Technical Guide on Internal Audit of Retail Industry

Internal Audit Standards Board

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

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Contents

Chapter 1

Introduction

1.1 Retail refers to the sale of goods to end users, not for resale, but for use and consumption by the purchaser. The retail transaction is at the end of the supply chain. In India the retail sector is the second largest employer after agriculture, although it is highly fragmented and predominantly consists of small independent, owner – managed shops. The Indian retail industry is the fifth largest industry in the world.

1.2 Retail industry is one of the fastest growing industries in India. The retail industry comprises of organised and unorganised sectors.

Organised retailing refers to trading activities undertaken by licensed retailers, i.e., those who are registered for sales tax, income tax, etc. These include the corporate-backed hypermarkets and retail chains, and also the privately owned large retail businesses.

Unorganised retailing refers to the traditional formats of low-cost retailing, For example, the local kirana shops, owner manned general stores, hand cart and pavement vendors, etc.

The organised sector represents only 5% share of the retail industry.

1.3 Post liberalisation the retail sector in India is heralded as one of the sunrise industries. Today within the booming service sector, retailing is the single biggest contributor in terms of GDP to the national income. Retail has played a major role world over in increasing productivity across a wide range of consumer goods and services.

1.4 The term retailing is a very broad term which can be used to denote a large range of products including durables and consumables. This sector can be categorised into:

(i) Food products

(ii) Soft goods – clothing, apparel, and other fabrics.

(iii) Hard goods ("hardline retailers") – appliances, electronics, furniture, sporting goods, etc.

Further, the retail industry includes the sale/ distribution of the following products:

- Clothing, textiles and fashion accessories
- Jewellery
- Watches, Footwear
- Health and Beauty Care Services
- Pharmaceuticals
- Consumer Durables, Home Appliances/ Equipments
- Mobile handsets, Accessories and Services
- Furnishings, Utensils, Furniture for Home and Office
- Food and Grocery
- Books, Music and Gifts
- Other personal products

Objective and Scope of Technical Guide

1.5 This technical guide is intended to assist internal auditors in carrying out internal audit of entities operating in the Retail Industry.

The management in concurrence with the internal auditor, taking into consideration, various pronouncements of ICAI and other regulatory requirements, assessments of control environment and business domain knowledge, primarily decides the scope of the internal audit. This technical guide deals with the operational areas of entities operating in this industry with emphasis on compliance of various regulations as applicable to such types of entities.

1.6 This Technical Guide covers the following aspects:

Part I	Glossary of terms peculiar to retail industry
Part II	Introduction
Part III	Scenario in the Indian retail industry and challenges faced by an entity operating in this sector.
Part IV	Legal framework and the entities for operating.
Part V	Discussion on internal audit and compliance related issues.
Part VI	Major areas of Internal audit significance, risks faced by an operating in this sector, procedures that the internal auditor entity should perform, and checklist of important audit procedures.
Part VII	Appendix

This technical guide does not cover the following aspects:

(a) Internal audit of routine operations in finance and other areas/ functions of business;

(b) Internal audit performed by the associated enterprises;

(c) Special audits;

(d) Investigations; and

(e) Retailing through E-commerce.

Chapter 2

About the Indian Retail Industry

2.1 Indian retail industry is one of the fastest growing industries in India, especially over the last few years. Though initially, the retail industry in India was mostly unorganised, and especially with the change of tastes and preferences of the consumers, the industry is getting more significant and organised as well. It is important for an internal auditor to have relevant business knowledge in this light, he needs to gain an understanding of the Indian retail industry, its evolution, initiatives from the Government special features of the retail Industry and the challenges faced by entities operating in this sector in order to understand the critical areas, nuances and knowledge of the business thereby helping him frame internal audit procedures to perform an efficient and effective internal audit.

Evolution of Retail Industry

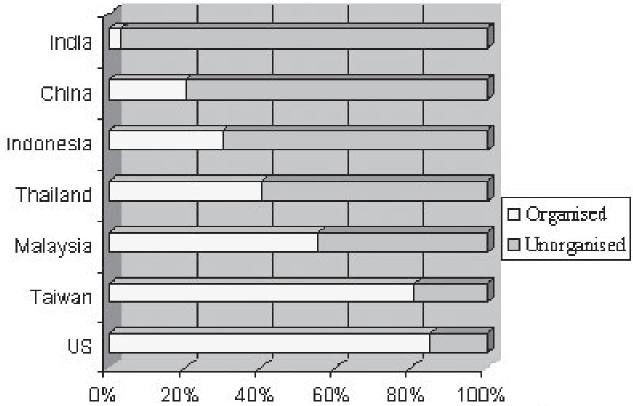
2.2 The origin of retail industry in India can be traced back to prior to the emergence of kirana stores and mom-and-pop stores, wherein weekly markets, village and rural melas were a source of commercial exchange and has been in existence for ages. Subsequently developed these stores used to cater to the local people providing convenience to neighbourhood, a pervasive reach, facilities of credit and a personal touch. Eventually, the government supported the rural retail. Many indigenous franchise stores came up with the help of Khadi and Village Industries Commission. Public distribution system and co-operatives emerged as a low cost method of distribution as supported by various Government schemes. The economy began to open up in the 1980s resulting in the change of retailing. The first few companies to come up with retail chains were in textile sector. With the passage of time, new entrants moved on from manufacturing to pure retailing.

2.3 Shopping malls emerged in the urban areas giving a world-class experience to the customers from the mid 1990's. Eventually, hypermarkets and supermarkets have emerged. The evolution of the sector includes the continuous improvement in the supply chain management, distribution channels, technology, back-end operations, etc. This would finally lead to consolidation, mergers and acquisitions and huge investments, resulted in development of the organised sector in Indian Retail Industry.

2.4 One of the major factors leading to the growth of the large retail industry was the introduction of an efficient banking system, especially, with the introduction of credit cards into the mainstream buying habits. This has led to the growth of the organised sector in the retail industry in small businesses couldn't afford the cost of purchases with credit cards because the turnover and profit margins didn't allow it.

2.5 The next revolution staring down the industry is the e-retailing. E-retailing was once considered a competitor of little threat because of the initial miscalculation of business focus compounded with outlandish outlays and unrealistic business models. But, e-retailing has refused to die and has taken the time to learn from their mistakes. The result is a mounting adversary to the giant chain stores in the shopping malls today. Their tool for success is, ironically, the same tool that help the larger chain stores push the smaller establishment into extinction, i.e., the banking revolution and the advent of credit cards and debit cards.

In spite of the recent sprout in large format stores, the ratio of organised retail to un-organised retail in India is significantly less in comparison globally.



	US	Taiwan	Malaysia	Thailand	Indonesia	China	India
Unorganised	15%	19%	45%	60%	70%	80%	97%
Organised	85%	81%	55%	40%	30%	20%	3%

Role of the Indian Government

2.6 The Government has been protecting the Indian retail sector from global players ever since liberalisation of the business in India. The government has been supporting the local grocery shops which might be wiped out in the event of complete opening of the retail market for Foreign Direct Investment (FDI) by global players, typically, to support the millions of small kirana shops and it forms the basis of livelihood for millions of people.

2.7 The government has taken steps to provide growth of e-commerce which eventually acts as the back-bone for growth of e-retailing. Besides developing the e-infrastructure in the country through effective telecom policy measures, the Indian government has created the necessary legal and administrative framework through the enactment of the Information Technology (IT) Act which combines e-commerce transactions and computer misuse and frauds rolled into an Omnibus Act. The Controller of Certifying Authorities (CCA) has been put in place for effective implementation of the IT Act. The Act also enables e-governance applications for electronic delivery of services to citizens.

Distribution System in Retail Industry

2.8 The industry has a three-tier system for the distribution of its products. The first tier is the manufacturer, the second tier is the intermediary, basically, the distributor or wholesaler, and the third tier is the retailer. The manufacturer sells or grants licenses based on different criteria. Each state government controls what products are brought inside its border.

2.9 The distributor or wholesaler sells and distributes the products to the retailers. An intermediary dealing with one type of product, is called as a distributor, dealer or a franchisee. In such a scenario, the goods/ products would be branded and the retailer intends to make substantial profits by buying directly from supplier/ wholesale agent and selling it to the customers.

Another option available for the intermediary would be dealing with multiple brands of a similar product from various manufacturers to prevent customers moving away to competitors due to lack of availability of desired brand.

2.10 Retailers purchase a product, mark up its cost, and advertise it for sale. The mark-up process is the key to the retailer's business because if the product is marked up too high, consumers will not buy it; and if it is marked up too low, there will be no profit and the supply may be quickly exhausted. In any case, the product value cannot exceed the Maximum Retail Price fixed by the manufacturer.

2.11 India is witnessing change in life styles of large section of the population. The need to understand the emerging markets and consumers has become a big challenge for the corporate world, especially, in creating and managing a powerful brand. By developing a powerful brand, entities can establish 'brand equity' and the equity assists firms to manage competition and to maintain market share. Branding is one of the most effective competitive tools and it is a challenging task for the marketer to nurture a brand into a strong profitable brand.

Today's brands are more visible than those in the past. They are everywhere-on the TV, hoardings, posters and print media. Brands while proclaiming their positive qualities pull down those of their rivals. Intangible assets such as brands, patents and know-now have become increasingly dominant elements of entity's value.

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E-Retailing in India

2.12 E-retailing, also known as e-tailing, is shopping through the internet and other media forms. There are many things that are common between direct retail stores and online retail stores. Both have the process of billing of the customers and have to maintain a relationship with the suppliers.

Bottlenecks Faced By E-Retailing in India

2.13 The bottlenecks faced by e-retailing in India are as follows:

(i) ***Problems with the Payment System***

People in India are not used to the online shopping system and moreover the online payment system through the credit card is also totally alien to them. Most of them do not avail of the transaction facilities offered by the credit cards/ debit cards. They are also dubious regarding the online payment system through the credit cards. Hence different payment options should be made available to them like the credit card/ debit cards, cash on delivery and net banking to give them further assurance.

(ii) ***Problems with Shipping***

The customers using the online shopping channel should be assured that the products that they have ordered would reach them in due time. For this, the retail companies have resorted to private guaranteed courier services as compared to postal services.

(iii) ***Offline Presence***

The customers should be assured that the online retailers are not only available online but offline as well. This gives them the psychological comfort that these companies can be relied upon.

(iv) ***Products Offered at Discounted Rates***

The online retailers save on the cost of building and employee salaries. Some part of this benefit should be moulded to the online customers by a reduction in the price of the product. The customers should be conveyed this message that they are getting the products at a discounted price.

(v) ***Linguistic Mismatches***

Most internet retail shops use English as their mode of communication. English may not be comprehensible to the majority of the Indian population. To increase the customer base, content in the online retail shops should be provided in local language.

(vi) ***Psychological Factors***

In general, Indians prefer to touch the products physically before buying them. This facility is provided through the multi-brand outlets, not available online. Further, the preferences of the customers are towards the traditional shopping methods.

Fraud Management System

2.14 The fraud management system must have the following important features:

(i) Business rules engine to allow the setup and maintenance of custom business rules.

(ii) Transaction processing APIs (Application Programming Interface) which allow multiple parameters as input, the ability to evaluate these parameters against the defined business rules and as a result provide as output the decision to accept, review or reject the order transaction.

(iii) The ability to setup and maintain fraud negative lists.

(iv) A risk prediction model or algorithm to provide a risk score based on historical data. It is possible that single software may not be able to provide these capabilities. In such scenarios, real time interfaces to an online risk prediction service (third party ASP model) may be required to determine the risk score which could then be used as an input to the business rules engine.

(v) A workflow engine to model the fraud business process. Another alternative is to build the workflow within the order management system (OMS). The details are as below.

- Fraud review screens for the order information and the rules tripped. As explained above, the alternative approach could be to build these on the OMS.

- The ability to record and store authorisation and settlement data for credit cards. This ability can be used to reconcile chargebacks from the payment providers against the original order transaction.

Order Management System (OMS)

2.15 The important activities performed by the Order Management System (OMS) to facilitate the fraud management process are:

(i) As in the case of the online store front, the Order Management System (OMS) must provide the ability to interface with the payment gateway for real time authorisations, AVS checks, card verification codes and payment programs, etc. This is based on the assumption that order and tender modifications are managed in the Order Management System (OMS).

(ii) The order related information required as input by the fraud rules engine is supplied by the Order Management System (OMS). This implies that the Order Management System (OMS) must have services to invoke the appropriate fraud APIs and act on the decisions provided by the rules engine.

(iii) Based on the directive provided by the rules engine, the Order Management System (OMS) must have the ability to put the order on hold and transition to the fraud business process. It should also have the ability to restart the order fulfillment process based on an accept decision from the rules engine or the fraud analyst.

(iv) The Order Management System (OMS) ideally should provide workflow capabilities to model the fraud business process flow. This could also include fraud review screens, ability to generate alerts and manage fraud related queues.

(v) The fraud review process can result in changes to the order including cancellations (for fraudulent orders), changes in payment types (new credit cards/ debit cards provided by customer) etc. If these modifications are managed within the Order Management System (OMS), then it should provided the user interface to make these changes as well as manage the backend processes of deallocating inventory, refunding the customers money etc.

(vi) In case the Order Management System (OMS) manages the customer related communications (sms, emails etc.,), hence it should also be able to manage the communication associated with payment and fraud related problems.

Date Warehousing Systems (EDW)/ Analytics

2.16 It is very important to have a data warehousing strategy associated with a fraud management implementation. The important functions to be performed by such a system are described below:

(i) The EDW needs to pull data from the fraud management system and the Order Management System (OMS).

(ii) The extent of the fraud problem faced by an online retailer can only be determined through analysis of order history data. This helps determine the direct and indirect fraud rates.

(iii) The validity of the business rules can be verified by using the EDW. They can also be prioritised based on analysis done on the EDW data.

(iv) The risk prediction models are only as good as the history data provided. These models must be continuously validated and updated based on data pulled by the EDW system.

(v) The thresholds for the rules engine can be validated using the EDW.

Fraud Prevention Techniques

2.17 The different types of fraud prevention tools and techniques used by online retailers are as follows:

(i) ***Online Payment Authorisation of Credit Cards/ Debit Cards***

The process ensures that the credit card/ debit card being used is not lost or stolen. It also makes sure that the card has enough credit balance to pay for the purchase. It cannot however make out that the person using the card is actually authorised to do so.

(ii) ***Address Verification Services (AVS)***

An AVS check matches the billing address provided by the customer with the billing address on file for that credit card/ debit card. The customer's address data is submitted together with each payment authorisation request. The system responds with a "score" signifying how well the address data matched. This tool is not very effective as it may not lead to a match in as many as 40% of the transactions and fraudster will have to file address of his credit card, hence nullifying the advantage of such a check.

(iii) *Use of Card Verification Codes (CVV)*

These codes consist of 3 or 4 digit numbers printed on the front or back of credit cards. These codes are required along with the credit card/ debit card details for authorisations to occur. These codes are not printed on receipts or stored in retailer databases to prevent easy access of the same by fraudster. This process requires that the card be physically present at the time of the transaction thus reducing card not present fraud scenarios.

(iv) *Negative Files*

These files, typically, define the set of minimum criteria an order transaction must satisfy before proceeding for fulfilment. These consists of lists of known fraudulent data such as email ids, stolen credit card/ debit card numbers and bad shipping addresses, etc. These files are based on past experiences, data mining of fraudulent orders and periodic updates by credit card/ debit card companies.

(v) *Risk Prediction Techniques/ Models*

Risk prediction model software analyzes data from million of online sales to extract the profile of fraudulent transactions. Based on these large and historical order samples, the software develops an algorithm to identify fraudulent orders. Every order transaction is evaluated by passing its attributes through this algorithm and a risk score is arrived at. Thresholds of this score can be used to identify orders to reject, review or accept.

(vi) *Rules Based Detection Techniques*

With rule – based detection software, online merchants define a set of criteria that each order transaction must meet. These criteria are a combination of risk scores, order information, tender information, customer demographics, geo locations and order history, etc. The software will automatically screen incoming order by these specific criteria and automate the decision to reject, review, or accept the order.

(vii) ***Manual Reviews***

This involves the manual review of potentially fraudulent orders by fraud analyst. These analysts review orders and get in touch with customers and payment providers to verify that orders are not fraudulent. This technique should be used in conjunction with risk prediction models and rules based detection. This ensures that the fraud analysts only look at a focused subset of orders having a high likelihood of being fraudulent. While manual review may be viable for smaller merchants with low order volumes, it is not normally a cost – effective or scalable solution for larger merchants with high order volumes or seasonal order peaks.

(viii) ***Verified by Visa/ MasterCard Secure Code***

These programs enable 2 parties (card holder and card issuer) to authenticate each other by exchanging electronic passwords before proceeding with an online transaction. When a previous register password is entered by a card holder and authenticated by the Visa/ Master Card System, the order cannot be charged back due to fraudulent reasons and the merchant is assured of zero liability by the payment providers. Implementation of payer authentication systems can protect merchants from certain charge backs due to fraud, but this protection may only apply if a merchant can maintain low chargeback levels.

All of the tools mentioned above are complementary to one another, as they each inspect different components of a transaction. The best way to combat fraud is to use layers of fraud protection. These layers of fraud protection can be introduced at different stages within the order lifecycle. These stages can be classified into the order capture business process within the online store front and order fulfilment business process within the order execution system.

Factors Leading to the Growth of Retailing in India

2.18 As purchasing power of Indian urban consumer is growing and branded merchandise in categories like apparels, cosmetics, shoes, watches, beverages, food and even jewellery, are slowly becoming lifestyle products. Indian retailers are taking advantage of this growth and aiming to grow, diversify and introduce new formats and are forced to pay more attention to the brand building process.

2.19 The contemporary retail sector in India is reflected in sprawling shopping centres and multiplex malls that offer shopping, entertainment and food under one roof. The concept of shopping has altered in terms of format and consumer buying behaviour, ushering in a revolution in shopping in India.

2.20 The trends that are driving the growing of the retail sector in India are as follows:

(i) Increase in disposable income and customer aspiration;

(ii) Low share of organised retail;

(iii) Abundance of requisite manpower;

(iv) Increase in expenditure for luxury items;

(v) Overall growth of economy at a rapid pace;

(vi) Increase in pay-scales of young workers in India; and

(vii) Increase in standard of living of the urban population.

Classification of Entities in the Retail Industry

2.21 The Entities in retail industry may be classified on the following basis:

Based on Business Structure

There are different businesses in which an entity operating in the retail industry can be set up. The major ones are elaborated hereunder:

(i) ***Agency/ Partnership System***

It refers to the methods of practicing and using another person's business model. The network partner manages the outlet but does not usually own the goods he is selling. The goods belong to the licensor. The agent signs buy-sell contracts on behalf of the licensor. In return for the sales of goods or services, the agent receives a commission specified in the licensing contract.

(ii) ***Dealership***

Retailers may find the business model of a licensed dealership as a mix of franchise and independent retailer. The licensee has the right (sometimes this is exclusive) to sell a brand of products. Unlike a franchise, the dealer can sell a variety of brands and there generally no fees is paid to the licensor. Dealerships may or may not be identified as an authorised seller or by the company's trademark.

(iii) ***Direct Distribution***

Offering goods and services directly to consumers, through face-to-face contact, usually at the client's home workplace or elsewhere outside of retail sales points a form of retail distribution outside of a chain of shops.

(iv) *E-store, Internet Store, On-line Store*

A sales point involved in e-trading over the internet under a unique world wide web (www) address, with an interactive form that allows the consumer to place an order for a product or service using the information provided (including price and method of payment).

