UNIT 6: AUDIT OF MUTUAL FUNDS

1. OVERVIEW

The first introduction of a mutual fund in India occurred in 1963, when the Government of India launched Unit Trust of India (UTI). UTI enjoyed a monopoly in the Indian mutual fund market until 1987, when a host of other government-controlled Indian financial companies established their own funds, including State Bank of India, Canara Bank and Punjab National Bank.

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 42 mutual funds recently. The AUM of the Indian MF Industry has grown from ₹ 3.26 trillion as on 31st March, 2007 to ₹ 19.04 trillion as on 31st May, 2017, about six-fold increase in a span of 10 years.

1.1 Regulatory Requirements: The regulatory authority, namely, the Security Exchange Board of India (SEBI) 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.

Association of Mutual Funds in India (AMFI): 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, the association of SEBI registered mutual funds in India of all the registered Asset Management Companies, was incorporated on August 22, 1995, as a non-profit organization. As of now, all the 42 Asset Management Companies that are registered with SEBI, are its members.

2. STRUCTURE OF A MUTUAL FUND

2.1 Framework of a Mutual Fund: 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.

**Sponsor:** - 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:** - The trustees of a Mutual Fund could be constituted as a ‘Board of Trustees’ or could be incorporated as a ‘Trustee Company.’ The Sponsor appoints the trustees for the mutual fund. Trusteeship fees are paid by mutual fund schemes.

**Asset Management Company (AMC):** - 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. Sponsor or the Trustee appoints the AMC through Investment Management.

### 2.2 Mutual Fund Schemes:

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<th>Type of Mutual Fund Schemes</th>
<th>By Structure</th>
<th>By Investment Objectives</th>
<th>Other Schemes</th>
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<td>Open Ended</td>
<td>Growth</td>
<td>Exchange Traded Scheme</td>
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<td>Closed Ended</td>
<td>Income</td>
<td>Tax Saving</td>
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<td>Interval Schemes</td>
<td>Balanced</td>
<td>Capital Protection</td>
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<td>Money Market</td>
<td>Fund of Funds</td>
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<td></td>
<td></td>
<td>Gilt</td>
<td>Real Estate Funds</td>
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1. **Open Ended Schemes** - This scheme allows investors to buy or sell units at any point in time. This does not have a fixed maturity date.

2. **Close Ended Schemes** - This type of scheme has a stipulated maturity period and investors can invest only during the initial launch period known as the NFO (New Fund Offer) period.

3. **Interval Schemes** – This type of scheme operates as a combination of open and closed ended schemes. It allows investors to trade units at pre-defined intervals.

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

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

6. **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.

7. **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.

8. **Gilt Funds** – Investments are predominantly in securities issued by the Government, thus, having very low risks.

9. **Exchange Traded Funds (ETFs)** – 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.

10. **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).

11. **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.

12. **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.
13. **Real Estate Funds** – A real estate fund is a type of mutual fund that primarily focuses on investing in securities offered by public real estate companies.

2.3 Investing in Mutual Funds:

2.4 Risks involved in Mutual Fund Business
2.5 Key Functions

1. **Investment** - The money collected are invested in capital market instruments such as, shares, debentures and other securities and money market instruments.

2. **Registrar and Transfer Agent (R&TA)** - The Registrar and Transfer Agent (R&TA), processes the financial and non-financial transactions for schemes of Mutual Fund.

3. **Fund Accountant** - Fund administration are the set of activities carried out in support of the actual process of running mutual fund business. Some of the functions which are specific to fund accounting activity are computation of Net Asset Value, accounting and maintenance of books of accounts for the schemes of mutual fund, calculation and payment of dividend etc.

4. **Risk and Compliance** - Manages risk and ensures compliance regulatory requirements.

5. **Custodian** – Custodian provides safekeeping of securities.

6. **Product & Sales** – Floats new schemes and promotes sales.

3. **CONDUCT OF AUDIT OF MUTUAL FUNDS**

SEBI (Mutual Funds) Regulations, 1996 provide that Board of Trustees of 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.

3.1 **Statutory Audit:**

1. The Regulations require that every asset management company for each scheme shall keep and maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of account, records and documents are maintained.

2. 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. Under
the SEBI Mutual Fund regulations, the statutory auditors of the AMC and Mutual fund schemes are to be different entities.

3. The auditor shall forward his report to the trustees and such report shall form part of the Annual Report of the mutual fund.

