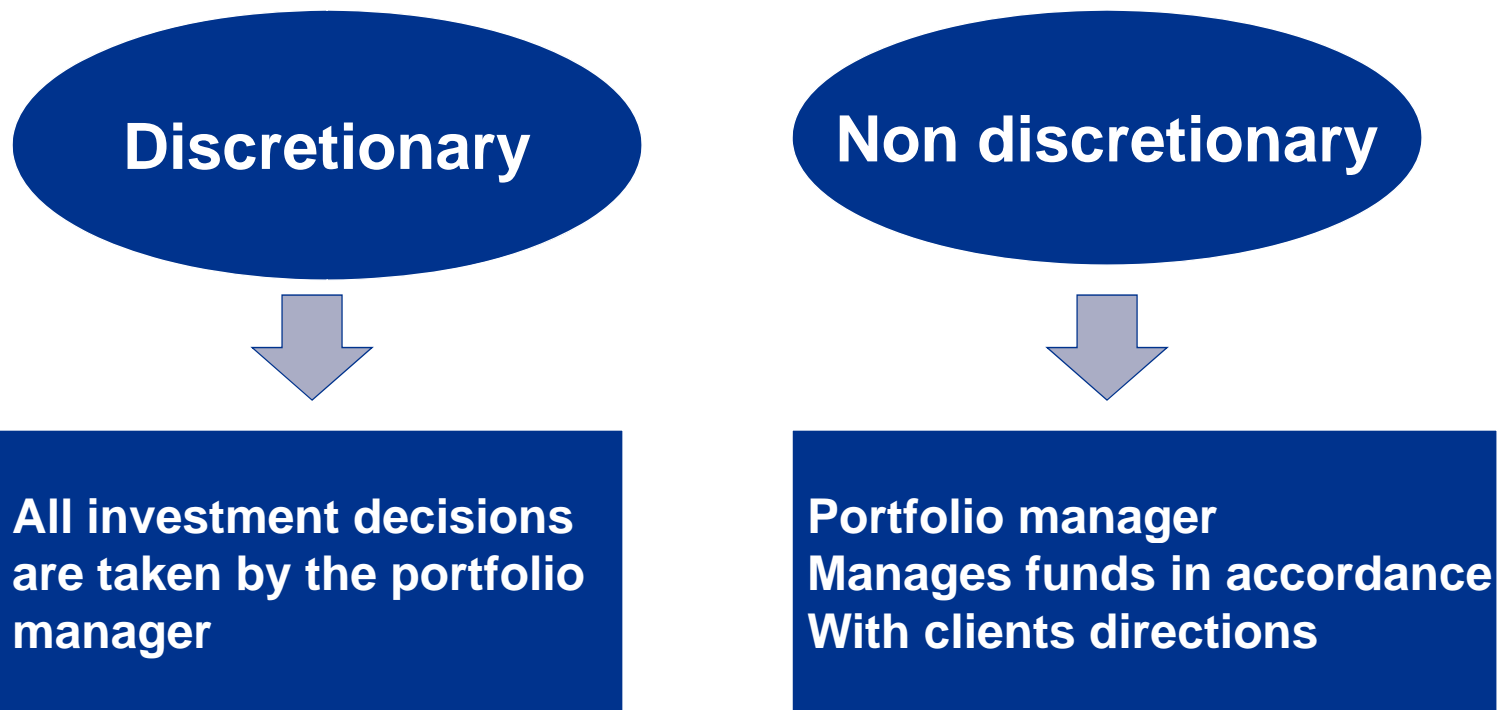


## Overview

Regulation 2(ca) of the SEBI (Portfolio Manager) Regulations, 1993 states *"**Portfolio Manager**" means any person who pursuant to a **contract or arrangement** with a client, advises or directs or undertakes **on behalf of the client the management or administration of a portfolio** of securities or the funds of the client, as the case may be.*



## Two types of PMS services



## Financial reporting framework

### Regulation 20 (3) – Accounts and audit

“The portfolio accounts of the portfolio manager shall be **audited** annually by an independent chartered accountant and a copy of the **certificate issued** by the chartered accountant shall be given to the client.”

**Silent on the financial reporting  
framework**

## Key accounting challenges

- **No specific guidance on accounting policies to be adopted**
- **No specific guidance on financial reporting disclosures**
- **Generally accepted accounting principles adopted in practice**
- **No specific format of independent auditors report prescribed by SEBI**

**Inconsistency & arbitrariness  
in portfolio accounts prepared by  
various PMS houses**

## Different Accounting and Disclosure practices

Particulars	Accounting practices
<b>Investments</b>	<ul style="list-style-type: none"> <li>- At cost</li> <li>- At market value / fair value</li> </ul>
<b>Entry load / brokerage</b>	<ul style="list-style-type: none"> <li>- Amortization</li> <li>- Upfront</li> </ul>
<b>Performance fees</b>	<ul style="list-style-type: none"> <li>- On anniversary date</li> <li>- On reporting date</li> <li>- At the discretion of portfolio manager</li> </ul>
<b>Portfolio accounts</b>	<ul style="list-style-type: none"> <li>- Balance sheet and Profit &amp; Loss</li> <li>- Statement of Affairs</li> </ul>
<b>Accounting system</b>	<ul style="list-style-type: none"> <li>- Cumulative account balances from inception of account</li> <li>- For the year / as at year end balances</li> </ul>

## Auditing challenges

- **Determination of the purpose of issuance of audit opinion on financial statements – general purpose or special purpose**
- **Investments recorded at FIFO basis – AS 13 compliance**
- **Detailed disclosure in notes to accounts – ensure transparency**

## Auditing challenges

- **Control testing on:**
  - Investment allocation
  - Common expenses allocation
- **Heavy reliance on ITGC and application IT controls**
- **Reliance on SAS 70 report in cases where accounting is outsourced to a Fund accountant**
- **Fair value of unlisted investments – reasonableness assessment**



# Thank You

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