(v) *Franchising System*

It refers to the methods of practicing and using another person's business model. The parties signing a franchising agreement remain totally independent of each other. Both the outlet and the goods (which are frequently supplied by the franchisor) belong to the franchisee. The franchisee purchases goods and services on its own behalf and account; the complete sales revenue belongs to the franchisee, who pays periodic franchise fees to the franchisor.

(vi) *Integrator*

It is a firm running a franchise or partnership-based retail chain. It may operate on a commission basis or act as supplier if the integrator is a wholesaler.

(vii) *Independent Retailer*

An independent retailer is one who builds his/ her business from the ground up *i.e.*, from the business planning stage to opening day of the retail store. He/ she may hire consultants, staff and others to assist in the business endeavor.

(viii) *Network Marketing*

Multi-level marketing (MLM) or network marketing is a business model where the selling of products depends on the people in the network. Not only a product is being sold, but other sales people are being recruited to sell that same product or product line.

Based on Size Operations

In India, there are different types of retail entities which can be classified in accordance with the size of operations as follows:

(i) ***Grocery Shop/ Store***

A retail outlet offering typical foodstuffs, non-food merchandise (mixed grocery and non-food stores), or groceries only. These refer to the kirana stores.

(ii) ***Small-format Shops***

There are grocery or mixed grocery and non-food shops under 400 sq. mtr in size. They are commonly referred to as mom and pop stores.

(iii) ***Convenience Stores***

Small-format chain stores open at least 11 hours a day, with a basic range of groceries, alcohol, cigarettes and newspapers/ magazines.

(iv) ***Exclusive Stores***

These stores are ranging from a size of 500 sq. ft. to 5,000 sq. ft. and above. This are owned/ managed by the company or through its franchise. These can offer single brand as well as multiple brands.

(v) **Speciality Stores**

These stores focus on a specific product category. These are medium sized layout in strategic location. Specialty stores provide a large variety base for the consumers to choose from the specific category.

(vi) **Large-format Stores**

These are grocery and mixed grocery and non-food stores typically above 400 sq. mtr in size (retail space). This covers hypermarkets, supermarkets and discount stores.

(vii) ***Discount Stores, Discounters***

These are grocery or mixed grocery and non-food stores around 1,000 sq. mt. in size, offering on average around 800 - 1,200 products, chiefly foodstuffs, often under the retailer's own private label or produced exclusively for the retailer. Prices are on average 15-30% lower than the market averages. These are of following two types:

Hard discounters - A type of discounter characterised by a limited product range and a predominance of low price private labels.

Soft discounters - A type of discounter characterised by a broader product range, including fresh food and mostly manufacturers' brands.

(viii) ***E-shopping Mall***

A website which presents the offers of a number of internet stores.

(ix) ***Hypermarkets***

These are mixed grocery and non-food stores over 2,500 sq. mt. in size, offering on average 40,000 items, around 50% of which are foodstuffs.

(x) ***Supermarkets***

These are mixed grocery and non-food or grocery stores over 300 - 2,500 sq. mt. in size, offering on average 5,000 -10,000 products, at least 70% of which are foodstuffs.

(xi) ***Delicatessen Supermarkets***

These are supermarkets with an extended premium range, targeting medium and high income customers.

Special Features of the Retail Industry

2.22 The retail industry is unique in certain aspects with respect to other industries. These can be broadly be classified as follows:

(a) Business Process Related

The business of an entity operating in a retail industry has certain unique characteristics, risks, nuances. Some of them are as follows:

(i) Most of big sized retailers have multiple stores across various locations and management of all department stores involves a sophisticated and comprehensive management information system (MIS). This would require periodic analysis of data on a store wise and department level wise basis.

(ii) The industry is labour intensive and requires trusted, young, attractive salesmen to enable sufficient pushing of products to the customers and stores. In the case of small grocery store, the owner directly supervises the entire activity. In large stores, there are sophisticated surveillance systems to supervise the activity to enable prevention and detection of thefts and shop-lifting by customers.

(iii) The success of a store is determined based on the correctness of the demand forecasting in a location as against the actual number. Hence, right information is required by the decision makers as regards the demand for a location.

(iv) The business processes and control systems are unique and needs to be commensurate to the size of retail store.

(v) The work timings of these stores would vary taking into consideration the size, location, customers they cater, products and employee availability.

(vi) Branding plays an important role in the Indian retail industry. Branded products as well as branded retails are chosen by informed customers and unbranded products still occupies a significant part of the retail market, especially in the rural areas.

(vii) Corporate strategy might be required to be periodically challenged in the light of changing business scenario and trends across markets. Further, there is need of standardisation of practices across locations and stores. This would require quick adaptability by the entire organisation to the dynamic changing environment.

(viii) Competition among products is extremely high with various promotional offers and schemes. Bigger retailers virtually kill the business of many small retailers in the vicinity through their intense marketing and offer to attract customers.

(ix) The demand factors for consumables and durables are significantly different and business intelligence plays an extremely important role for the success of the entity.

(x) The risks for a retail industry are different from any other industry. The areas of risk can vary from business risk to business continuity risk.

(b) Supply Chain Management and Billing

Unlike many other industries, the contract and billing process are unique. There is wide range of practices taking into consideration the depth of penetration of this industry. Some important aspects are as follows:

(i) The dynamics of the Supply Chain Management (SCM) plays the most critical part of the retail industry and involves the efficient management of the distribution processes and delivery processes to enable success in its operations. This is taking into consideration the complexity of the procurement process from suppliers across geographical locations at varied terms and conditions.

Big entities have warehouses which act as incubators for their stores and replenish them on a periodic basis. Further, such replenishments might be from local purchases or from a centralised location.

(ii) Significant economies of scale exist in related to format of the store.

(iii) Payment might be made in the form of cash, cheque or debit/ credit card, discount coupons/ vouchers, etc. Considering the volume of transactions, the entities might face challenges ensuring an error free billing of its products.

(iv) Billing process is typically related to format of the store. It is system driven in the case of large form stores and fairly simple and unorganised in the case of small format stores. Billing needs to be done on a real time basis and there cannot be any delays on this front.

(c) Material Storage and Handling

The success of the store depends on efficiency of management of products and materials, considering the perishable nature of products. Some special features are as follows:

(i) Considering the size and volume of materials, entities find it relatively challenging to maintain sufficient control on the inventory and to perform routine inventory verification. Further, there must be a unique comprehensive inventory management system to provide for the precise tracking of inventory across locations and distributors to enable the retailers to appropriately deal with them.

(ii) Proper accounting and control is required to be performed for stock returns, freebies and offers apart from gift vouchers.

(iii) Certain products are perishable and in certain products, pilferage too would be a major concern. Proper handling of these materials is an integral part of proper inventory management.

(iv) Inventory requirement at each location would be unique in accordance with the cultural preferences, demography of people and lifestyle of the vicinity. The availability of inventory should be in accordance with.

(v) In the case of transfer between stores or locations of the same management, there needs to be sufficient tracking of transferred stock and periodic reconciliation to enable proper tracking of inventory.

(vi) Visual Merchandising is an integral part of promotional activities and plays a major role in strategy making in the retail industry.

(d) Economic Conditions

Uncertainty/ instability of economic conditions – both globally and in India has an impact on the industry. Some important aspects are as follows:

(i) Consumer Confidence Index (CCI) is widely considered an economic indicator of household consumption expenditure. Consumers tend to increase consumption when they feel confident about the current and future economic situation of the country and their own financial situation. Business is directly based on the Consumer Confidence Index of the consumers.

(ii) The impact of global economic changes is extremely significant with a retail Industry. This is owing to the high reliance of foreign suppliers for sourcing of certain key products and materials.

(iii) In general, the retail industry involves a significant amount of expenditure in foreign currency for the sourcing of various products.

(e) Other Unique Features

There are certain unique features apart from those mentioned above which an internal auditor might be required to be aware of:

(i) Information technology plays a very significant role in providing the right picture to the managers and decision makers. In the event of a failure in business systems, it would lead to a complete paranoiac situation across business units and standstill of operations.

(ii) Retail Industry faces a lot of *"Window Shoppers"* where shoppers engage in the activity of browsing shops with no intent to purchase, possibly just to pass the time between other activities, or to plan a later purchase.

(iii) Considering that in certain cases, when the demand is seasonal, there might be requirement for extra work force which could be in the form of an additional temporary employee or extra shift of an existing employee. Proper employee management plays a key role in the overall success of the entity.

It is therefore, extremely important for an internal auditor to understand these special features for conducting the internal audit of the entity.

Stock Keeping Unit

2.23 It is a unique identifier for each distinct product and service that can be purchased. The usage of Stock Keeping Unit (SKU) is rooted in data management, enabling the company to systematically track its inventory or product availability, such as in warehouses and retail outlets. They are often assigned and serialised at the merchant level. Each Stock Keeping Unit (SKU) is attached to an item, variant, product line, bundle, service, fee, or attachment. SKUs are often used to refer to different versions of the same product.

Challenges Faced by an Entity Operating in the Retail Industry

2.24 This section is intended to highlight some of the significant challenges faced by an entity operating in the retail industry so as to enable the internal auditor to plan and perform the internal audit accordingly. The internal auditor is required to perform such audit procedures specific to the entity as deemed necessary to ensure systematic evaluation of risk management, control and governance processes. Some of these challenges are given below:

(i) Control over Loss of Inventory due to factors such as Spoilage, Damages, Wastages, Theft and Shop Lifting, etc.

A perennial problem faced by an entity operating in this industry is dealing with inventory and its loss. Success of any entity operating in this space is based on the efficacy of inventory management. Further, loss of control over inventory might be due to other factors such as frequent shifting of inventory in accordance with specific product promotional schemes or consumer needs and fashion, change in visual merchandising strategy, stock levels. It might also be difficult to perform physical verification of stock in the event of continuous operations.

The internal auditor needs to ensure that there is an adequate system to ensure proper inventory management and to ensure that there is no unnecessary loss has been inflicted due to lack of an appropriate inventory management system.

(ii) Lack of Trained Work Force and Required Skill for Retail Management

Lack of trained and reliable work force acts as a major barrier towards expansion for an entity operating in this sphere and finding capable managers has become a perennial challenge predominantly on account of limited preference given to retail sector by highly educated labour class. This might lead to following unidentified business potentials, risks and problems:

(a) Declined stock and cash control;

(b) Delay in billing of products leading to poor consumer satisfaction;

(c) Impacts on the overall brand of the entity;

(d) Control over contract workers for menial jobs;

(e) Odd working hours;

(f) Female workers and their timings;

(g) Dynamic incentive system; and

(h) Employee turnover.

The internal auditor can assess management of employment recruitment policy.

(iii) Overall Management of Various Stores/ Establishments by an Entity

This is one of the most critical challenges that the entity might face. The management information system of the entity should be comprehensive enough to deal with all complexities that might arise in the process. This is more significant considering the changing customer preferences. Reasons for the same are as follows:

(a) Local consumption habits.

(b) Need for variety.

(c) Cultural issues – In and around the store.

Management becomes challenging on account of following intrinsic factors:

(a) Dynamic corporate environment and changing corporate strategy.

(b) High competition in the field and the stress to deliver something new and to attract customers.

(c) Decision on sufficiency of safety measures such as insurance coverage.

(d) Shop in Shop accounting.

(e) Payment controls.

(f) Daily collection controls.

(g) Employee turnover, etc.

The internal auditor has to assess the overall management of stores across locations and verify in the light of his observations, the efficiency of the overall management information system.

(iv) Absence of Developed Supply Chain and Integrated IT Management

As an entity grows, a proper supply chain management system needs to be in place to enable sustained growth of the entity. This can be further achieved through implementation of the appropriate system. The system might be in-house or through an external service provider and the decision is required to be taken after making a comprehensive cost-benefit analysis. Supply chain bottlenecks may be due to following factors:

(a) Several products are reserved for SSIs;

(b) Distribution, logistics constraints, restrictions of purchase and movement of food grains, absence of cold chain infrastructure; and

(c) Long intermediation chain.

This would result in:

(a) Limited product range;

(b) Makes scaling up difficult;

(c) High cost and complexity of sourcing and planning; and

(d) Lack of value addition and increase in costs by almost 15%.

Further, supply chain management needs to be managed through an appropriate Enterprise Resource Planning (ERP) system and might require periodic review as to ensure sufficiency of controls of the system in the current scenario.

The internal auditor can assess management of supply chair. The internal auditor may, accordingly, assess the risk of business with regards to alignment of the existing business practices/ procedures to the required.

(v) Intrinsic Complexity of Retailing

The intrinsic complexities in the industry are due to following factors:

(a) Rapid price changes;

(b) Constant threat of product obsolescence;

(c) Inability to move to an efficient inventory management system;

(d) Low margins;

(e) Strict competition leading to price wars;

(f) Multiple licences/ clearances required for starting up;

(g) Consignment sales;

(h) Sales returns;

(i) Speed of expansion to new locations; and

(j) Security systems required and unique technology identified.

The internal auditor has to assess such types of risks and precautions taken by management to avoid them.

(vi) High Cost of Real Estate and Lack of Sufficient Infrastructure for Scaling-up

Another major factor would be the cost incurred for initial set up and establishment cost which is directly related to the real estate cost, i.e., cost of construction/ rental of the location for retailing and thereby might push up the cost of operation significantly. Lack of clear ownership of titles and high stamp duty costs, result in increase of start up cost for retailer. Hence acts as a restricting barrier for the organised sector in retail industry.

The internal should assess the process of evaluating the suitability of location for retail business and forecasting the profitability for the location.

Structural impediments could be in the nature as follows:

(a) Lack of urbanization

(b) Poor transportation infrastructure

(c) Consumers habit of buying fresh foods and

(d) Administered pricing.

(vii) Timings of operations

Entities operating in this sector would open quite early in the morning and closes late at night. There would be a lot of operational challenges, such as, rotation of employees, daily closure of books and completion of regular processes, etc.

The internal auditor should assess sufficiency of controls for routine/ daily closure.

Forces that Affect the Retail Industry

An analysis of the forces that affect the entity operating in the retail industry is summarised below:

(i) *Threat of New Entrants*

Over the last decade, there has been a decrease in the number of independent retailers predominantly because of the entry of huge corporates into this sector. Their vertical structure and centralised buying gives chain stores a competitive advantage over independent retailers.

(ii) *Power of Suppliers*

Historically, retailers have tried to exploit relationships with suppliers. Big retailers have extraordinary influence on the suppliers and they have the ability to make or break a small supplier. In the retail industry, suppliers tend to have very little bargaining power.

(iii) *Power of Buyers*

Individually, customers have very little bargaining power with retail stores. If customers demand high-quality products at bargain prices, it keeps retailers within limits and are conscious of the customers.

(iv) *Availability of Substitutes*

The tendency in retail is not to specialize in one good or service, but to deal in a wide range of products and services. This means that what one store offers you will likely find at another store. Retailers offering products that are unique have a distinct or absolute advantage over their competitors.

(v) *Competitive Rivalry*

Retailers always face stiff competition. The slow market growth for the retail market means that firms must fight each other for market share. More recently, they have tried to reduce the cut-throat pricing competition by offering frequent flier points, memberships and other special services to gain the customer's loyalty.

Technological Updates

Many softwares are available based upon the unique need of the retailer.

The internal auditor should have an indepth understanding of Standard on Internal Audit (SIA) 14, *Internal Audit in an Information Technology Environment,* to perform required internal audit procedures around the system.

The predominant softwares are listed below:

(i) *Point of Sales and Inventory Management Software*

A wide range of Point of Sale (POS) applications have been developed on platforms such as Windows and UNIX. The availability of local processing power, local data storage, networking, and graphical user interface made it possible to develop flexible and highly functional POS systems. The most common software are as follows:

(a) ACCESS

(b) Active Retail – Retail Management Software

(c) GAAP Software

(d) InFlow Inventory Management System

(e) WinTill

(ii) *Retail Management Systems Software*

Retail Management Systems Software, manages financial reporting, accounting and operations of retail stores by integrating core business processes such as Point of Sale (POS), Customer Relationship Management (CRM), inventory management, accounting, human resources, marketing and e-commerce. By implementing a retail management system, organizations can increase sales, decrease costs and maximise competitive advantage. These applications facilitate the distribution of key data throughout an enterprise and provide the infrastructure for accurate sales reporting and revenue forecasting. The most common retail management software include the following:

(a) Chain Drive

(b) Epicor Retail

(c) Retail Pro

Apart from the above, there are many Retail Accounting Softwares which include SAP, Tally ERP 9, Microsoft Dynamics RMS and the internal audit needs to have appropriate knowledge of these softwares to ensure selection of appropriate audit procedures to perform an effective internal audit.

(iii) *The Major Innovations*

Over the past few years, there have been many major innovations which include the following:

(a) *Radio-frequency Identification (RFID):* This involves identifying customers by issuing them smart cards embedded with smart chips. These cards would be Radio-frequency Identification (RFID) enabled and would give information regarding the customer like his preferences, shopping behaviour, etc.

(b) *E-Catalogue based Selling:* Limited range of merchandise is available in-store, while the range of a hyper format is made available through self browse kiosks.

(c) *Mobile Point of Sale (POS):* This would enable the purchase of goods while putting them in a shopping cart. The customer would be spared from the hassle of standing in long queues.

(d) *Digital Signage:* Static signboards have not proved beneficial in terms of helping a customer to track a product. Digital signboards integrated with an automated tracking system can make this easier.

(e) *Intelligent Database:* A detailed database of the customer is made available online and helps the retailer to understand a particular customer's buying characteristics.

Chapter 3

Legal Framework

3.1 This Chapter details the various acts applicable and organisations that supervise and regulate the Retail Industry. Gist of various statutory provisions applicable to the Retail Industry is detailed under ***Chapter 4*** of this Technical Guide.

Ministry of Commerce and Industry, GOI

3.2 The mandate of the Department of Commerce is regulation, development and promotion of India's international trade and commerce through formulation of appropriate international trade and commercial policy and implementation of various provisions thereof. This Ministry formulates the regulatory provisions pertaining to the Industrial Policy and Promotion and EXIM Policy in India.

The Department of Industrial Policy and Promotion (DIPP), set up under the Ministry of Commerce and Industry is responsible for Intellectual Property Rights relating to patents, designs, trade marks and geographical indication of goods and oversees initiative relating to their promotion and protection. This Department also formulates, promotes, approves and facilitates the Foreign Direct Investment (FDI) Policy.

Director General of Foreign Trade (DGFT) is a government organisation in India responsible for the formulation of export-import guidelines and principles for Indian importers and Indian exporters of the country. The basic role of the Department is to facilitate the creation of an enabling environment and infrastructure for accelerated growth of international trade.

Ministry of Finance, GOI

3.3 The Ministry of Finance, Government of India looks after various financial affairs of the state of India. The Ministry of Finance is responsible for monitoring various aspects of the Indian economy. The Ministry of Finance operates through various departments.

- Department of Economic Affairs
- Department of Disinvestment
- Department of Expenditure
- Department of Financial Services
- Department of Revenue

Various statutes,

- Customs Act, 1962,
- Central Excise Act 1944,
- Value Added Tax Act,
- Central Sales Tax, 1956,
- Income Tax Act, 1961
- Service Tax Act

to name a significant as applicable to the retail industry are formulated and governed by this ministry.

Ministry of Consumer Affairs, Food and Public Distribution, GOI

3.4 This Ministry operates through two significant departments:

(i) ***Department of Consumer Affairs***

The Department of Consumer Affairs under Ministry of Food and Consumer Affairs is responsible for the formulation of policies for consumer co-operatives, monitoring prices, availability of essential commodities, consumer movement in the country and controlling of statutory bodies like Bureau of Indian Standards (BIS) and Weights and Measures.