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<th><strong>The auditor’s report shall comprise</strong></th>
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<td><strong>A.</strong> A certificate to the effect that,—</td>
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<td>(i) he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit;</td>
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<tr>
<td>(ii) the balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the Fund for the accounting period to which the Balance Sheet or, as the case may be, the Revenue Account relates;</td>
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<td>(iii) the statement of account has been prepared in accordance with accounting policies and standards as specified in the Ninth Schedule.</td>
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<td><strong>B.</strong> The auditor shall give his opinion as to whether:</td>
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<tr>
<td>(i) the Balance Sheet gives a true and fair view of the scheme wise state of affairs of the fund as at the balance sheet date, and</td>
</tr>
<tr>
<td>(ii) the Revenue Account gives a true and fair view of the scheme wise surplus/deficit of the fund for the year/period ended at the balance sheet date.</td>
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4. The valuation policies and procedures shall be regularly reviewed (at least once in a Financial Year) by an independent auditor to seek to ensure their continued appropriateness.

5. **Internal Financial Controls:** Section 143 of the Companies Act, 2013 ("the 2013 Act" or "the Act") requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting and the procedures in respect thereof are carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the date specified in management's assessment. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.
Paragraph A1 of Standard on Auditing (SA) 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing” states, “The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor’s opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

Considering the above, the auditor needs to obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.

Further, the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements.

3.2 Internal Audit: The scope of the internal audit 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.

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.

The emerging role of the internal auditor requires that there is proactive 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.

3.3 Concurrent Audit: The scope of the concurrent audit broadly covers day-to-day key operations of mutual fund and AMC service providers, such as, deals entered into with the brokers, calculation of daily NAV, money market operations, etc.

3.4 Information Systems Audit: 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. Mutual Funds/AMCs should get the above systems audit conducted once in two years. The Systems Audit Report and compliance status should be placed before the Trustees of the mutual fund. The systems audit report/findings along with trustee comments should be communicated to SEBI.

3.5 Inspection:

(A) As per Regulation 61 of SEBI (Mutual Fund Regulations), 1996, SEBI 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 asset Management Company 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 asset management company 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 Asset Management Company;

(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 thereunder 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 asset management company; and

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

(B) As per Regulation 63, the mutual fund, trustees or asset management company shall allow the inspecting officer to have a reasonable access to the premises occupied by it or by any other person on its behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the mutual fund, trustees and asset management company or such other person and also provide copies of documents or other materials which in the opinion of the inspecting officer are relevant for the purpose of the inspection. The inspecting officer, in the course of inspection or investigation, shall be entitled to examine or record the statements of any director, officer, or employee of the mutual fund, trustees and Asset Management Company. It shall be the duty of every director, officer, or employee of the mutual fund, Asset Management Company or trustee to give to the inspecting
officer all assistance in connection with the inspection or investigation, which the inspecting officer may reasonably require.

The inspecting officer shall, as soon as possible, on completion of the inspection or investigation submit a report to the Board. He may also be required to submit an interim report if directed by the Board.

The SEBI has also the power in addition to normal audit, 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 Asset Management Company:

Provided that the Auditor so appointed shall have the same powers of the inspecting officer as stated in regulation 61 and the obligation of the mutual fund, Asset Management Company, Trustee, and their respective employees in regulation 63, shall be applicable to the investigation under this regulation.

3.6 Other Relevant Points

1. Physical verification of gold underlying the Gold ETF units shall be carried out by statutory auditors of mutual fund schemes and reported to trustees on half yearly basis.

2. The review of Risk Management Systems shall be a part of internal audit and the auditors shall check their adequacy on a continuing basis. Their reports shall be 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 Board.

3. Based on the certification by the auditors, the Board of Directors of AMC will have to confirm on a yearly basis that:

   i. Trustees shall check compliance with guidelines relating to recording of investment decisions through statutory / internal auditors or other systems developed by them.

   ii. Commission paid to distributors include payments made to group entity of distributors

4. The Ninth and Eleventh Schedule of SEBI (Mutual Funds) Regulations provide the accounting policies to be followed for determining distributable surplus and accounting the sale and repurchase of units in the books of the Mutual Fund. Thus, the format for Scheme Balance Sheet provides for disclosure of Unit Premium Reserve.

In this perspective, SEBI vide its Circular, dated March 15th, 2010, clarified that the Unit Premium Reserve, which is part of the sales price of units that is not attributable to realized gains, cannot be used to pay dividend. However, it is observed that some Mutual Funds are using Unit Premium Reserve for distribution of dividend. It is therefore reiterated that:

   a. When units of an open-ended scheme are sold, and sale price is higher than face value of the unit, part of sale proceeds that represents unrealized gains shall be credited to a separate account (Unit Premium Reserve) and shall be treated at par with unit capital and the same shall not be utilized for the determination of distributable surplus.
b. When units of an open-ended scheme are sold, and sale price is less than face value of the unit, the difference between the sale price and face value shall be debited to distributable reserves and the dividend can be declared only when distributable reserves become positive after adjusting the amount debited to reserves as per para 2(a)(ix) of Eleventh Schedule of SEBI (Mutual Funds) Regulations.

5. Auditor shall verify the outsourcing policy with the intermediaries and verify whether the same has been adhered to.