(ii) ***Department of Food and Public Distribution***

The Department of Food and Public Distribution is charged with the prime responsibility of the management of the food economy of the country. The twin objectives of the department are to ensure the following:

- Remunerative rates for our farmers.
- The supply of food grains at reasonable prices to the consumers through the public distribution system.

Ministry of Food Processing Industries

3.5 The Ministry of Food Processing Industries is the nodal agency of the Government of India for processed foods and is responsible for developing a strong and vibrant food processing sector with emphasis on the following:

- Stimulating demand for appropriate processed foods.
- Achieving maximum value addition and by-product utilisation.
- Creating increased job opportunities particularly in rural areas.
- Enabling farmers to reap the benefits of modern technology.
- Creating surpluses for exports.

In the era of economic liberalisation where the private, public and co-operative sectors are to play their rightful role in development of food processing sector, the Ministry acts as a catalyst for bringing in greater investment into this sector, guiding and helping the industry in a proper direction, encouraging exports and creating a conducive environment for the healthy growth of the food processing industry.

A Gist of Important Regulations Applicable to an Entity in Retail Industry

Foreign Direct Investment Policy

3.6 The Foreign Direct Investment (FDI) Policy is formulated by the Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry. The FDI Policy governs the foreign investments in equity of entities established in India. There are different limits allowed for FDI in India for investment in retail sector. The Government has taken steps to protect the smaller retailers and prevented the entry of large global retailers into the Indian markets.

Information Technology Act, 2000

3.7 The main objective is "to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as "electronic commerce (E-commerce)", which involves the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the government agencies". This Act is of significance in the current context since the operations of Retail Industry are significantly carried out through the electronic media.

Other Applicable Indian Acts to the Industry

3.8 Standard on Internal Audit (SIA) 17, "*Consideration of Laws and Regulations in an Internal Audit*" issued by the ICAI requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non-compliance by the entity with relation to laws and regulations may materially affect the financial statements. However, the internal auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

3.9 Thus, in addition to the various Acts, Rules, Bye Laws, Regulations, Circulars, etc., the internal auditor is required to verify some other applicable regulations which include the following:

(a) *Governance Laws*

- The Companies Act, 1956
- Partnership Act, 1932/ Limited Liability Partnership Act, 2008
- Shops and Establishments Act of respective states
- The Sale of Goods Act, 1930
- The Negotiable Instruments Act, 1881

(b) *Economic Laws*

- The Income tax Act, 1961
- Central Excise Act, 1944
- The Customs Act, 1962
- Value Added Tax and Sales Tax Act
- Central Sales Tax Act, 1956
- Service Tax under the Finance Act, 1994
- The Agricultural Produce Cess Act, 1940

(c) *Labour Laws*

- Employees Provident Fund Scheme, 1952
- Employee State Insurance Act, 1948

- Payment of Gratuity Act, 1972
- Payment of Bonus Act, 1965
- Professional Tax enacted by the respective states
- The Child Labour (Prohibition and Regulation) Act, 1986
- The Minimum Wages Act, 1948
- The Weekly Holidays Act, 1942

(d) *Consumer Protection*

- Consumer Protection Act, 1986
- The Essential Commodities Act, 1955
- Prevention of Black Marketing and Maintenance of Supply of Essential Commodities Act, 1980
- Emblems and Names (Prevention of Improper Use) Act, 1950
- The Standards of Weights and Measures Act, 1976.

(e) *Intellectual Property Rights*

- Trademark Act, 1999
- The Patents Act, 1970
- Indian Copyright Act, 1957

(f) *Other Laws as applicable to the Industry*

- The Indian Contract Act, 1872
- Foreign Contribution Regulation Act, 1976
- Securities Exchange Board of India Act, 1992

- Securities Contracts Regulation Act, 1956
- The Land Acquisition Act, 1894
- The Specific Relief Act, 1963

3.10 Apart from the abovementioned laws, the internal auditor is required to be aware of the local legislations under which the entity/ undertaking operates e.g., Karnataka Shops and Commercial Establishments Act, 1961, prescribes the daily and weekly hours, extra wages for overtime work, holidays for all entities established in Karnataka.

The internal auditor is required to ensure the compliance of respective state legislations too as part of his internal audit procedures. The internal auditor is also expected to be aware of various circulars issued by the RBI towards foreign currency transactions.

Other Applicable Acts to the Retail Industry

3.11 Apart from the above Indian regulations that the Retail Industry is surrounded with, there are other regulations pertaining to the country of the client for whom the services are provided or due to listing status. The principal regulations that affect Indian Retail Industry are as follows:

The Sherman Antitrust Act, 1890

The Sherman Antitrust Act, 1890, has been passed in the United States to enable a free market economy and the best consumer protection. The Sherman Act outlaws all contracts, combinations and conspiracies that unreasonably restrain interstate and foreign trade. The Sherman Act also makes it a crime to monopolize any part of interstate commerce. An unlawful monopoly exists when only one firm controls the market for a product or service, and it has obtained that market power, not because its product or service is superior to others, but by suppressing competition with anti-competitive conduct. The Act is not violated simply when one firm's vigorous competition and lower prices take sales from its less efficient competitors i.e., competition is working properly.

There have been many other regulations subsequently legislated to further the objective of the Sherman's Antitrust Act, 1890 such as the Claytons Act, 1914 and the Robinson-Patman's Act, 1936.

Chapter 4

Statutory Laws Applicable to Retail Industry

4.1 This chapter is intended to provide broad overview of various laws, compliances normally required for entities operating in this sector. The internal auditor may refer to bare act of these laws and regulations and study the different cases judgements by competent authorities.

Considering that these regulations undergo frequent amendments/ changes, a detailed checklist has not been prepared. The internal auditor must update himself with the amendments, pronouncements, new regulations from time to time to ensure effective performance of internal audit.

Value Added Tax Act and Central Sales Tax Act, 1956

Value Added Tax

4.2 Considering that retail industries are involved in the distribution and sale of products in different states, Value Added Tax Act of the respective state would be applicable for all such sales made by the entity.

Input Credit set off Scheme

4.3 "Input" means any goods including capital goods purchased by a dealer in the course of his business for re-sale or for use in the manufacture or processing or packing or storing of other goods or any other use in business.

The entity can claim input credit on all sales made in the state of procurement itself.

In the event the goods are transferred and sold in another state, then VAT paid on procurement of such goods would not be eligible for input credit.

Registration

4.4 Registration under Value Added Tax Act would be applicable to all retailers wherein the total turnover exceeds a basic limit as prescribed in the respective Value Added Tax Act.

Central Sales Tax Act, 1956

4.5 The objects of the Act, as stated in preamble of the CST Act are as follows: –

- To formulate principles for determining (a) when a sale or purchase takes place in the course of inter-state trade or commerce, (b) When a sale or purchase takes place outside a State, and (c) When a sale or purchase takes place in the course of imports into or export from India.
- To provide for levy, collection and distribution of taxes on sales of goods in the course of inter-state trade or commerce.
- To declare certain goods to be of special importance in inter-State trade or commerce and specify the restrictions and conditions to which State laws imposing taxes on sale or purchase of such goods of special importance (called as declared goods) shall be subject.

Central Sales Tax Act, 1956 deals with sale between different states and provisions for claiming credit on payment of Central Sales Tax.

Service Tax

4.6 Retail Industry is a product based industry. But, the industry would be utilising the services of many other service providers. Service Tax paid by the entity can be availed credit/ set-off under Central Excise Act, 1994.

4.7 The following is an illustrative list of major capital goods, inputs and input services on which CENVAT can be availed:

- Central Excise Duty (CED)/ Additional Duty of Customs (CVD) on machinery or equipments.
- Central Excise Duty (CED) on office equipment and computers.
- Central Excise Duty (CED) on consumable tools and packing materials.
- Central Excise Duty (CED) on chemicals used or consumed.
- Advertisement Agency.
- Courier Services.
- Clearing and Forwarding Agent.
- Goods Transport Agency.
- Manpower Recruitment and Supply Agent.
- Real Estate Agent.
- Storage and Warehousing Services.
- Intellectual Property.
- Franchise.
- Professionals and Consultants.

- Business Auxiliary Services.
- Construction of Office or Factory.
- Transportation of Goods by Road Service.
- Market Research and Market Survey.
- Recruitment and Supply of Manpower Service.

The input credit can be availed only on payment made. The input credit cannot be availed on accrual basis. However, in case there is excess credit during the month, the same can be carried forward to the following month and can be set-off whenever service tax liability arises.

Import of Services

4.8 Section 66A envisages taxation of the services which are received in India from a foreign national or foreign entity. The situation envisaged is that any taxable service:

- Provided or to be provided by a person who has:
  - Established a business in a country other than India; or
  - A fixed establishment from which the service is provided or to be provided in a country other than India; or
  - His permanent address or usual place of residence is in a country other than India.

(And)

- Received by a person (recipient) who has his:
  - Place of business in India;
  - Fixed establishment in India;

- Permanent address in India;
- Usual place of residence in India.

4.9 Import of service is not to be treated as output services. The taxable services for which the liability is created in terms of section 66A cannot be treated as output services for the purpose of availing CENVAT credit of duty/ tax paid on inputs or input services. Credit of inputs and input services used in the said services received cannot be considered as inputs by the service receiver.

Further, the credit available cannot be used for payment of service tax liability on import of services. However, the service tax paid on import of services can be availed as input credit against the output liability or rebate of the same can be claimed.

Trademark Act, 1999

4.10 A Trade Mark is a visual symbol in the form of a word, a device, or a label applied to articles of commerce with a view to indicate to the purchasing public that is a good manufactured or otherwise dealt in by a particular person as distinguished from similar goods dealt or manufactured by other persons, i.e.,

- It identifies the product of its origin;
- It guaranties its unchanged quality;
- It advertises the products; and
- It creates an image for products.

4.11 The objective of the Trademarks Act, 1999 is to register trademarks applied for in the country and to provide for better protection of trade mark for goods and services and also to prevent fraudulent use of the mark. The Trademarks Act, 1999 has been implemented for the following purposes:

- Registration of Service Marks allowed in addition to Trademarks for goods.

- No separate application necessary for each category/ class of goods or services i.e., a single application would be required. However, filing fee will be charged separately for each class of goods/ services.
- The term of registration of trademark is ten years, subject to renewal thereafter.
- The system of maintaining registration of trademark in Part A and Part B with different legal rights, dispensed away.
- Registration of trademarks which are imitations of well known trademarks not permitted.
- Registration of Collective Marks owned by associations allowed.
- Offences relating to trademark made cognizable.
- Filing fees enhanced by more than 8 times.
- Extension of application of convention countries.

Central Excise Act, 1944

4.12 The Central Excise Act, 1944, has been enacted for enduring the following objectives:

- Realising the revenues in a fair, equitable and efficient manner;
- Administering the Government's economic, tariff and trade policies with a practical and pragmatic approach;
- Creating a climate for voluntary compliance by providing guidance and building mutual trust;
- Combating revenue evasion, commercial frauds and social menace in an effective manner.

4.13 The main statutes which are related to the levy and collection of Central Excise duty are as follows:

- The Central Excise Act, 1944
- The Central Excise Tariff Act, 1985
- The Central Excise Rules, 2002
- CENVAT Credit Rules, 2004
- Central Excise Valuation (Determination of Price of Excisable goods) Rules, 2000

4.14 Valuation can be made through different methods and the most common method for pricing of products is through the ***Retail Sale Price Method***.

(i) The Central Government may, by notification in the Official Gazette, specify any goods, in relation to which it is required, under the provisions of the Standards of Weights and Measures Act, 1976 (60 of 1976) or the rules made there under or under any other law for the time being in force, to declare on the package thereof the retail sale price of such goods, to which the provisions of sub-section (2) shall apply.

(ii) Where the goods specified under sub-section (1) are excisable goods and are chargeable to duty of excise with reference to value, then, notwithstanding anything contained in section 4, such value shall be deemed to be the retail sale price declared on such goods less such amount of abatement, if any, from such retail sale price as the Central Government may allow by notification in the Official Gazette.

(iii) The Central Government may, for the purpose of allowing any abatement, take into account the amount of duty of excise, sales tax and other taxes, if any, payable on such goods.

Shops and Establishment Act

4.15 The purpose of this Act is to regulate conditions of work and employment in shops, commercial establishments, residential hotels, restaurants, eating houses, theatres, other places of public entertainment and other establishments. This act provides for regulation of establishments, employment of children, young persons and women, leave and payment of wages, health and safety, etc.

The applicability of the act extends to following:

(a) It applies to all local areas specified in the Act.

(b) Establishment means any establishment to which the Act applies and any other such establishment to which the State Government may extend the provisions of the Act by notification.

(c) Employee means a person wholly or principally employed whether directly or through any agency, whether for wages or other considerations in connection with any establishment.

Considering this act is governed by the State Government, the returns, rules, forms, regulations and procedures vary in accordance with the state enactments.

The Standards of Weights and Measures Act, 1976

4.16 This Act has been enacted to establish standards of weights and measures, to regulate trade or commerce in weights, measures and other goods which are sold or distributed by weight, measure or number, to provide for matters connected therewith or incidental thereto.

This act applies to whole of India and, basically, provides different guidelines regarding the following:

- Establishment of Standards as related to Weights and Measures.

- Physical representation of standard units.
- Standards of weights and measures.
- Custody and verification of standard equipments.
- Inter-state trade or commerce in weight, measure or other goods.
- Import and export of weights and measures.
- Regulation of the Act.
- Penal Provisions.

Competition Act, 2002

4.17 The Monopolies and Restrictive Trade Practices Act, 1969 has metamorphosed into the new law, Competition Act, 2002. The new law is designed to repeal the extant MRTP Act. The basis of the Competition Act, 2002, is to promote the welfare of the people by securing and protecting as effectively, as it may, a social order in which justice social, economic and political shall inform all the institutions of the national life, and the State shall, in particular, direct its policy towards securing:

(a) That the ownership and control of material resources of the community are so distributed as best to subserve the common good; and

(b) That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

Components of Competition Act

4.18 The rubric of the new law, Competition Act, 2002 has essentially four compartments:

(a) Anti Competition Agreements.

(b) Abuse of Dominance.

(c) Combinations Regulation.

(d) Competition Advocacy.

(a) Anti Competition Agreements

Entities enter into agreements, which may have the potential of restricting competition. Horizontal agreements are among competitors and the vertical agreements are relating to an actual or potential relationship of purchasing or selling to each other. A pernicious type of horizontal agreements is the cartel. Vertical agreements are pernicious, if they are between firms in a position of dominance.

Most competition laws view vertical agreements, generally, more leniently than horizontal agreements, as prima facie, horizontal agreements are more likely to reduce competition than vertical agreements.

Horizontal agreements, which include members of cartels, are presumed to lead to unreasonable restrictions on competition and are, therefore, presumed to have an appreciable adverse effect on competition. In other words, they are per se illegal. The underlying principle in such presumption of illegality is that the agreements in question have an appreciable anti-competitive effect.

(b) Abuse of Dominance

Dominant Position has been appropriately defined in the Act in terms of the position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to (i) operate independently of competitive forces prevailing in the relevant market; or (ii) affect its competitors or consumers or the relevant market, in its favour.

The Act prevents enterprise from abusing its dominant position. Dominant position is the position of strength enjoyed by an enterprise in the relevant market which enables it to operate independently of competitive forces prevailing in the market or caffects its competitors or consumers or the relevant market in its favour.

Dominant position is abused when an enterprise imposes unfair or discriminatory conditions in purchase or sale of goods or services or in the price of purchase or sale of goods or services. Again, the philosophy of the Competition Act is reflected in the provision, where it is clarified that a situation of monopoly per se is not against public policy but rather the use of the monopoly status such that it operates to the detriment of potential and actual competitors.

(c) Combinations Regulation

The Competition Act is also designed to regulate the operations and activities of combinations, i.e., a term, which contemplates acquisitions, mergers or amalgamations. Thus, the operation of the Competition Act is not confined to transactions strictly within the boundaries of India but also such transactions involving entities existing and/ or established overseas.

(d) Competition Advocacy

Competition advocacy creates a culture of competition. There are many possible valuable roles for competition advocacy, depending on a country's legal and economic circumstances. The Regulatory Authority under the Act, namely, Competition Commission of India (CCI), in terms of the advocacy provisions in the Act, is enabled to participate in the formulation of the country's economic policies and to participate in the reviewing of laws related to competition at the instance of the Central Government.

4.19 The internal auditor should understand these regulations in depth before charting down his audit procedures and areas of verification.

Chapter 5

Internal Audit

Need for Internal Audit

5.1 Considering the nature of the Retail Industry and the pace at which the Industry has grown over the past decade, need for ensuring proper controls need not be over emphasized. With the increasing number of frauds in the software field, and considering the vulnerability of the sector to modification of data, internal audit becomes significant. Internal audit also helps in verifying the controls in place within the entity with regard to sufficiency and effectiveness in the light of overall business. Internal audit also helps in assessing the risks faced by the entity and provide a method for management of the same. Internal controls and risk management are extremely important activities in a entity operating in the Retail Industry.

5.2 Effective internal audit provides a tool to ease out all complexities, ensures that systems and processes are adequate to support the growth and are adapted to the changes in various regulations, thereby ensuring sustained growth and development.

"Preface to the Standards on Internal Audit", issued by the Institute of Chartered Accountants of India defines the term *"Internal Audit"* as 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 internal control system."

The definition highlights the following facets of internal audit.

- Internal auditor should be independent of the activities they audit. The internal audit function is in general considered independent when it can carry out its work freely and objectively. Independence permits internal auditors to render impartial and unbiased judgment essential to the proper conduct of audits.

- Internal audit is a management function, thus, it has the high-level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilisation of resources, compliance with laws, management information system etc.

- Internal audit's role should be a dynamic one, continually changing to meet the needs of the organisation. There is often a need to change audit plans as circumstances warrant. These changes may include coverage of new areas, assistance to management in solving problems, and the development of new internal audit techniques.

- An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organisation through ethical and effective governance.

- Risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor plays an important role in providing assurance to management on the effectiveness of risk management.

- Internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated. Thus, the examination and appraisal of controls are normally components, either directly or indirectly, of every type of internal auditing assignment.

Factors Contributing to the Evolution of Internal Audit

5.3 "*General Guidelines on Internal Audit*" issued by the Institute of Chartered Accountants of India describes the factors contributing to the evolution of internal audit in India. A few such factors are as follows:

(i) Increased Size and Complexity of Businesses

Increased size and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations.

(ii) Enhanced Compliance Requirements

Increase in the geographical spread of the businesses has also led to crossing of political frontiers by businesses in a bid to tap global capital. This has thrown up compliance with the laws of the home country as well as the laws of that land as a critical factor for existence of businesses abroad.

(iii) Focus on Risk Management and Internal Controls

Internal auditors can carry out their job in a more focused manner by directing their efforts in the areas where there is a greater risk, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources.

(iv) Stringent Norms Mandated by Regulators to Protect Investors

The regulators are coming up in a big way to protect the interests of the investors. The focus of the latest regulations being ethical conduct of business, enhanced corporate governance and financial reporting requirements, etc.

(v) Unconventional Business Models

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

(vi) Intensive use of Information Technology

Information technology (IT) is invariably embedded in all spheres of activities of a modern business enterprise today, from data processing to resource planning to online sales and e-commerce. Use of IT has, however, increased the threat of data thefts or losses on account of systems failure or hacking/ espionage, as well as the need to comply with the cyber laws, etc.

(vii) An Increasingly Competitive Environment

Whereas deregulation and globalisation have melted the political as well as other barriers to entry in the markets for goods and services, free flow of capital, technology and know-how among the countries as well as strong infrastructure has helped in bringing down the costs of production and better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.

Standards on Internal Audit

5.4 Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI) has, till date, issued seventeen Standards on Internal Audit (SIAs) and the same are as follows:

SIA 1 Planning an Internal Audit

SIA 2 Basic Principles Governing Internal Audit

SIA 3 Documentation

SIA 4 Reporting

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

5.5 These Standards are recommendatory in nature and codify the best practices in the field of internal audit. "*Framework for Standards on Internal Audit*" promotes professionalism in the internal audit activity and comprises of four components, *viz.*, the Code of Conduct, the Compliance Framework, the Body of Standards and the Technical Guide.

Standards on Internal Audit (SIAs) are important for carrying out an internal audit of Retail Industry. The internal auditor and the audit team are expected to be updated on the latest pronouncements issued by the Institute in order to conduct an effective internal audit.

Terms of Internal Audit Engagement

5.6 The auditee is expected to formally communicate the appointment to the internal auditor. Upon receiving the communication, the internal auditor should send an engagement letter, preferable before the commencement of engagement so as to avoid any misunderstanding. The internal auditor and the auditee should agree on the terms of engagement before commencement. Standard on Internal Audit (SIA) 8, "*Terms of Internal Audit Engagement*" establishes standards and provides guidance in respect of terms of engagement of internal audit activity whether carried out in house or by external agency.

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

(i) Objective of the Internal Audit;

(ii) Management's responsibilities;

(iii) Scope of internal audit (including reference to the applicable legislation, regulation and various pronouncement of ICAI);

(iv) Access to records, documents and information required in connection with the internal audit;

(v) Expectation to receive management's written confirmation in respect to representation made in connection with the audit;

(vi) Basis on which fees shall be computed and the billing arrangements thereof;

(vii) Industry specific area;

(viii) References received from the parent company, if any; and

(ix) Undertakings and locations to be covered.

The scope of the terms of engagement, after decineating the broad areas of function of internal audit, should clarify that any additional services that are not emcompassed by the engagement letter shall be performed only on mutual agreement and with separate engagement letter.

5.8 The terms of the engagement should clearly lay down the requirements as to manner and frequency of reporting and the list of intended recipients of the internal audit report. The engagement letter should contain a condition that the report of the internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and the auditee unless there is a statutory or a regulatory requirement to do so.

Knowledge of the Business

5.9 Before the commencement of audit assignment the internal auditor should have or obtain the knowledge of the business and its environment. The internal auditor should acquire sufficient knowledge to enable him to identify and understand the events, transactions and practices that can have significant effect on the internal audit process. Such knowledge shall be helpful to the internal auditor in assessing the inherent risk and control risk and in determining the nature, timing and extent of the internal audit procedures. Knowledge of the business assists the internal auditor in:

- Assessing the risk and identifying the problems;
- Planning and performing the internal audit effectively and efficiently;
- Evaluating audit evidence; and
- Providing better service to the client.

5.10 Standard on Internal Audit (SIA) 15, "*Knowledge of the entity and its Environment*" establishes Standards and provides guidance on what constitutes knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and its environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process.

5.11 The internal auditor should prepare the flow of events, transactions, processes and practices within the organisation. This will help in gaining better understanding of the processes and the existence of the internal controls. Illustrative flowchart of "A Typical Process in Retail Industry" is given as **Appendix 1.**

Audit Planning, Materiality and Sampling

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

- Appropriate attention is devoted to significant areas of audit.
- Potential problem are identified.
- Skills and time of the staff are appropriately utilised.
- Work is carried out in accordance with the applicable to pronouncement of ICAI.
- Work is carried out in conformity with the applicable laws and regulation.

5.13 Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*" provides guidance in respect of planning an internal audit plan. An internal audit plan is a document defining the scope, coverage and resources including time, required for an internal audit over a defined period. In preparing an internal audit plan, internal auditor should obtain an understanding of the accounting and internal control system prevalent within the entity and exercise preliminary judgement regarding the critical areas to be considered during the internal audit. It also helps the auditor in determining the audit materiality, nature and extent of audit procedures to be adopted.

5.14 While designing an audit sample, the internal auditor should consider the specific audit objectives, materiality, population from which the internal auditor wishes to select the sample, area of audit significance and the sample size. Standard on Internal Audit (SIA) 5, "*Sampling*" provides that ***when using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient and appropriate audit evidence to meet the objective of internal audit engagement unless otherwise specified by the client.***

Internal Control

5.15 Standard on Internal Audit (SIA) 12, *"Internal Control Evaluation"* states that *"Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met".*

5.16 *"Internal Control System"* means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

5.17 SIA 12, "Internal Control Evaluation" lays down that Internal control system consists of interrelated components as follows:

- Control (or Operating) Environment

- Risk Assessment
- Control Objectivity Setting
- Event Identification
- Control Activities
- Information and Communication
- Monitoring
- Risk Response.

5.18 The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. The internal control system extends beyond those matters which relate directly to the functions of the accounting system.

5.19 ***The internal auditor should obtain an understanding of the significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach. The internal auditor should use professional judgment to assess and evaluate the maturity of the entity's internal control. The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.***

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

The importance of internal controls in a Retail entity need not be over-emphasised. Internal audit plays a major role in determining the effectiveness of internal controls and highlights areas for improvement.

Internal Audit in an Information Technology Environment

5.21 Computer Information system (CIS) environment exist when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data and the significance in relation to the audit, whether those computers are operated by the entity or third party.

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

5.23 The data in a retail entity operating in a CIS environment is, generally, voluminous. The CIS automatically generates material transaction or entries and exchanges transaction automatically with other organisation as in Electronic Data Interface (EDI) systems. Source documents, computer files and other evidential matter exist only for short period and in machine readable form. The use of the Computer Assisted Audit Technique (CAAT) shall increase the efficiency in the performance and enable the internal auditor to economically apply certain procedures to the entire population or accounts transaction.

5.24 The internal auditor should consider the CIS environment in designing audit procedures to reduce the audit risk to an acceptable low level. The internal auditor should also document the audit plan, the nature, the timing and the extent of audit procedures performed and the conclusions drawn from the evidence obtained which may be in the electronic form. The internal auditor should ensure that such electronic evidence is adequately and safely stored and is retrievable in its entirety as and when required.

5.25 Standard on Internal Audit (*SIA)* 14 *"Internal Audit in an Information Technology Environment"* establishes standards on procedures to be followed when an internal audit is conducted in an information technology environment. The internal auditor should also review the effectiveness and safeguarding of IT resources, including- people, applications, facilities and data.

5.26 ***The internal auditor should review the robustness of the IT environment and consider any weakness or deficiency in the design and operation of any IT control within the entity, by reviewing:***

(a) System Audit reports of the entity, conducted by independent Information System auditors;

(b) Reports of system breaches, unsuccessful login attempts, passwords compromised and other exception reports;

(c) Reports of network failures, virus attacks and threats to perimeter security, if any;

(d) General controls like segregation of duties, physical access records, logical access controls;

(e) Application controls like input, output, processing and run-to-run controls; and

(f) Excerpts from the IT policy of the entity relating to business continuity planning, crisis management and disaster recovery procedures.

Overview of Compliance

5.27 Compliance means ensuring conformity and adherence to Acts, Rules, Regulation, Directives and Circulars.

Standard on Internal Audit (*SIA) 17 "Consideration of Laws and regulations in an Internal Audit"* issued by the Institute of Chartered Accountants of India requires that ***when planning and performing***

audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non compliance by the entity with laws and regulation may materially affect the financial statements. The requirements in this SIA are designed to assist the internal auditor in identifying the significant impact of non-compliance with law and regulation on the functioning of the entity. However, in view of inherent limitations on the role of the internal auditor, he is not responsible for preventing non-compliance and cannot be expected to delete non-compliance with all law and regulations.

5.28 The term "*Non compliance*" refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of the entity or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activity of the entity) by those charged with governance, management or employees of the entity.

5.29 Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statement or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulation are to be complied with by management or prescribe the provisions under which the entity is allowed to conduct its business. Non-compliance with laws and regulation could result in financial consequences for the entity such as, fines, litigation, etc. It may also, in extreme cases, have a potential effect on going concern as an entity.

5.30 The internal auditor should plan and perform the internal audit recognising that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. In order to plan the internal audit, the internal auditor should obtain an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

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

- Use the internal auditor's existing knowledge of the entity's industry and business.
- Inquire with management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
- Inquire with management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity.
- Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

5.31 After obtaining the understanding, the internal auditor should perform procedures to identify instances of non-compliance with those laws and regulations where non-compliance should be considered while preparing financial statements, specifically:

- Inquiring with management as to whether the entity is in compliance with such laws and regulations.
- Inspecting correspondence with the relevant licensing or regulatory authorities.
- The internal auditor should also perform substantive tests of details of classes of transactions, account balances or disclosures.

5.32 The significance of compliance are as follows:

(i) The benefits to the Industry are:

- Helps in compliance with legal terms and covenants and thereby reduces penalties and charges.
- Increased internal control.

- Reduction of internal frauds and losses.
- More time available for other core activities.
- Increases efficiency in operations.
- Customer satisfaction.

(ii) Benefits to the Customers:

- Ensures safer market place.
- Safeguards the customer interests.
- Quality assurance.
- Enhanced consumer protection.

(iii) Benefits to the stakeholder:

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

Chapter 6

Major Areas of Internal Audit Significance

6.1 Internal audit procedures that apply to any industry also apply to an entity operating in the retail industry. In this technical guide, internal auditing procedures pertaining to Retail Industry have been specified. These audit procedures are an illustrative in nature which can be performed in addition to the regular internal audit procedures performed by an internal auditor.

Invoicing

6.2 The invoicing process varies significantly and is directly based on the size of the retail store. To elaborate, it varies from a systematic billing process and checking process in the case of large stores to non-systematic cash-based billing in the smaller stores. The billing and invoicing process in the retail industry needs to be simple, systematic, fast, secure and error-free to ensure avoiding unnecessary waiting time for billing and plays a major role in the success of the organisation.

It might be pertinent to note that potential for omitted/ manipulating income is greater in e-retailing, due to the borderless and paperless feature of the organisation. With online retail, the reconciliation of shipment costs with both cost of goods sold and income is another quality audit technique.

In general, cheques are received from customers whom the management is familiar with or from customers who procure large quantities of products. The management might also offer "*on account*" payment from such customers.

6.3 A few common types of billing include:

(i) *Cash Pay Outs*

As discussed above, the accounting for cash is a primary focus for the internal auditor. Considering that cash is paid for a significant part of the billing by the entity, maintenance of proper records is a critical part of the overall organisation management. It is equally important to ensure that there is sufficient and appropriate fixing of responsibility in the case of management of cash.

(ii) *Z Tapes*

Most simple cash registers contain a "Z" key which can only be operated by the manager, owner or a key employee. The Z key totals the entire history of activity on the cash register for a period of time, providing a summary total for (sales) taxable sales, non (sales) taxable sales, credit card sales, credit card tips, cash sales, lottery sales, coupons and discounts, etc. Each day's Z tape is used to record the daily sales in the sale journal. These tapes must be retained by the owner and made available for the examination.

(iii) *Point of Sale (POS)*

This is a computerised accounting system that records sales along with related items, such as employee's time and tips received, or reductions to inventory and calculations of profit on each sale. These machines can produce financial statements, periodic statements of profit and loss, profits per item, payroll checks, etc.

6.4 Transfer of property of products can through the following methods:

(i) ***Counter service***—Where goods are out of reach of buyers and must be obtained from the seller. This type of retail is common for small expensive items (like jewellry) and controlled items like medicine and liquor. It was common before the 1900s in the United States and is more common in certain countries.

(ii) ***Delivery (Commerce)***—Where goods are shipped directly to consumer's homes or workplaces. Ordering on telephone is now common, either from a catalog, newspaper, television advertisement or a local restaurant menu, providing for immediate service.

(iii) ***Door-to-Door Sales***—Where the salesperson sometimes travels with the goods for sale.

(iv) ***Self-service***—Where goods may be handled and examined prior to purchase. It has become more common since the 1920s.

6.5 Retailers use different methods to collect and account for cash. In some stores, only the owner collects cash from customers. In larger stores, key employees collect and account for cash. In more sophisticated systems, a Point of Sale (POS) cash register may record sales and decrease inventory at the same time.

Considering the nature of the sector, frequent job rotation would enable the entity to prevent errors and de-motivate the employee to do any fraudulent activity.

6.6 The accounting policy for recognition of revenue too would be an integral part of the internal audit procedures to be performed by the internal auditor. He should understand the process in depth to ensure its appropriateness.

If the internal auditor suspects the billing system/ process followed by the management, he can take the help of a systems expert to ensure that there are no manipulations in the system.

6.7 The internal auditor needs to verify all these clauses as a part of performance of internal audit procedures. The internal auditor may also perform following analytical procedures:

(a) *Same-store Sales*

Same-store sales is a business term which refers to the differential in revenue generated by a retail chain's existing outlets over a certain period of time (often a fiscal quarter or a particular shopping season), compared to an identical period in the past, usually in the previous year

(b) *Initial Mark up Percentage*

The initial markup is the average markup required on all products to cover the cost of all items, incidental expenses, and to obtain a reasonable profit. The initial markup is expressed as a percentage and this helps the entity to estimate the cost of the product for determination of the sale price.

(c) *Sales Mix Ratio*

The term *"Sales Mix Ratio"* refers to the relative proportion in which an entity's products are sold. The concept is to achieve the combination that will yield the greatest amount of profits. Most companies have many products, and often these products are not equally profitable. Hence, profits will depend to some extent on the company's sales mix. Profits will be greater if high margin rather than low margin items make up a relatively large proportion of total sales. Hence, the entity must ensure that it pushes the right products through visual merchandising. The internal auditor might comment on the efficiency of the entity in maximising profits through an effective sales mix.

(d) *Operational Margins Period Wise*

The internal auditor may compute the operational margins such as gross profit margin, periodically and ascertain the variance between the different periods compared with. For e.g., the internal auditor compares the gross margin for the month of February with that of January or February of the preceding year, he might observe huge variances in the margins. The internal auditor is required to seek explanations from the management for such significant fluctuations and understand the reason for such fluctuation. This might provide an insight on the effectiveness of the management in operations apart from ensuring that there has not been any fraud during the period.

(e) *Significant Fluctuations in Revenue*

Significant fluctuations in gross revenue over a period time needs to be explained in the overall light of the business scenario, taking into consideration seasonal changes and promotional offers. This will provide a deeper insight into the risks faced by the internal auditor and also an insight to the client's business apart from identifying irregularities. The internal auditor might also compare the revenue over a period of time to verify the change in turnover and seek explanations as appropriate.

(f) *Revenue per Square Foot*

One of the methods to evaluate and compare the department wise performance would be to compare the revenue per square foot/ square metre, whereby a common metric is formulated to compare the performance of the department and justify the cost incurred towards the store. Efficiency of usage of space can be understood by the internal auditor by this estimate.

The internal auditor might make a suitable analysis by estimating the revenue per square foot pertaining to that particular department and justify the space provided to the same. This enables proper allocation of office space to enable profit maximisation and enhance customer satisfaction.

(g) *Actual Profitability vs Budgeted Profit Comparison*

In general, every store is given a daily, weekly and monthly turnover targets. These budgets/ targets are determined based on following factors:

(i) Turnover achieved on the same day during the previous period.

(ii) Location of the store.

(ii) Size, availability of products.

(iv) Promotional offers and discount sales.

The effectiveness of the budgets can be estimated based on its comparison with the actual sales. The internal auditor can assess the efficiency of budget making and verify whether the entity's procedures with regards to target setting are realistic. The internal auditor might suggest any changes required to be made to ensure proper function of the existing system.

(h) ***Ratio on the Modes of Revenue***

The internal auditor might analyse and compare the ratio of revenue received through following:

(i) Credit Card Payments:

(ii) Cash Billing:

(iii) Credit Billing:

(iv) Passes/ Coupons: and

(v) Discount Vouchers.

This would provide an insight on the collection system. It also enables the auditor to understand the cash flow mechanism and strengthen controls suitably.

(i) ***Average Revenue per Bill***

This ratio can be ascertained by estimating the total revenue and total bills raised in a particular period. This ratio is the total amount billed divided by the number of bills raised and analysed store-wise over a period of time. This would provide an insight whether the customer's confidence, requirement of number of billing counters and proper queuing system.

(i) *Percentage of Errors and Rejections*

The internal auditor can verify the quality of billing through measurement of total errors and rejections as against the total volume of billing made. This would help the internal auditor to assess risk of loss of revenue due to incorrect billing, entity's training in billing and efficiency of the billing staff.

(k) *Revenue from Categories of Goods*

The internal auditor may estimate the total revenue received from products sold at discounts and products sold at MRP. It might provide an insight of effectiveness of discount given to a particular product *vis-a-vis* in increasing the customers flocking to the store and incidentally, the turnover.

6.8 These ratios should be prepared and compared over a period of time. If these ratios are inconsistent over that period, proper explanations needs to be obtained, thereby helping the internal auditor in assessing effectiveness, sufficiency, appropriateness of controls and also to highlight the risk environment the business is under. It should also be verified whether the entity monitors such ratios on a regular basis.

6.9 The following is model checklist related to the billing process:

S.No.	PARTICULARS	Yes	No	N/A
1	***Verification of Billing Mechanism***			
1.1	Is there a proper billing system commensurate with the size of business?			
1.2	Have the controls been verified to ensure fixing of appropriate responsibility to the person? Are there sufficient systems to ensure periodic			

S.No.	PARTICULARS	Yes	No	N/A
	job rotation preventing mis-appropriation of funds?			
1.3	Are the systems inbuilt to detect any billing mistakes and errors?			
1.4	Is there any log maintained by the entity as regarding errors and mistakes in billing?			
1.5	Does the entity take sufficient measures in ensuring prevention of such instances?			
1.6	Does the entity have a proper system of collection of the amount billed?			
1.7	Is the collection made in a manner enabling quick movement of customers apart from ensuring that there are sufficient control processes?			
1.8	Is there a routine checking of collections (cash, coupons, vouchers, credit card receivables, etc.) made at the time of change in billing personnel?			
1.9	Is the checking performed by an authorised person?			
1.10	Is the collection verified and reconciled on a daily basis and approved?			
1.11	Are the processes sufficient to ensure appropriate banking of cash and sending of coupons to the head office?			
1.12	Is there sufficient monitoring by the entity to ensure prevention and			

S.No.	PARTICULARS	Yes	No	N/A
	detection of losses on account of shop-lifting and theft?			
1.13	Has there been a sufficient system for audit/ verification to ensure that the billing system is without any mistakes?			
1.14	Has any statistical function been performed for estimating the queuing system and area allocation system of the store?			

Cash Management Policies

6.10 Efficient cash management processes are pre-requisites to execute payments, collect receivables and manage liquidity. Managing the channels of collections, payments and accounting information efficiently becomes imperative with growth in business transaction volumes. This includes enabling greater connectivity to internal corporate systems, expanding the scope of cash management services to include "full-*cycle*" processes (i.e., from purchase order to reconciliation) *via,* e-commerce, or cash management services targeted at the needs of specific customer segments. Cost optimisation and value-add services are customer demands that necessitate the creation of a mechanism to serve the various customer groups.

6.11 Some of the cash management techniques followed by companies are as follows:

(i) Account Reconciliation Services

Balancing a cheque book for a very large business can be quite a difficult process. Banks have developed a system to overcome this issue. They allow companies to upload a list of all the cheques whereby at the end of the month, the bank statement will show not only the cleared cheques but also uncleared ones.

(ii) Positive Pay

It is an effective anti-fraud measure for cheque disbursements. Using the cheque issuance data, updated regularly with cheque issuance and payment, the bank balances all cheques offered for payment in bank. In the case of any discrepancies, the cheque is reported as an exception and is returned.

(iii) Balance Reporting Services

Balance reporting services help in procuring a company's current banking information from its accounts. With this service, the banks can offer almost all types of transaction-specific details.

(iv) Lockbox

It facilitates the cash improvement where, instead of being delivered to business address, customer payments are delivered to a special post office (PO) box. It is only the customers' payments that are delivered in the PO box and the company's own bank collects the amount and delivers them to the banks of the customers. The bank of the customer processes the payments for direct deposit to the entity's bank account. Lockbox contents are regularly removed and processed.

(v) Cheque Writing

In order to execute the payments faster, banks are providing cheque writing facility to the corporate customers wherein customer can print the cheques locally at their own office with the facility of digital signatures and company logos.

(vi) Bin Management of Post-dated cheque(PDC)

Corporates are outsourcing the activity of Post Dated Cheque (PDC) management to the banks for further reducing the cost of operations, administration, and data maintenance.

(vii) Liquidity Management

In order to have efficient utilisation of excess funds, corporate avail the facility of liquidity management. Liquidity management system prudently manages various assets and liabilities (on- and off-balance sheet) and ensures that cash inflows have an appropriate relationship to the approaching size of cash outflows. The system ensures that necessary funds are available to entertain all cash outflows as they fall due.

Adequate cash management mechanisms ensure efficient collection, systematic disbursements, and ideal deployment of idle funds, tiding over immediate cash needs, and compensating the banks that support these activities of the company. An advanced cash management system enhances the possibilities of earning high net interest income, creates efficient balance sheets, minimises expenses on resources, and reduces the company's exposures to potential risks related to seasonality of business and debt repayments.

Cash continues to play a dominating role in the retail industry. Even the ascent of the cashless payments, more than 50 percent are cash transactions with variations depending on region, industry and sales format. Small shopping baskets, in particular, are usually paid for in cash. Cash handling is a cost intensive process for retail companies, and offers major potential for improving productivity.

6.12 The internal auditor's analytical procedures is divided into the following four steps:

(i) *Analysis of Structures and Processes*

Analyse the factors such as, customers' payment habits at the point of sale. This gives an exact picture of the status-quo in a company store.

(ii) Development of Solution Proposals

Parallel to this, the retailer's intentions and objectives with regard to cash automation are discussed and specified.

Together with the hard facts from the status quo analysis, these aspects form the basis for working on concrete solution scenarios.

(iii) ***Piloting in the Store***

Recommendations involve not only the Point of Sale (POS) hardware but also include re-design and optimisation of the entire cash process in a store. These include return on investment calculations, which, due to the current situation analysis, already contain very detailed and realistic pay-back forecasts.

(iv) ***Decision on the Project***

With the experiences gained during piloting, possibly enhanced with a customer survey, the retailer has sufficient data and facts on which to take his investment decision. This is then specified, the project is planned in detail, and the rollout scope and schedule defined.

Retailing is very heterogeneous, various segments, national regulations, different processes and corporate cultures necessitate a tailored solution that fits exactly.

Advantages

(i) Potential for savings through automated end-to-end handling of the cash flow from the point of sale to the cash office and on to the cash-in-transit operator for posting at the bank.

(ii) Considerable reduction in discrepancies (at the point of sale and between the cash center and store) due to efficient controlling and better monitoring facilities.

(iii) Fewer interfaces thanks to a closed cash cycle.

(iv) Cash flow transparency with end-to-end controlling and reporting to reduce operational risk.

Objective

The objective of cash management systems is to eliminate potential security loopholes by implementing a closed cash cycle.

Procurement of Materials and Consumption

6.13 Procurement is the most important activity in the retail industry. It refers to the products procured by the concern for sales. The procurement involves sourcing of products from different vendors across various geographical locations. Management of procurement of products plays an important role in the success of the entity.

6.14 Sourcing can be done directly from the following sources:

- Manufacturers,
- Intermediaries - wholesalers, distributors and dealers,
- Internet and web-based softwares

6.15 Considering that the total cost of goods consumed accounts for around 75% of the expenditure incurred by the entity and the entity generally operates in a very small net margin, the importance of procurement of products at the right time and the right sources plays a significant role in ensuring the profitability of business and sustainability of business.

6.16 Evaluation of a vendor is a very complex process due to of the following factors:

- No. of suppliers.
- No. of products.
- Varied geographical location of suppliers.
- Different terms with each supplier with regards to credit period, delivery time, time lag, etc.

- Cost of products.
- Perishable nature of certain key products
- Different handling requirements for different products.
- Size and volume of the products.

Supplier evaluation needs to be performed by every retailer to ensure that there are no constraints in supply on timely basis, quality of the products are ensured, reliability and terms of arrangement. Further, the screening process should ensure that the vendor has ethics and has no track record of any fraud in the past. The internal auditor needs to verify whether the entity has evaluated each vendor. The internal auditor also verify the basis and process of evaluation.

Some common types of system driven vendor frauds include the following:

- An employee's home address matches a vendor's address.
- An employee's initials match a vendor's name.
- Checks are written to "*cash*".
- A vendor's address contains a P.O. box.
- Vendor data are missing or found to be illogical.

6.17 The following procedures might be performed by the internal auditor.

(i) Sell-through Rate

The sell-through rate is a calculation, commonly represented as a percentage, comparing the amount of inventory a retailer receives from a manufacturer or supplier against what is actually sold to the consumer. This enables the internal auditor to understand the movement of goods.

(ii) Open to Buy

The goal of good inventory management is to maintain an appropriate level of inventory for the amount of sales. This enables the internal auditor to evaluate the utilisation of working capital in the entity.

(ii) Fill Rate

The ratio refers to the percentage of consumer orders satisfied from stock at hand. It is a measure of inventory's ability to meet demand. This enables the internal auditor to estimate whether the entity has been placing order sufficient enough to meet the demand of products from customers and to ensure that there is no loss of sales and customer loyalty.

(iii) Suppliers for a Key Product

It might be better for the entity to have multiple suppliers for a critical product to ensure the availability of products on a timely basis, risk reduction, avoiding over reliance on a particular supplier and ensuring better bargaining power. The internal auditor might provide the management an analysis for such products.

(iv) Percentage of Delayed Delivery by Supplier

The internal auditor may estimate the percentage of deliveries received on a delayed basis to total deliveries from a particular supplier. This enables the internal auditor to obtain an insight on the efficiency of the supplier.

(v) Total Consumption to Total Revenue Product Wise

The internal auditor shall assess whether the entity has a proper control on the consumption to sales ratio (product wise) to verify whether there have been significant fluctuations over a period and have explanations obtained from client for such deviations. The internal auditor can evaluate whether there have been any losses in any of the products and whether the entity is taking steps to ensure that visual merchandising is performed for the right product. In the event of the consumption being excess of revenue, the entity might obtain an understanding that the particular product that gets easily damaged/ perished or stolen and accordingly, would deal with them.

(vi) Inventory Turnover

This Ratio measures the number of times, on average, the inventory is sold during the period. Its purpose is to measure the liquidity of the inventory. This enables the internal auditor to estimate the efficiency of movement of goods and management of inventory by the entity.

S.No.	PARTICULARS	Yes	No	N/A
1	**Procurement of Materials and Consumption**			
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			

S.No.	PARTICULARS	Yes	No	N/A
	as regards quality, reliability, price amongst 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	Are there any contracts entered by the entity with suppliers for critical materials to ensure adequate supply at a reasonable price?			
1.10	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 delivery note?			
1.11	Are there sufficient documentary controls such as Gate Pass for entry of goods?			
1.12	Has a sample check for compliance of procedures performed?			
1.13	Is the process of receipt of material properly co-ordinated to the finance department to ensure proper accounting?			
1.14	Does the material receiving department maintain sufficient records of receipt and inspection of material?			

S.No.	PARTICULARS	Yes	No	N/A
1.15	Has the delivery note been approved by the appropriate level of authority before making the entry?			
1.16	In cases where materials are supplied by client, has the internal auditor ensured that there has been appropriate accounting of such material?			
1.17	Does the entity have proper control for materials received from the client? Are they separately identified and demarcated?			
1.18	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?			
1.19	Does the entity have a process of evaluation of all the vendors?			
1.20	Has the level of approval been specified for each vendor?			
1.21	In the event the entity is sourcing from foreign suppliers, has the entity entered into a contract / legal agreement for such supplies?			
1.22	Has the contract between suppliers made complete with all terms and conditions and have the risks appropriately specified?			
1.23	Has the entity made an analysis of the suppliers that may cause critical			

S.No.	PARTICULARS	Yes	No	N/A
	operational problems if there was any default?			
1.24	What would be the likely financial impact of a critical operational issue/ disruption to the operations?			
1.25	Does the entity have a system of consumption booking commensurate to the size of business?			
1.26	In the case of credit sales, does the entity have sufficient measures to book sales at the appropriate time in accordance with the terms of sale?			
1.27	In case of any sales returns, does the entity have a uniform policy across all stores?			
1.28	Does the entity have a proper control on such returns to ensure appropriate accounting of them?			

Supply Chain Management

6.18 Supply Chain Management (SCM) is the management of a network of interconnected businesses involved in the ultimate provision of product and service packages required by end customers. Supply Chain Management spans all movement and storage of raw materials, work-in-progress and finished goods from point of origin to point of consumption.

6.19 Supply Chain Management ensure that the availability of products is at the right time and at affordable cost. The Supply Chain function involves vendor management, quality assurance and transportation. Vendor management assumes critical importance in retail business where one has to deal with multiple products. Supply Chain Management is viewed in fully vertically integrated firms, where the entire material flow is owned by a single firm and those where each channel member operates independently

6.20 Six Sigma, in Supply Chain Management (SCM), helps in achieving substantial benefits in terms of costs and quality. For effective implementation of Six Sigma in Supply Chain Management, it require collection of data from multiple organisations spread across multiple geographical locations.

6.21 Supply Chain Management involves two broad categories i.e., *strategic and operational.* As the term implies, strategic decisions are made typically over a longer time horizon. These are closely linked to the entity's strategy and guide supply chain policies from a design perspective. On the other hand, operational decisions are short term, and focus on activities over a day-to-day basis. The effort in these type of decisions is to effectively and efficiently manage the product flow in the "*strategically*" planned supply chain.

6.22 The strategic decision in Supply Chain Management needs to include four major decision areas:

- Location,
- Production,
- Inventory, and
- Transportation (distribution),

6.23 Typically, a Supply Chain Management would include the following components

(i) ***Distribution Network Configuration***: Number, location and network missions of suppliers, production facilities, distribution centers, warehouses, cross-docks and customers.

(ii) ***Distribution Strategy:*** Operating control (*e.g., centralized, decentralized or shared*); Delivery scheme, (*e.g., direct shipment, pool point shipping, cross docking, Direct Store Delivery (DSD), closed loop shipping*); Mode of transportation, (*e.g., motor carrier, including truckload, parcel, railroad;*

intermodal transport, including trailer on flatcar (TOFC) and container on flatcar (COFC); Ocean freight, air freight); Replenishment strategy *(e.g., pull, push or hybrid)*; and Transportation control *(e.g., owner-operated, private carrier, common carrier, contract carrier, or Third Party Logistics (3PL))*.

(iii) ***Trade-Offs in Logistical Activities***: The above activities must be well co-ordinated in order to achieve the lowest total logistics cost. Trade-offs may increase the total cost if one of the activities is optimised. For example, full truckload (FTL) rates are more economical on a cost per pallet basis than less than truckload (LTL) shipments. If, however, a full truckload of a product is ordered to reduce transportation costs, there will be an increase in inventory holding costs which may increase total logistics costs. It is therefore imperative to take a systems approach when planning logistical activities. These trade-offs are key to developing the most efficient and effective Logistics and SCM strategy.

(iv) ***Information***: Integration of processes through the supply chain to share valuable information, including demand signals, forecasts, inventory, transportation, potential collaboration, etc.

(v) ***Inventory Management***: Considering the volume of inventory, and that certain products are perishable in nature. The entity needs to ensure that the materials are stored to facilitate retrieval based on the expiry date of the particular product. To enable this, the system should be comprehensive enough to track details of all products procured from different suppliers.

(vi) ***Cash-Flow***: Arranging the payment terms and methodologies for exchanging funds across entities within the supply chain.

6.24 Operations Research (OR) is a critical tool that enables the entity in framing the ideal supply chain management system.

6.25 Internal audit is an important functions activity as entities work to manage its increasingly complex and pervasive supply chain risk. Supplier disruption can immediately and significantly affect profitability, impair growth opportunities, shatter shareholder value, and compromise reputation through a decreased level of public confidence.

Six Sigma

6.26 Six Sigma is a business management strategy. It is widely used in many sectors of industry. Six Sigma seeks to improve the quality of process outputs by identifying and removing the causes of defects (errors) and minimising variability in manufacturing and business. It uses a set of quality management methods, including statistically methods and creates a special infrastructure of people within the organisation ("Black Belts", "Green Belts", etc.) who are experts in these methods.

6.27 Each Six Sigma project carried out within an organisation follows a defined sequence of steps and has quantified financial targets (cost reduction or profit increase). A six sigma process is one in which 99.99966% of the products manufactured are statistically expected to be free of defects (3.4 defects per million).

6.28 Six Sigma enables:

- Improvement in delivery time.
- Reduction of logistics cost.
- Lesser inventory cost.
- Improvement in the final finished product/ service.

6.29 To achieve this, Six Sigma uses a methodology known as DMAIC. DMAIC is an acronym for the following five-step improvement process, i.e., Define, Measure, Analyze, Improve, Control:

(i) ***Define Opportunities:*** Define design goals that are consistent with customer demands and the enterprise strategy.

(ii) ***Measure Performance:*** Measure and identify CTQs (characteristics that are Critical To Quality), product capabilities, production process capability, and risks.

(iii) ***Analyze Opportunity:*** Analyze to develop and design alternatives, create a high-level design and evaluate design capability to select the best design.

(iv) ***Improve Performance:*** Improve or optimise the current process based upon data analysis using techniques, such as, design of experiments or mistake proofing, and standard work to create a new, future state process. Set up pilot runs to establish process capability.

(v) ***Control Performance:*** Control the future state process to ensure that any deviations from target are corrected before they result in defects. Implement control systems such as, statistical process control, production boards, and visual workplaces, and continuously monitor them.

Implementation of Six Sigma

6.30 One key innovation of Six Sigma involves the "*professionalising*" quality management functions. Prior to Six Sigma, quality management in practice was largely related to the production floor and to statisticians in a separate quality department. Formal Six Sigma programs borrow martial arts ranking terminology to define a hierarchy (and career path) that cuts across all business functions.

Analysis of a failed project helps the team to know about the lack of commitment as well as attention by senior management, towards the business and cultural investment that were required for accomplishing and sustaining the new levels of performance.

Assessing the Various Deployment Stages of Six Sigma

6.31 Six Sigma Assessment Procedures cannot be the same. The assessment procedure developed by an organisation cannot be applied to any other organisation, or for even any other process. Companies that are successful in their own right have always developed. In fact, some of them have even used their internal audit system along with their own criteria in assessment.

One of the most important things to remember in the implementation process is assessing the status quo at various intervals. Assessing a process reveals any deviations, if done from the intended line of progress. Process optimisation and control are needed to render progressively higher quality in the deployment process. Performance efficiency and timeliness are also important, to put into place as an appropriate set of balances and checks to control all these factors.

6.32 The internal auditor is required to have good understanding of the entity and the possible challenges the entity might face in the process of implementing Six Sigma. Each entity have different challenges in the process of implementation of Six Sigma.

Six Sigma Assessment Procedures

6.33 The basic function of an assessment procedure is to understand the gap between "*as is*" and "*what it should be*" state of the process stage. The "*should be*" list indicates at the points decided in the very starting. Six Sigma assessment procedures include the following:

- Leadership.
- Communication and implementation in day-to-day activities.
- Project performance competency and effectiveness.
- Organisational transformation.
- The impact of the customer on processes.

The assessment method used in this category includes written tests and interviews of top level managers all the way down to line employees, along with other meetings and seminars.

The overall results are applicable only to core business areas. In addition, result of the leadership assessment also show possible areas of weakness and improvement. In fact, these results help in drawing up a course correction plan.

6.34 The internal auditor required to frame his own procedures for testing the effectiveness of implementation of Six Sigma taking into consideration the uniqueness of each implementation in light of its overall business situation.

6.35 The following analytical procedures might be performed by the internal auditor regarding supply chain management system:

S.No	PARTICULARS	Yes	No	N/A
1	**Analysing the Supply Chain Management System**			
1.1	Has the entity made a comprehensive study on the supply chain?			
1.2	Is the supply chain management system commensurate with the size of business?			
1.3	Has the entity taken steps to evaluate the cost-benefit of having an in-house system to an external service provider?			
1.4	Are the terms of contract with the external service provider appropriate in the overall business scenario?			
1.5	Are there sufficient indemnification clauses available in the agreement to enable management of risk to an appropriate level?			
1.6	Are there established risk tolerances by type of risk, supplier, commodity, etc?			

S.No	PARTICULARS	Yes	No	N/A
1.7	Is there a clear understanding of the true cost (direct plus indirect) of supply chain risk events?			
1.8	Is the estimate of the cost made and reviewed at frequent intervals?			
1.9	Are there any pre-defined management responses corresponding to increased levels of supplier risk?			
1.10	Is there a system of Risk-based pricing and performance analysis to support improved risk response development?			
1.11	Has the entity focussed on early intervention and identification of any default than a crisis management?			
1.12	Is there a contingency plan for recovery in the event the distributor/ distribution system fails for any reason?			
2	**Distribution Network Configuration**			
2.1	Has the entity analysed the benefit of an external distributor as against an internal system?			
2.2	Considering the importance of the distribution network, does the entity have a prescribed network and organised system of movement of products?			

S.No	PARTICULARS	Yes	No	N/A
2.3	Does the entity have a written policy for its distribution network and mobilisation of goods?			
2.4	Does the entity have all its major suppliers at strategic locations?			
2.5	Are there sufficient controls within the entity for procuring same or similar products from various suppliers/ distributors?			
2.6	Are the distribution centres located at strategic locations to enable quick movement and timely availability of products?			
2.7	Are there sufficient controls in the entity to ensure that the decisions are made by the appropriate personal and every movement is authorised by the appropriate level of authority?			
2.8	Does the entity have a process of identifying frequent delays/ errors/ losses and rectifying the same?			
2.9	Does the entity have a control matrix for sourcing of good and products from various production locations, warehouses and distribution centres?			
2.10	Are the controls sufficient to ensure that sourcing is made from the right suppliers/ distributors and available on a timely basis?			
3	**Distribution Strategy**			
3.1	Does the entity have a strategy for efficient handling and managing inventory movement?			

S.No	PARTICULARS	Yes	No	N/A
3.2	Does the strategy clearly cover all areas of decision making?			
3.3	Is the strategy renewed at a frequent basis?			
3.4	Are there instances wherein the entity has procured goods/ transported goods at a price which is more than its alternative?			
3.5	In such cases, are there sufficient approvals obtained to incur higher costs for the procurement of goods?			
3.6	Are there sufficient control systems installed to enable capture of exceptions and appropriately highlight such variances?			
3.7	Has the entity estimated the cost of various strategies and its benefits accepting the final strategy?			
4	**Trade-offs in Logistical Activities**			
4.1	Has the entity made an evaluation of the cost of alternatives possible?			
4.2	Does the entity have a scientific basis of evaluation the overall cost of transportation?			
4.3	Has the method of evaluation of cost of transport between options made in a comprehensive manner?			
4.4	Do the Logistics Company cause any critical operational problems? Are they reliable?			

S.No	PARTICULARS	Yes	No	N/A
4.5	Has a comprehensive agreement made between them to ensure that the Logistics Company would bear the risks related to transportation of goods?			
4.6	If the entity has an in-house logistics division, are there sufficient controls within the entity to ensure that there is no excess cost involved in transportation?			
4.7	Are there written policies for logistics cost to be incurred?			
5	**Information**			
5.1	Does the entity have a comprehensive system to track all the cost incurred for logistics operations and distribution system management?			
5.2	Does the entity make a risk analysis based on such information?			
5.3	Has the entity have a comprehensive system to study the transportation time, transportation cost per product, lead time, and inventory level of all products?			
5.4	Does the entity make forecasts of demand of individual products to procure them on a timely basis?			
6	**Inventory Management**			
6.1	Does the entity have sufficient control on the individual product stock available at different locations?			

S.No	PARTICULARS	Yes	No	N/A
6.2	Is there an automated/ semi-automated system of routing of inventory from different locations to enable the availability of products?			
6.3	Taking into consideration the volume of products and the types of products, does the entity have a periodic reconciliation system?			
6.4	Is frequent physical verification performed at all locations at a simultaneous basis and reconciled with the books on a periodic basis?			
6.5	Are the procedures to conduct physical verification of inventory sufficient taking into consideration the volume of transactions and the no. of stores involved?			

Payroll

6.36 In a retail industry, the cost of payroll in relation to the turnover of the entity might not be very significant. But, the success of the retailer depends on the management of personnel and the availability of right persons. Thought the entity individually might hire huge number of employees, but, the collective employment given due to the retail industry is quite significant in terms of number of people employed in this sector across the nation.

Most entities process payroll for the month, based on the records of a different period. For example, when payroll for the month of December is processed, then the leave records, performance record for the period 25th November to 24th December would be considered. The main reason for such processing is to ensure disbursement of payroll by the specified day of the month.

6.37 The internal auditor needs to ensure that proper, adequate and appropriate cut-off procedures are in place to ensure proper computation and disbursement of salary to the employees. The procedures for computations of amount to be deducted on various heads also need to be verified in accordance with organisational policies and procedures. The internal auditor needs to verify the policies and procedures and compliance of the same on a sample basis.

Computation of incentives is a complex area in any entity operating in a retail industry. The entity, generally, provide incentive based on location, store's turnover, growth in business, innovative approach applied by the Stores Manager, etc. The process becomes complex, especially, when the entity needs to estimate the said information for every store across all geographical locations. For smaller entities, the process is much simple as there is no need for such detailed evaluation.

Compliance with various regulations too is a tedious job, especially, when the entity has presence across different states. In such a scenario, the entity might have to obtain separate registration certifications for different statutes, such as, VAT, Shops and Establishments Act, Professional Tax, Tax Deduction Account Number (TAN), etc. The entity generally has protocols for ensuring compliance with regulations.

6.38 Certain entities operating in the retail industry provide an opportunity for employees to take ownership in the company through issues of stocks. The schemes may be in the follwing form:

- Stock Awards
- Employee Stock Option Plan
- Employee Stock Purchase Plan.

These schemes also enable creation of a long term relationship and trust between the entity and the employee and helps in employee retention.

6.39 The internal auditor needs to verify the following policies of the entity:

(i) ***Job Rotation***

Job rotation is an approach to management development where an individual is moved through a schedule of assignments designed to give the employee exposure to the entire operation. It is also practiced to allow qualified employees to gain more insights into the processes of a company, and to reduce boredom and increase job satisfaction through job variation. Job rotation might be between posting of an employee to different departments within the store to different operations such as maintenance, supervision, billing, reporting, etc.

(ii) ***Different Shifts***

In general, big entities and retail stores build customer loyalty by providing them the convenience of time of shopping through working for more hours. Thereby, most stores established work more than 12 hours a day. Considering the duration of operation, the entity might have to hire employees on a shift basis. The internal auditor may verify the processes in the entity to support such a shift system and enable proper handing over of responsibilities.

6.40 A *time sheet* is a method for recording the amount of a worker's time spent at work to enable tracking of details related to leave and absence to enable the determination of employee's compensation. In some situations, the recording of time sheet is done through an electronic/ automatic process and is driven by software. In such cases, the internal auditor is required to understand the process in detail and verify the process on a sample basis, exceptions, if any, noted on the project should be taken seriously by the internal auditor and adequate explanations should be obtained.

6.41 The internal auditor may also perform additional analytical procedures over a period of time and compared them for ascertaining following inconsistencies:

(i) ***No. of Bills Raised/ No. of Hours***

This ratio is determined by the number of bills an employee processes to the total time taken by him over a period of time. By analysing this ratio, the internal auditor can understand the skill level of employees, steps taken by the management towards maintaining efficiency, importance of training and ability of the management in identifying the right person for the job. This ratio gains significance, especially, because by processing of bills quickly, customer's, satisfaction can be maintained and thereby enables development of brand and loyalty.

(ii) ***Average Employee Cost per Store***

Average cost incurred for an employee (cost includes incentives, gifts, entertainment costs incurred for a store) can be computed by dividing the total cost on employees in a store incurred for a period to average number of employees during the period. The internal auditor may compare this information between different periods or with different stores and ensure that there is no significant unexplainable difference in the average employee cost per store.

(iii) ***Total Revenue per Store to Number of Employees/ Employee Cost***

This ratio can be computed based on the total revenue of the store in a particular period to the number of employees/ employee cost in the same month. This would enable the internal auditor to understand the importance of a firm in terms of its significance.

(iv) ***Employee Turnover Ratio***

Employee turnover ratio helps the internal auditor to verify the attrition rate and assess the entity's effectiveness and steps taken towards prevention of attrition and retention of key employees. In case of employee turnover ratio being higher than the industry, the internal auditor must obtain explanations for the reason for such high turnover ratio.

(v) ***Reconciliation with Respect to Changes in the Number of Employees***

The internal auditor can assess the movement in employees for a month in comparison with another by tracing the additions and deletions due to additions, terminations, retirements, etc., in a month based on each grade and obtain an insight on the plans of the management.

6.42 The following is a 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 the appropriate level of authority?			
1.2	Is the payroll process complete in all aspects, as applicable to the entity?			
1.3	Does the entity maintain a check-list of statutory remittances to be made on account of PF, ESI, Labour Welfare Fund etc.?			
1.4	Are cheques prepared and signed by 2 different employees?			
1.5	If the entity opts for bank transfer, is there sufficient level of authority to issue to a bank transfer instruction to the bank?			
1.6	Is the payroll processing cross checked before payment is made?			
1.7	Are there sufficient manual records maintained by the entity with regards to their recruitment, offer letter,			

S.No.	PARTICULARS	Yes	No	N/A
	appraisals and increments and all other correspondences with the employee?			
1.8	Have the incentive schemes been verified by the internal auditor on a test basis?			
1.9	Are controls in place to ensure that incentives are computed in accordance with the schemes?			
1.10	Have these controls been tested for effectiveness?			
1.11	Have we performed sample testing of incentive workings made and paid to the employee to ensure adherence to the Incentive system?			
1.12	Is the attrition rate exceedingly high? Have justifications for such a high rate, if any obtained?			
1.13	Does the entity maintain separately all complaints, and redressals received from the employees?			
1.14	Have the reasons and explanations for any failures and control weakness observed on review of these complaints?			
1.15	Does the entity comply with the accounting requirements for ESOP, ESPP schemes and have a proper record of the shares opted by the employees?			
1.16	Does the entity have sufficient controls and records for cases where disbursements are made to employees working from home?			

Fixed Assets

6.43 In general, an entity operating in the retail industry would have the following types of fixed assets:

- Freehold land and leasehold land
- Buildings, warehouses and leasehold improvements
- Plant and Machinery
- Office equipment
- Computer and software
- Furniture and Fixtures
- Electrical Installations
- Vehicles

6.44 In case, the event of a comprehensive distribution system is being operated by the entity, the entity have a large number of warehouses and storage locations apart from transportation vehicles. The entity is required to have sufficient control in such cases to ensure that the assets are being used properly and periodic physical verification might be of paramount importance.

6.45 The entity might lease certain assets for installation at the stores. The internal auditor might be required to verify whether there is proper control over such leased assets.

Further, the internal auditor might be required to ensure that there are sufficient controls within the entity to differentiate between own assets and those assets provided by the vendors/ manufacturers to promote their product. The internal auditor may also perform additional analytical procedures over a period of time and compared them for ascertaining any inconsistency such as following:

(i) ***Ratio of Assets Installed to Area***

The internal auditor might verify the ratio of the total value/ no. of assets put to use per square foot across different stores and in case of any significant difference arising in such a ratio, the internal auditor needs to seek explanation thereon.

(ii) ***Asset Utilisation Ratio***

Asset utilisation ratio is the ratio of total revenue to the total assets. It helps the internal auditor to assess the effectiveness of assets with respect to the revenue made by the entity. The greater the asset utilisation ratio, the higher is the operating efficiency of the entity.

(iii) ***Asset Coverage Ratio***

Asset coverage ratio is a measure of company's ability to cover the amount of its existing debts. Essentially, an asset coverage ratio measures the tangible, physical and monetary assets of a company against its outstanding debts and overall liability to derive an understanding of the company's current financial situation. This ratio is a part of a larger liquidity analysis, which takes into consideration factors like, cash on hand, long-term financial obligations, and current liquidity assessments.

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***. Audit techniques which the internal auditor can perform for verification of assets include procedures such as, verification of laptops at the time of logging on to the server/ network monitored through a special software, verification of software licences and validity, number of licences against number of computer systems used for specific purpose and so on.

6.46 The following is a model checklist related to fixed assets:

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Fixed Assets**			
1.1	If there are laptops issued to employees, does the information system division have sufficient control over the laptops? Are these laptops verified on a frequent basis?			
1.2	Does the entity have sufficient protection for its Servers from both internal and external damage?			
1.3	Are there sufficient control and processes to ensure capitalisation of assets on the appropriate date?			
1.4	Has the entity taken assets on lease and is there sufficient control on such assets?			
1.5	In case, assets are held at mobile/ temporary stores, does the entity have sufficient control over them and does it make a periodic physical verification?			
1.6	How are assets received from manufacturers identified and ensured that they are not disposed off?			
1.7	In the event, the entity is dealing with distribution/ sale of products which are of the nature of fixed assets, are there sufficient controls and procedures to ensure appropriate classification?			

Data Security

6.47 Data security is a major problem in the retail industry. Security in a retail industry can be bifurcated into two significant components:

(i) Information Technology Security

The various sources of danger to data can be in the form of following:

(a) Natural Calamity

Fire, flood, earthquake, falling elephants can cause damage to hardware including server, computers and other physical storage devices.

(b) Theft of Data

Data theft is a growing problem primarily perpetrated by office workers with access to technology such as, desktop computers and hand-held devices capable of storing digital information such as, flash drives, iPods and even digital cameras. Since employees often spend a considerable amount of time developing contacts and confidential and copyrighted information for the company they work for, they often feel they have some right to the information and are inclined to copy and/or delete part of it when they leave the company, or misuse it while they are still in employment.

While most organizations have implemented firewalls and intrusion-detection systems very few take into account the threat from the average employee that copies proprietary data for personal gain or use by another company. A common scenario is where a sales person makes a copy of the contact database for use in their next job. Typically, this is a clear violation of their terms of employment.

(c) System Crash

A system crash is a condition where a program (either an application or part of the operating system) stops performing its expected function and also stops responding to other parts of the system. Often the offending program may simply appear to freeze. If this program is a critical part of the operating system kernel the entire computer may crash.

(d) Computer Fraud

Computer fraud covers a variety of activity that is harmful to people. Computer fraud is using the computer in some way to commit dishonesty by obtaining an advantage or causing loss of something of value. This could take form in a number of ways, including program fraud, hacking, e-mail hoaxes, auction and retail sales schemes, investment schemes and people claiming to be experts on subject areas.

(e) System Bugs

A bug is the common term used to describe an error, flaw, mistake, failure, or fault in a computer program or system that produces an incorrect or unexpected result, or causes it to behave in unintended ways. Most bugs arise from mistakes and errors made by people in either a program's source code or its design, and a few are caused by compilers producing incorrect code.

(f) Power Failure, Accidental Deletion/ Modification

Power failure and accidental deletion/ modification of files is a common type of problem faced by many small entities due lack of sufficient infrastructure and also training to the employees.

(g) Hacking

Hacking could be in the form of:

- Passwords required to enter or change the PC's BIOS;
- Passwords required to enter a network;
- Passwords required to start the operating system;

- Passwords required to enter major software packages (e.g. payroll); or
- Encrypted (encoded) data files

(h) Telecommunication Failure

Sometimes, the telecommunication network might fail, which might result in freezing of flow of data from and to the computing system. During such time, the entity might not be able to perform its operations.

(i) Virus Problem

A computer virus is a computer program that can copy itself and infect a computer. A computer virus has two major classifications. They have the ability to replicate itself, and the ability to attach itself to another computer file. Every file or program that becomes infected can also act as a virus itself, allowing it to spread to other files and computers.

(j) Unknown Risks

There might be threat to data due to other reasons not included above. The internal auditor must keep an eye on these too to ensure complete data security.

6.48 The data of both the client and the entity needs protection. There might be severe penalties imposed by the client on account of fraudulent activities by the entity. The work area would not be reasonably accessible by an outsider without proper security check and prior authorisation to ensure safety of data and to prevent theft thereto. Conditions such as inhibition of use of mobile phones, personal laptops, cameras, and pen drives are enforced.

The internal auditor needs to verify the sufficiency of control of data. He should also obtain explanations for any loss/ damage of data, if any during the reporting period apart from steps taken to prevent them in the future. He should also verify whether the policies and procedures are put in place. The internal auditor may refer to SIA 14, "Internal Audit in an Information Technology Environment" and SIA 16, "Using the work of an Expert".

6.49 The following is a model checklist related to internal audit under computer environment

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Computer Environment**			
1.1	Is there a sound computer/ laptop usage policy formed by the entity?			
1.2	Does the usage policy cover all possible areas?			
1.3	Is it frequently updated and circulated to all users?			
1.4	Are there sufficient firewalls installed in the server to ensure proper security and is it frequently updated?			
1.5	Is there a proper internet usage policy and does it bind all the employees?			
1.6	Is there a frequent systems audit done to ensure in time detection of all irregularities?			
1.7	Does the entity take all possible steps to prevent, detect and punish fraud?			

(ii) Physical Security

The entity should safeguard their property, staff and customers. Entity also uses physical security as a deterrent to prevent shoplifting and crime. Further, to ensure enhanced security, entities are looking towards technology and automated systems to prevent shoplifting and crime. The tools include video surveillance and integrated systems.

Ensuring the security of retail organization would mean protecting customers, staff and assets, while benefitting from complete visibility of sales floor, point-of-sale (POS), receiving doors, distribution centres and parking facilities. It would involve security of the following areas/ activities:

(a) ***In-Store***

- Ensure integrated surveillance of POS and cash-handling areas.
- Manage access to restricted areas and locked displays.
- Protect customers and employees.
- Verify fire, intrusion and electronic article surveillance (EAS) event alarms using video.

(b) ***Back Office and Warehouse***

- Protect employees and prevent theft.
- Safeguard assets and equipment.
- Monitor productivity and safety.
- Track time and attendance through access control.

(c) ***Parking and Outdoor Premises***

- Identify suspicious vehicles.
- Ensure entry and exit point security.
- Protect assets and buildings.
- Monitor merchandise delivery.

Further, International organisations have also established standards and guidelines for physical security as part of an overall security management program that also includes information security and meets governmental requirements and consumer expectations.

Certain examples of internationally recognised standards and guidelines that are used to implement security management systems to effectively manage physical security pertaining to the retail industry would include following:

- BS 25999-1:2006: Business Continuity Management Code of Practice (management system for disaster recovery and business continuity)

- BS 7799-3:2006: Guidelines for Information Security Risk Management (management system approach for the assessment and treatment of risk)

- ISO/PAS 28000:2005: Specification for Security Management Systems for the Supply Chain (management system specification for physical security)

- ISO 22000:2005: Food Safety Management Systems - Requirements for Any Organization in the Food Chain (management system for preventing the introduction of food safety hazards)

- OHSAS 18001: Occupational Health and Safety Management (specification for health and safety management systems)

The internal auditor might extend his scope of internal audit to verify the importance given by management to physical security system. Further, he might be able to understand and correlate the relationship between reduction of costs related to theft/ shrinkage and incurred for enhanced physical security.

6.50 An illustrative list of procedures that an internal auditor might perform would include:

S.No.	PARTICULARS	Yes	No	N/A
2	**Physical Security**			
2.1	Does the entity provide sufficient importance to physical security and security measures?			

S.No.	PARTICULARS	Yes	No	N/A
2.2	Are the security arrangements made reviewed by the management on a periodic basis to ensure that there is sufficiency of security measures at each store/ location?			
2.3	Does the management ensure a continuous shifting of security personnel from each department/ location?			
2.4	How does the management treat theft and shoplifting cases in the event the fraudster has been traced?			
2.5	Does the management believe in periodic modification of security procedures and systems to ensure that there is limited possibility for external people and employees in ascertaining failures in internal security?			
2.6	Does the management make an estimate to verify as to what would be the maximum possible loss in the event of failure of security measures and systems?			
2.7	Are there sufficient Disaster recovery systems within the organisation to act in the event of any mishap/ failing of security measures? Are the employees sufficiently trained in that aspect?			

Operating Costs

6.51 The significant operating costs for any entity operating in a retail industry include the following:

(i) Lease Expenses

Lease expenses could be of the nature of leasing of office building for work space, or leasing of assets for official purpose or accommodation provided to the employees. This would be a significant part of the expenses considering that the entity needs to own the location or lease the location for its display. The success of the entity is based on location of store and, incidentally, to have a store at the right location would mean incurring higher cost.

(ii) Advertisement and Marketing Expenses

Advertisement expenses are incurred predominantly for the purpose of creation and development of a strong brand name. Branding is one of the most important aspects of any business, large or small, retail or Business to Business (B2B). An effective brand strategy gives major edge in increasingly competitive markets. A brand is something that tells the customers (existing and prospective) what they can expect from the entity's products, and also differentiates offering from competitors.

The various strategies that the entity might use for marketing are as follows:

(a) ***Loyalty Program***

A retail establishment or a retail group may issue a loyalty card to a consumer who can use it as a form of identification when dealing with that retailer. By presenting the card, the purchaser is typically entitled to either a discount on the current purchase, or an allotment of points that can be used for future purchases.

The loyalty program might be monitored by program managers who are typically agencies with specialist skills in loyalty consulting, creative and communication, data analytics, loyalty software, and back end operations.

(b) ***Multi-channel Marketing***

Multichannel marketing is using many different marketing channels to reach a customer. A channel might be a retail store, a web site, a mail order catalogue, or direct personal communications by letter, e-mail or text message. The objective of the company doing the marketing is to make it easy for a consumer to buy from them in most appropriate manner.

To be effective, multi-channel marketing needs to be supported by good supply chain management (SCM) systems, so that the details and prices of goods on offer are consistent across the different channels. It might also be supported by detailed analysis of the return on investment from channel, measured in terms of customer response and conversion of sales. Multi-channel marketing allows the retail merchant to reach its prospective or current customer in a channel of his/ her liking.

(c) ***Penetration Analysis***

Penetration analysis deals with the analysis of the extent of reach of a particular commodity. The analysis helps the management in identifying the requirement of stock at a particular location and methods to promote the same.

(iii) **Store Maintenance Expenses**

Maintenance of a store is inevitable to provide customer satisfaction and to ensure that goods are not perished earlier than they are supposed to. Hence, the entity has to incur significant maintenance expenses. In general, the entity might enter into an Annual Maintenance Contract (AMC) with agencies to enable such maintenance on a regular and professional basis.

(iv) **Finance Charges**

Finance charges are incurred for the purpose of working capital and capital expenditure of a retail industry. The entity needs to ensure cost efficiency in borrowing of funds. The entity might also opt for an external commercial borrowing for the purpose of incurring expenditure in foreign currency.

Measuring Operational Efficiency

6.52 The internal auditor can measure the operational efficiency by following methods:

- Operations research - based method.
- Data Envelopment Analysis (DEA).

A retail store is deemed efficient (efficiency = 1), if its output is optimal (maximum possible) for given inputs in comparison with the outputs and inputs of all comparable stores. The efficient frontier is a series of points or a line connecting the most efficient stores which are determined after comparing outputs and inputs of all retail stores. Therefore, Data Envelopment Analysis (DEA) produces relative efficiency boundaries of the retail stores under study, which are called envelopes.

In this study, efficiency is the ratio of the weighted sum of outputs to the weighted sum of inputs. The weights are estimated separately for each retail store such that its efficiency is the maximum possible or is equal to 1. Weights are automatically calculated for all the stores while calculating their relative efficiencies. Therefore, weights change each time a store's efficiency is calculated using this model and are measured relative to the remaining stores.

6.53 The internal auditor is required to verify the procedures and controls for capturing of specific expenses with regards to its sufficiency, appropriateness and efficiency. Moreover, the internal auditor needs to ensure that common expenses are allocated across these undertakings in a justifiable basis. The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

(i) *Total Fixed Cost*

Significant increases in the total fixed cost signals expansion activity. In such cases, the internal auditor needs to verify the sufficiency of controls with respect to the growing entity.

(ii) *Operating Cost to Revenue (Undertaking-wise)*

An entity operates in varied legal environment and different challenges are faced by the entity operating in each such environment. The internal auditor can estimate the operating cost (i.e., cost including labour, communication, lease and all other variable expense to the particular undertaking) to the revenue generated by it. This would provide a basis for evaluating the cost effectiveness of operating in each of the undertakings.

(iii) *Variable Cost per Man Hour per Undertaking*

Variable cost per man hour can be computed by dividing the total cost incurred in an undertaking divided by man hours for the same period. This can be compared with different periods to verify whether there has been a significant increase/ decrease in the expense and identify reasons for the same.

(iv) *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.

Other Areas of Internal Audit Significance

6.54 Other areas of internal audit significance are as follows:

(i) Visual Merchandising

Visual merchandising starts with the store itself. The management decides the store design to reflect that the store is going to sell the product and how to create a warm, friendly, and approachable atmosphere for its potential customers.

Many elements can be used by visual merchandisers in creating displays including color, lighting, space, product information, sensory inputs such as, smell, touch and sound, etc. as well as technologies such as, digital displays and interactive installations.

6.55 Retail professionals display the product to make the shopping more comfortable, convenient and customer friendly in the following manner:

- Making it easier for the customer to locate the desired category and merchandise.
- Making it easier for the customer to self-select.
- Making it possible for the customer to co-ordinate and accessorize.
- Informing them about the latest fashion trends.

6.56 The benefits of visual merchandising are as follows:

- Educating the customers about the product/ service in an effective and creative way.
- Establishing a creative medium to present merchandise in 3D environment, thereby enabling long lasting impact and recall value.
- Setting the company apart in an exclusive position.
- Establishing linkage between fashion, product design and marketing by keeping the product in prime focus.
- Combining the creative, technical and operational aspects of a product and the business.
- Drawing the attention of the customer to enable him to take purchase decision within shortest possible time, and thus augmenting the selling process.

6.57 Following are the techniques of enhancing visual merchandising:

(a) Planogram

A planogram allows planning the arrangement of merchandise on a given fixture configuration to support sales through proper placement of merchandise by style, option, size, price points, etc. It also enables a chain of stores to have the same merchandise displayed in a coherent and similar manner across the chain.

The main purpose is to support ease of applicability to the merchandiser while also increasing selection and enhancing the merchandise display in a neat and organised manner.

(b) Window Displays

A retailer's window is the most controllable element in relation to image and must match the merchandise's target demographic. Display windows may communicate style, content and price. They can be seductive, exciting or based on emotional stimulus through stimulation, or evocation of all five senses. Another direction taken by retailers who rely on volume sold is price-based selling. These clearly emphasize value for money with easy and obvious ticketing.

(c) Food Merchandising

Restaurants, Grocery Stores, and C-stores are using visual merchandising as a tool to differentiate themselves in a saturated market. With Whole Foods leading the way, many are recognizing the impact that good food merchandising can have on sales. If a food merchandising strategy considers the five senses, it will keep customers lingering in the store, and help them with the buying decision process. Texture can be utilised to entice customers to touch, and samples are the best form of food advertising. Especially for large quantity items, the ability to experience the product before committing to the purchase is critical. Food merchandising should educate customers, entice them to buy, and create loyalty to the store.

The internal auditor might analyse visual merchandising considering the importance of visual merchandising in the success of a store. It might include matters such as, periodic improvements that can be made or realignment/ shuffling of inventory.

Surprise Verification

6.58 If physical verification or examination is done without prior information to the management, it is called as Surprise Check. An element of surprise is experienced by management or the employee in such cases. Surprise check is used in physical verification of cash, security items, inventory, etc.

The internal auditor might use surprise checks as an effective tool for finding effectiveness and continuity of internal controls.

(ii) Managing Shrinkages

Retail shrinkage is the difference in the value of stocks as per books and the value of actual stock at the store on any given date.

Shrinkages at the stores could be on account of any one or combination of the following:

(a) Process Lapse

There could be a number of lapses that lead to shrinkages at the stores. Some of the main ones could be as follows:

- Lesser Receipts at the stores against what is transferred out of the Distribution Centre. Where receipts are not verified 100 per cent on receipt, this cannot be ruled out.
- Understatement/ accounting of damages at the stores. Stores may have a tendency to understate the damages including handling damages that are destroyed at the stores itself. This will result in shrinkages for those SKUs which were not removed from the books as damaged stocks.

- Understatement/ accounting of dump of fruits and vegetables. Understatement of dump is quite common as it reflects the operational efficiency of the store; such under accounted products get reported as shrinkages when stocks are verified.

- Non updation of manual bills into POS.

- Delayed or non accounting of returns made to the DC/ Vendors from the stores.

- Non-updation of consumer promotions in the system leading to manual intervention at the POS.

- Other cases which warrant manual intervention at the POS as manual intervention may result in wrong billing too.

(b) System Lapses

- Poor quality of scanners or stickers and duplicate SKU code would force manual intervention at the POS. Manual intervention may also amount to errors and contribute to shrinkages.

- Other system lapses due to which book stocks are reported wrongly.

(c) Vendor Fraud

Short supply by the vendor as against the quantity in the Goods Received Note (GRN) would certainly amount to shrinkages at the warehouse/ DC itself. Moreover, any such malpractice adapted by DSPs (direct supplies to stores) would also amount to shrinkages.

(d) Employee Fraud

This is one of the common means of fraud causing shrinkages. The following could be a few types of malpractices:

- Improper Invoicing – either billing lesser quantity/ non billing of certain products/ billing products with lower prices as against actual selling price of products sold.

- Theft by employees.
- Frauds in the case of products exchanged by customers.
- Fraudulent practice in handling home deliveries.

(e) Customer Shop Lifting

This is another common problem causing shrinkages. Generally, specific products including beauty products, skin care products, razors, etc. are more prone to such shop lifting by customers. It is also extremely difficult in controlling the customer theft though some measures are being taken by a few retailers based on their experience and learning.

6.59 Corrective steps taken at the right point of time would certainly help the retailers mitigate the risk to a greater extent and reduce the losses on account of shrinkage. The following could be some areas where best practices need to be deployed:

- Having clear SOPs for operations at stores.
- Ensure adherence to the SOPs.
- Avoid or minimise manual intervention at the POS.
- Ensure proper training to the staff.
- Educate the staff on the importance of reduction of shrinkages.
- Proper physical verification of stocks.
- Deployment and monitoring of CCTV at the stores.
- Employees frisking.
- Background check on staff.

6.60 The following measures would certainly help in reducing the shrinkages:

- Setting up a dedicated internal/ external team to handle stock checks at each of the stores periodically. Initially each store is covered atleast once a month.
- Creation of stock check squad that would visit each store every day and verify a few SKUs on a random basis. The scope of services to be provided by an internal auditor might also include surprise checks on a random basis.
- Surprise verification of receipts at the stores.
- Monthly/ quarterly audit of the entire operations of the stores to assess adherence to the laid down processes.
- Closely monitoring stores with huge shrinkages.
- Closely monitoring and analysing category of products that contribute to huge shrinkages.

6.61 The internal auditor may consider shrinkage as an essential part of his audit procedures. The areas that may be reviewed by the internal auditor are as follows:

- Methodology designed by management to precisely manage shrinkage.
- Control measures taken by the management.
- Sufficiency of procedures controlling shrinkage.
- Effectiveness of the steps taken by the management.
- Detecting weaknesses in the system.

(iii) Handling of Products and Disposal of Damages and Expiries/ Products nearing Expiry/ Obsolescence

(a) *Handling of Products*

Handling of products would be an important part in the activities carried by a retail industry. It involves activities such as, pushing, pulling, lifting, carrying and holding.

The internal auditor may perform assessment of each manual task and the following factors should be considered in framing his internal audit procedures:

- Nature of the objects being handled;
- Actions and movements involved in the task;
- Range of weights handled;
- Availability of lifting and moving equipment;
- Force to be applied;
- Duration and frequency of the task;
- Time and distance over which the object is handled;
- Working posture imposed by the task;
- Training and experience of the employee;
- Age of the employee doing the task;
- Work environment;
- Workplace layout and housekeeping;
- Analysis of relevant injury statistics;
- Protective clothing and equipment required to do the task; and

- Any other factor considered relevant by the employer, employees or employee representatives.

(b) ***Disposal of Damages and Expiries***

The internal auditor would assess the following in case of disposal of damages and expiries/ products meaning expiry/ obsolescence:

- Storage systems and manuals of the entity;
- Periodicity of verification of stock;
- Methodology used in identification of damages for each class of products;
- Methods to prevent damages and its sufficiency;
- Identification of the types and classes of products which are subject to damages;
- Treatment of identified damages and its disposal;
- Controls on disposal of such goods;
- Verification procedures at the time of receipt of goods from the supplier/ distributor/ manufacturer;
- Agreement with vendors in the event of such damages/ loss;
- Sufficiency of controls for accounting for such damages and disposals;
- Analysis of cost of damages and nature of goods damaged; and
- Comprehensiveness of stock taking procedures.

Maintenance of Books, Reporting, Management, Control and MIS

6.62 The internal auditor is required to verify the sufficiency of controls related to maintenance of books of accounts by the entity. The internal auditor is also required to verify the controls for allocation of costs between different departments in every store and verify whether it is adequate and reliable in the light of overall business operations.

An entity in retail industry might have various stores. Accordingly, accounting operations might be performed centralised, decentralised or may be a combination of both manner. The entity might find it best suited if the accounting system is comprehensive enough to provide a Management Information System (MIS) sufficient information for decision making and enable the entity to understand complexities of business, status of implementation of new ideas and the status of operations of the entity.

6.63 The reporting system should be comprehensive enough and should be able to provide the following information.

(i) Sales and Collection

- Daily statement of sales through cash, credit card, coupons, credit sales, debit card across individual stores.
- Reconciliation between sales and collection status with outstanding debtors.
- Trends of sales in a particular location.
- Department-wise sales.
- Consumption *vs* Sales Analysis.
- Benefits of advertisement through additional revenues and customer loyalty.

- Repetition of customers to estimate customer loyalty through customer loyalty programs.
- Highlight the growing demand of a particular product to capitalise on its sales and *vice-versa*.
- Impact of visual merchandising on different products.
- Benefit of promotional schemes as against normal sales.

(ii) Inventory Management

- Loss of inventory on account of theft, spoilage/ perishing of goods.
- Inventory at each store, warehouses and storage centres.
- Inventory ageing system.

(iii) Supplier Analysis

- Matrix of orders placed for each product across departments.
- Status of all pending orders.
- Orders that have exceed the expected due date pending receipt.
- Tracking of credit period for each distributor.

(iv) Others

- Gross Profitability Ratio across different products.
- Customer feedback review analysis.
- Sensitivity analysis for price and discounts, non-availability of key products.

6.64 Model checklist related to maintenance of accounts and documents is as follows:

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 each store located across states to enable proper declaration of turnover for statutory purposes such as VAT Returns?			
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 location-wise employee details to ensure proper allocation of payroll cost to the location?			
1.5	Are the books of accounts closed every month?			
1.6	Whether the time period for the closure of the books of accounts on a monthly basis is reasonable with regards to the operations of the entity?			
1.7	Are the controls for re-opening of books proper to ensure prevention of manipulation?			

S.No.	PARTICULARS	Yes	No	N/A
1.8	Are the books maintained in a manner to provide information to the management for decision making?			

Fraud and Management

6.65 Retail Frauds might significantly affect the revenue of the entity operating in retail industry. On an average around 3% of revenue is lost on account of frauds. *Shrinkage* or *Fraud* in retail is a key issue. Shrinkage is the *"loss in inventory on account of a combination of employee theft, shoplifting, vendor fraud and administrative error."*

In mom-and-pop stores, the owners do not feel the impact as it is believed that manning the store themselves is vigilant enough. In large-format stores, however, it is difficult to check as wares are spread out.

6.66 Various categories of fraud constitute a major component of the shrinkage. Among the factors responsible for shrinkage losses, employees and vendors are critical factors that need to be managed by retailers. Employees may resort to direct theft, under invoicing in collusion with customers, stealing cash, etc., whereas vendors can under-deliver in terms of number, size or quality of items as against the bill invoice.

The growing motivation among employees to lead a luxurious life, high reliance on skilled resources, thereby leading to weaker internal controls, and overdependence on existing systems and processes give rise to increased risk of fraud in retail sector.

Some of the most potentially costly fraud schemes operating in the retail industry happen far from the selling floor, the security cameras and the cash register. They happen when employees behind the scenes circumvent processes and take advantage of insufficient oversight. Retailers face some unique risks that can have a potentially devastating impact on the company's bottom line and reputation. Retail companies should be proactive in identifying fraud risks and implementing anti-fraud programs and controls to minimize the risk of fraud.

6.67 The common categories of fraud that affect the retail industry are as follows:

(i) Financial Reporting Fraud

It can be in many forms and is, generally, committed to make an entity or a subsidiary, branch or operating center of an entity appear to have performed better than it actually has. One of the most common issues relates to revenue recognition schemes wherein sales are boosted to mislead management, shareholders, or lenders regarding the performance of a particular entity, location, product line, or sales team. While the perpetrator might not realize an immediate benefit from the scheme, such individuals might benefit indirectly by improperly receiving commissions or other incentives such as stock awards based on fraudulent information. Perpetrators of these schemes can be anyone who has an incentive or perhaps is under significant amount of pressure to show positive results and has the opportunity to commit fraud.

There are many types of revenue recognition schemes in this type of fraud. Some of the common issues are as follows:

(a) Bill-and-hold Transactions

It occurs when a sales order is processed, but the inventory is not shipped to the customer. The inventory may be separated in the warehouse, sitting on the loading dock or shipped to a third-party warehouse or staging facility. Sometimes, this may occur because the customer is not ready, willing or able to accept delivery. Decentralized structure and weak controls around inventory make this fraud easier to accomplish. Periodic inventory reviews as well as review of sales, sales returns and accounts receivable aging reports may reveal unusual trends to merit investigation.

(b) Channel Stuffing

It includes shipping substantially more inventory to a reseller than he can reasonably use, but agrees to accept it based on unusual or extraordinary terms, like, extended payment terms, deep discounts, or allowing the return of unsold goods for full credit beyond the company's normal returns policy. Operations without formal, enforced procedures for negotiating, approving, and documenting sales agreements are often victims of this type of fraud.

(c) Side Agreements

The normal contract terms are changed or invalidated by an oral or written agreement. Side agreements, usually, accompany channel stuffing as a way to induce resellers to take on more inventory than they can reasonably resell. Lack of written policies regarding agreements are one risk factor that makes this fraud easier to perpetrate; another is a commission program based on gross sales where low margins and high returns aren't penalized.

(d) Backdating

It is another way of fraudsters misstating revenue in which sales documents make a transaction appear to have occurred in a prior period,. Again, failure to institute or enforce policies about negotiating and executing sales agreements can be a risk factor here.

Certain frauds can be identified by the internal auditor through performance of analytical procedures as described earlier. A few indications might be in the nature of following:

(i) Decreasing Gross Margins

Increasing sales are increasing could signal a side agreement for a special discount.

(ii) Unusually High Returns

It could be caused by a channel stuffing arrangement or other side agreement permitting reseller returns of unsold goods.

(iii) Unexplained Differences in Physical Inventory

It indicates a bill-and-hold fraud is taking place.

(iv) Buildup of Aged Accounts Receivable Balances

It might be caused by backdating, side agreements, or channel stuffing arrangements.

(v) An Unusual Spike in Sales

An unusual spike in sales just before the end of the reporting period could indicate any of these schemes.

(ii) Misappropriation of Assets (Theft of Cash or Inventory)

It is a second category of fraud that occurs in retail industry. The various forms of this type of fraud are as follows:

(a) Cash Skimming

It can be conducted through sales transactions and fictitious returns. Customer payments on accounts accompanied by account write-offs are another way to skim cash. A retailer with weak system security or failure to segregate sales, cash receipts and accounting functions is an easy target for cash skimming.

(b) Theft of Inventory

It can be as simple as removal of inventory from the warehouse or along the supply chain. It can include adjustment of books and records to hide the theft. This is more likely to happen in companies with multiple inventory locations or complex supply chains. Failure to properly segregate inventory and record keeping duties makes this kind of theft easy to accomplish.

(c) Marketing Fraud

It is another way of fraudsters misappropriating assets. The entity's personnel collude with customers to share rebates, discounts or promotional items. Where sales people maintain long-term client relationships and have significant latitude with terms, this type of fraud can occur.

The indicators include the following:

- Growing accounts receivable balances without sales increases.
- Lower than expected gross margins.
- Higher than expected promotional allowances.
- Unusual number of credit adjustments, customer account write-offs, or customer returns.
- Unexplained variances in inventory; larger than expected shrink percentages.

(iii) Unauthorized Receipts and Expenditures

It is a third category of fraud that strikes retailers. The areas of fraud can include the following:

(a) Improper Vendor Allowances

Customers and/or retail employees commit this fraud. This is a risk when vendor allowances are significant and not documented properly, particularly, if policies for negotiating these allowances aren't formal, and procedures for tracking them aren't strict. Retail employees may collude with a vendor's staff or create false documentation to gain allowances, discounts, or rebates. These improper benefits might be used to overstate performance for a location or product line, or pocketed by the fraudster.

This can be identified through analyzing and identifying the following:

- Unexpected variances in gross margins which could be due to fluctuations in allowance amounts or timing.

- Decrease in sales while gross margins stay steady.

(b) Bribery or Corruption

When retailers operate in several regions or countries and corporate oversight is less, this type of fraud occurs. Lack of segregation of duties between vendor approval and purchase authorisation, or new customer approval and sales contract authorisation can enable these frauds. They often take the form of kickbacks.

The internal auditor should be alert to factors such as high expenses in a particular location, sole-source contracts and perform his audit procedures accordingly to detect acts that are against the interest of the entity.

6.68 To protect the entity from fraud and misconduct in business processes, vigilant observation of financial indicators and implementation of effective anti-fraud programs and controls help in reducing risk of fraud and protect company from financial and reputation damage. With potential risks and marked instances of fraud and theft, it is imperative for retail companies to take the following steps:

(i) Adopt robust internal controls backed by strong data analytics to mitigate key fraud risks and to raise red flags at early stages.

(ii) Devise a whistle blower policy allowing employees, customers and vendors to report malpractices directly to the management.

(iii) Determine policies pertaining to prevention, detection and investigation of frauds and to have action plans defined for conducting investigation if an incident occurs.

(iv) Set-up dedicated team, internal/ external,to handle stock checks at each of the stores periodically.

(v) Collate an end-to-end study of material movement from source to destination, including counter checks and cross tallying.

With rising challenges in the sector, the key to success is staying competitive without compromising on the quality of services. Cost effectiveness is necessary to achieve this, and an effective fraud risk management will help companies to identify potential leakage points and opportunities to save.

Risks Faced by a Retail Industry

6.69 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.

The internal auditor needs to verify whether sufficient controls are available in the entity to detect such risks and prevent its occurrence by including management to take appropriate steps in the light of overall business environment.

6.70 The risks faced by a retail industry can be broadly classified as following:

(i) Business risk

(ii) Political risk

(iii) Inventory management risk

(iv) Environment risk

(v) Brand/ reputation risk

(vi) Systemic risk

(vii) Technology and data security risk

(viii) Business continuation risk

Business Risk

6.71 Business risk comprises the following:

(i) A change in the product range based on customers changing preference needs.

(ii) A change in the legal environment that imposes new conditions, costs or restrictions upon the manner of providing the services, the means by which the services are delivered to the customer.

(iii) A change in the volume of transactions, either to:

(a) Increase (requiring additional hiring and perhaps a change in business process) or

(b) Decrease (resulting in sub-optimization of dedicated resources or re-allocation of resources).

(iv) Risks due to international operations.

(v) Unprecedented increase in the cost of real estate leading to increased cost of operations and strain on the profitability.

(vi) Increase in workers' compensation cost and retention of key employees.

(vii) Change in consumer confidence leading to significant locations in consumption of certain category products.

(viii) Risks on account of non-compliance with statutes.

(ix) Changing importance for locations might have a significant impact taking into consideration the initial investment required to be made at every location and higher rentals that might be paid for them in comparison to the others in the vicinity.

(x) Credit risks related to commercial business consumers.

(xi) Timely availability of information to enable decision making at the right time.

(xii) Increased competition from mass marketers and home improvement retailers.

(xiii) There is *mergers and acquisition risk* that an enterprise might change owners.

(xiv) Risks due to fraud and theft.

(xv) Risks due to acts of God such as earthquake, flood, wind storms, etc.

Political Risk

6.72 Political risk represents the degree to which social and governmental environments may change in the future. This risk may manifest itself in events over which a government has no control, such as, *riots or new elections*. Other events may be caused by a government, such as, *an embargo on imports or exports, increases in tariffs, new prohibitions on transactions with specific countries.*

In international outsourcing transactions, political risks need special attention due to the long-term nature of the relationship. There are a number of techniques that can mitigate, but not eliminate, such risks.

Further, the country makes policy for Foreign Direct Investment (FDIs) by a foreign entity in retail sector in India. This is subject to political risks and the policy viable to change which might have a significant impact on the operations and the business established in India. There might also be instances where additional duty is charged on certain products imported in India *e.g.*, *antidumping duty*. In such cases, the entity might not be able to reap the benefit of cheaper products for its customers. Moreover, the entity is affected by retail policies of the country from which the entity procures products e.g., if there is any quota for exports, it might have an impact on the prices of goods.

Inventory Management Risk

6.73 This might have a direct impact on the profitability of business. The entity's procedures with regard to mitigation of risks might be crucial to ensure business competency. The risks with regard to inventory management might include the following factors:

(i) Delay in receipt of products due to poor supply chain management/ supplier management. With the inter-connectedness and flow that has to come to make the chain work properly, the smallest disruptions can throw an organisation off course.

(ii) Inability to source products from the right source and at the right prices.

(iii) Inefficient inventory management system, wherein, the goods are not made available at the right time to the customers leading to poor branding and decline in customer loyalty.

(iv) Rapid obsolescence of inventory.

(v) Technological obsolescence of electronic products.

(vi) Shipping risks due to delicate nature of electronic products.

(vii) Improper handling of goods.

Environment Risks

6.74 Environmental risks associated with the retail industry, generally, fall into one of two categories:

(i) Site Acquisition, Development, and Construction

Considering that retailers buy and develop retail property, the retailers should develop an effective due diligence process, and manage environmental risk. The significant cost would be on account of following:

- *Cleanup Cost Cap* for "capping" the cost of cleaning up known pollution conditions.

- ***Pollution Legal Liability*** for transferring the risk of cleaning up unknown pre-existing pollution conditions, third party claims, and other related exposures.

- Loss of income due to ***delay in opening***/ scheduled completion of the project.

(ii) Store Operations

Environmental risks arising from retail store operations, generally, fall into one of two categories:

(i) *Nature of products/ services sold*— Retail operations that store and sell significant volumes of paints, solvents, chemicals, petroleum products, fertilizers, pesticides, automotive batteries, and similar products obviously have a higher degree of environmental risk.

(ii) *Store maintenance*— The risks associated with store maintenance are summarized in the table below:

Maintenance Activity	Exposure
Painting	Volatile organic vapors from paints and thinners & proper disposal of paint and/ or thinner-soaked rags and brushes.
Floor stripping	Volatile organic vapors from stripping compounds.
Renovations	Disturbing/ releasing asbestos or lead-based paint in older facilities.
Improper roofing	Growth of mold and release of mold spores.

Brand/ Reputation Risk

6.75 Enterprise viability depends on maintaining the goodwill of the enterprise brand. Damage to reputation might never be recovered, or might only be recovered at great expense and distraction. Reputational risk is significant in a retail industry.

6.76 Brand risk management techniques include the use of scripts, supervision, random audits, ongoing training and customer feedback. Legal issues in reputational risk can arise where the customer wishes to terminate a service provider, redirect its efforts or adjust the pricing to reflect a loss of goodwill.

Systemic Risk

6.77 Regulators and governments focus on the risks to the systems that support local and global economies. A systemic risk affects all participants in an economic sector or industry.

When planning any solution to the sourcing dilemma, executives and managers need to understand the nature of systemic risk and adopt appropriate risk planning strategies.

Technology and Data Security Risk

6.78 Technology risk refers to the risk that an entity faces due to change in technology or obsolescence of existing technology. In the event of change in technology, the investment made by the entity becomes futile. Technology could be in the form of purchase/ creation of software or hardware.

Data is subject to numerous and varied threats including following:

- **Insider theft** through unauthorized queries and file or report access.
- **Hacks** such as, SQL-injection, cross-site scripting, poisoning, and other OWASP listed attacks.
- **Physical theft** of servers and tapes.

Business Continuance Risk

6.79 The major risk which affect the business continuance would include improper supply chain management, damage of brand and significant changes in economic situations. The entity must be prepared to mitigate these risks and ensure successful carrying of business.

Risks Mitigation Techniques

6.80 An illustrative list of risks mitigation techniques that the management might opt for would include following:

(i) In the current environment, the entity should have complete knowledge about those risks and consider all pitfalls, understand the exposures, and develop risk management practices and programs that address this evolving exposure.

(ii) Prioritising the risks, creating a plan to strategically manage the risks, implementing the plan as necessary, and monitoring the plan's implementation for evaluation and improvement purposes.

(iii) Certain risks, such as, frauds, environmental damage might be reduced through visual inspections, carrying on surprise checks and verification, visual merchandising, just in time approach, etc.

(iv) It might be appropriate for the entity to have a comprehensive insurance policy to cover significant part of risks.

(v) Training of employees in inventory handling, especially in the case of managing open/ broken bags, containers, perishable and sensitive products.

(vi) Proper store maintenance procedure should be implemented.

(vii) A risks identification system would be required to be installed. The Management Information System should provide for certain yardsticks which would enable the management identify the critical risks and its impact on the entity.

(viii) Indemnity clauses with suppliers and external vendors would ensure that any loss arising due to suppliers and external vendors would be indemnified.

The internal auditor might be required to make a complete assessment of enterprise risks and provide an insight on methods of mitigation of risks. The internal auditor might prepare a questionnaire or a checklist for this purpose.

Mystery Audit

6.81 Mystery shopping is an objective view of a business through the eyes of a customer. A mystery shopper visits a business anonymously, posing as a regular customer, to experience and evaluate the level of customer service provided by the business. Mystery shopping provides management with a detailed assessment of employee performance and the variables that affect a customer's experience and satisfaction with the business.

It is a tool used by mystery shopping providers and market research companies to measure quality of retail service or gather specific information about products and services. Mystery shoppers posing as normal customers perform specific tasks such as, purchasing a product, asking questions, registering complaints or behaving in a certain way and then provide detailed reports or feedback about their experiences.

Tools used for mystery shopping assessments range from simple questionnaires to complete audio and video recordings. Mystery shopping can be used in any industry, with the most common venues being retail stores, hotels, movie theaters, restaurants, fast food chains, banks, gas stations, car dealerships, apartments, health clubs and health care facilities.

Methodology of Mystery Shopping

6.82 When a client company hires a company providing mystery shopping services, a survey model will be drawn up and agreed to which defines what information and improvement factors the client company wishes to measure. These are then drawn up into survey instruments and assignments that are allocated to shoppers registered with the mystery shopping company.

The details and information points shoppers take note of typically include the following:

- Number of employees in the store on entering.
- How long it takes before the mystery shopper is greeted.
- The name of the employees.
- Whether or not the greeting is friendly, ideally according to objective measures.
- The questions asked by the shopper to find a suitable product.
- The types of products shown.
- The sales arguments used by the employee.
- Whether or how the employee attempted to close the sale.
- Whether the employee suggested any add-on sales.
- Whether the employee invited the shopper to come back to the store.
- Cleanliness of store and store associates.
- Speed of service.
- Compliance with company standards relating to service, store appearance, and grooming/ presentation.

Shoppers are often given instructions or procedures to make the transaction, a typical to make the test of the knowledge and service skills of the employees more stringent or specific to a particular service issue (known as scenarios). For instance, mystery shoppers at a restaurant may pretend they are lactose-intolerant, or a clothing store mystery shopper could inquire about gift-wrapping services. Not all mystery shopping scenarios include a purchase.

While gathering information, shoppers usually blend in to the store being evaluated as regular shoppers. They may sometimes be required to take photographs or measurements, return purchases, or count the number of products, seats, people during the visit. A timer or a stopwatch may be required.

After the visit the shopper submits the data collected to the mystery shopping company, which reviews and analyzes the information, completing quantitative or qualitative statistical [analysis] reports on the data for the client company. This enables measurement against the previously defined criteria.

The internal auditor might be required to include the following into consideration for the performance of mystery audit:

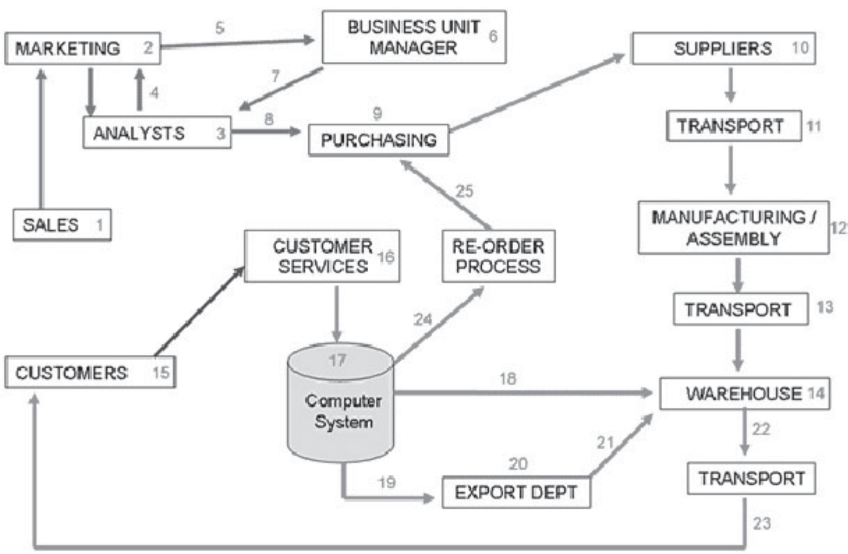
(i) The mystery audit program which details the periodicity, selection criteria, methodology of testing.

(ii) The scope of verification (such as, testing of management's efficiency of controls, implementation of entity's policies, behaviour and sensitivity of employees and their customer relations, control over inventory, and so on)

(iii) The reporting requirements by the internal auditor.

Appendix 1

A Comprehensive Supply Chain Management Process in a Retail Industry.



1. This flow chart shows a typical manufacturing supply chain work flow detailing which areas of the business are involved.

2. The sales department identifies a need for a product. The sales department tell the marketing department about their idea and provide any supporting information/ data.

3. The marketing department use business analysts to support the project and to complete the research.

4. Data and supporting evidence is passed back to the marketing department for completion of a business plan.

5. A fully detailed business plan is forwarded to the Business Unit Manager / Directors.
6. This unit comprises of the senior business directors or managers who make a decision on the project.
7. After approval the plan is passed back to the analysts to prepare and implement the manufacturing process.
8. Details of raw materials and components passed to purchasing.
9. Purchasing work with logistics and transport to plan the purchase and delivery of the materials to the manufacturing plant.
10. Suppliers receive orders for product and then despatch on agreed transport on agreed dates.
11. Carriers approved by the business transport the raw materials and components to the manufacturing site.
12. Products are received into the warehouse and then moved to manufacturing.
13. Finished products are moved from manufacturing to the finished goods warehouse which might be situated locally or in a remote location.
14. Finished goods are put into inventory awaiting orders. The company computer system is updated. Product is now available to sales.
15. Customers place orders through customer services.
16. Customer Services take orders and input them to the company computer system.
17. The central computer system maintains transaction records and provided visibility of product for sale.

18. An order is completed and a pick list sent to the warehouse.

19. A copy of the order is sent to the export department for completion of export documentation.

20. Export department manages the final despatch of the product and produces any export documents.

21. Documents are sent to the warehouse to meet up with the finished order.

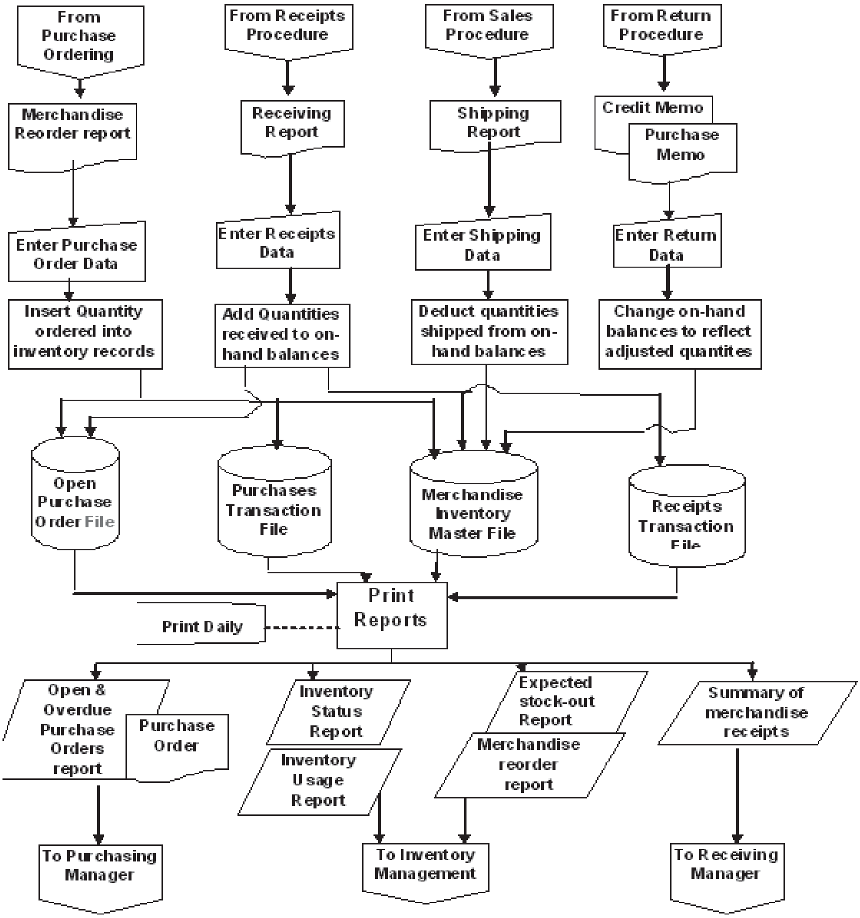
22. The order is despatched by the warehouse.

23. The transport company collects the consignment and delivers it to the customer based upon the terms of carriage.

24. As stock has now been used the computer system generates a request for new stock.

25. The re-order process generates a request to the purchasing department to place new orders with the suppliers.

A Comprehensive Inventory Management Flowchart:



Process Flow Description:

1. A retail company receives the merchandise reorder reports.

2. They take the data from those reports and key it into the computer to create a record (which is the basic process of taking data and converting it into information).

3. They then take each record and store it into different files.

4. Retail entity receives receiving report.

5. They then input the data from the report into the computer.

6. That data is then converted into information in the form of records.

7. The records are then stored into different files (one of which adds to inventory on-hand balances).

8. Retail entity receives shipping report from the sales department.

9. They then take the data from the report and input it into the computer to create information in the form of records.

10. They then take the individual records and store them into separate files (which in turn deducts from the inventory on-hand balances).

11. Retail entity received credit and purchase/ debit memo.

12. Return data is keyed into the computer.

13. That data is then converted into information in the form of records.

14. These records are then stored into different files that will update/ change on-hand balances to reflect the adjusted quantities

15. The Open Purchase Order File, Purchase Transaction File and Merchandise Inventory Master File (a permanent file) are updated when the quantity ordered are inserted into inventory records.

16. The Open Purchase Order File, Merchandise Inventory Master File and Receipts Transaction File are updated after the quantities received have been added to on-hand balances.

17. Only the Merchandise Inventory Master file is updated after the shipped quantities have been deducted from oh-hand balances.

18. Lastly, only the Merchandise Inventory Master File is updated after the changes on the on-hand balances are made to reflect the adjusted quantities.

19. Once all the information is stored and the files are updated, reports are printed (daily).

20. The Open and Overdue Purchase Orders Reports and the Purchase Order document are sent to the Purchasing Manager.

21. The Receiving Manager receives the Summary of merchandise receipts – A report which summarizes all receipts for the day.

Reporting in this model case:

Inventory Management receives 4 different reports:

- *Inventory Status Report* – A report that shows where you stand on your inventory. (how much inventory you have on hand)
- *Inventory Usage Report* - How much inventory is being used at the current output level.
- *Expected Stock-out Report* – How much and what inventory you expect to be sold out
- *Merchandise Reorder Report* – A report that shows what inventory needs to be reordered

Appendix 2

List of Organisations, On Line resources and other sources

1	Electronic Retailing Association	http://www.retailing.org
2	National Retail Federation	http://www.nrf.com/
3	International Mass Retail Association	http://www.imra.org
4	National Association of Chain Drug Stores	http://www.nacds.org
5	Association for convenience and petrol retailing	http://www.nacsonline.com
6	National Grocers Association	http://www.nationalgrocers.org