17.1 Audit of Members of Stock Exchanges

A stock exchange is an organized market for the purchase and sale of listed industrial and financial securities. The securities dealt in at a stock exchange include the shares and debentures of public limited companies, Government securities, and bonds and securities issued by the municipal bodies and port trusts, etc. The Securities Contracts (Regulation) Act, 1956 defines a stock exchange as, “an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities.”

The Securities and Exchange Board of India Act was passed by the Parliament and assented to by the President of India in 1992. The powers vested in SEBI under the SEBI Act, 1992 include powers under the Securities Contracts (Regulation) Act like powers to call for periodic and annual returns from stock exchanges, licensing of dealers in securities, amendment to the rules and bye-laws of stock exchanges, etc. The SEBI has wide powers under the Act and the Rules to ensure proper conduct of affairs of the stock exchanges by giving suitable directions, however, the Securities Contracts (Regulation) Act, was promulgated only in 1956. The Securities Contracts (Regulation) Rules were framed thereunder in 1957. The Government has wide powers under the Act and the Rules to ensure proper conduct of affairs of the stock exchanges by giving suitable directions.

17.2 Functioning of Stock Exchanges

It is important for auditor to understand adequate knowledge about important aspects of functioning of stock exchanges and the manner in which the transactions are entered into by the members of stock exchanges.

17.2.1 Regulation of Stock Exchanges

The Securities and Exchange Board of India (SEBI) is the apex, statutory regulatory body for the securities market with the express mandate of investor protection and development and regulation of market under SEBI Act, 1992. Apart from SEBI, Securities Contracts (Regulation) Act, 1956 which provides for regulation of transactions in securities through control over stock exchanges, Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities, Public Debt Act, 1942, Companies Act, 2013, Banking Regulation Act, 1949 and Income Tax Act, 1961 also have a substantial bearing on the working of the securities market.
17.2 Advanced Auditing and Professional Ethics

17.2.2 Securities and Exchange Board of India

SEBI is a body corporate having perpetual succession. It has been given quite wide powers for the achievement of the objectives of the SEBI Act, 1992. SEBI’s main function is to regulate the business in securities market. SEBI, for the purposes of regulation of securities market, can issue directions to stock exchanges, companies, stock brokers or to any other person. SEBI Act, 1992 empowers SEBI to levy monetary fines and penalties on any person incurring a default under the Act in the following cases:

- failure to furnish any document, information, books, other documents, return or report called for by the Board;
- failure to maintain books of accounts and records;
- failure by an intermediary to enter into an agreement with his client, redress the grievances of investors;
- failure by a person sponsoring or carrying on any collective investment scheme, including mutual funds, without obtaining certificate of registration;
- failure by a stock broker to issue contract notes in the form and manner specified by the stock exchange, failure to deliver any security or failure to make payment of the amount due to the investor, charging of excess brokerage;
- any person dealing, communicating, counselling on the basis of some price sensitive information;
- failure by a person to disclose the aggregate of his shareholding in a body corporate before he acquires any shares of that body corporate and failure to make a public announcement to acquire shares at a minimum price in case of takeovers.

SEBI also has the power to suspend or cancel the certificate of registration of a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market. This includes depository, depository participant, custodian of securities, foreign institutional investor and credit rating agency also.

The Securities Contract (Regulation) Act, 1956 empowers any recognised stock exchange may, subject to the previous approval of the Securities and Exchange Board of India, make bye-laws for the regulation and control of contracts.

It may be noted that since SEBI is the regulator of the securities market, the Securities Contract (Regulation) Act, 1956, through section 10, empowers SEBI to make or amend the byelaws of stock exchanges.

17.2.3 Governing Body

The Governing Body of a stock exchange can comprise of elected representatives of the members of stock exchange, nominated public representatives and/or professional directors. The Governing Body has powers, subject to SEBI approval, to make, amend and suspend the
operation of the Rules, Bye-laws and Regulations of the stock exchange besides having jurisdiction over all its members. The Governing Body is specially empowered to admit or expel members and their subordinates.

17.2.4 Membership

Business at a stock exchange, can only be transacted by a member of the stock exchange. A member of NSE cannot transact business at BSE unless he is a member of BSE also. The members of stock exchanges are also called stock or share brokers. The members enter into transactions either on their own behalf or on account of their clients, including sub-brokers. There are several ways of placing an order with a member. It could be either directly or indirectly through a sub-broker. Since the stock exchange operations involve considerable financial commitments on the part of its members, its membership is restricted to persons who are financially sound and possess adequate experience. The Securities Contracts (Regulation) Act, 1956, the SEBI Act, 1992 and various rules, regulations, notifications, etc., lay down the requirements for becoming a member of a stock exchange. Each stock exchange has its own SEBI approved rules and regulations regarding the admission of members. A stock exchange can have membership in multiple trading segments such as Capital Market Segment, Wholesale Debt Market Segment and Derivatives Segment. The deposit / fee structure applicable to a member depends on the trading segments in which the member is admitted.

17.2.5 Classification of Securities Traded

A security (in common parlance also known as scrip) which is allowed to be traded on any Exchange can either be listed with the Exchange or be permitted to be traded without being listed on the Exchange. A listed company is bound by the listing agreement with the exchange. The listed companies have to pay the listing fees as prescribed by the Securities and Exchange Board of India to the Exchange. However, in case of permitted securities, listing fees is not payable to the Exchange.

17.2.6 Margins

There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interests of the investors, members are required to keep certain deposits with the stock exchange authorities. These deposits are termed ‘margins’. The members are required to collect the margin from their clients, wherever applicable, and deposit the amount collected with the Clearing House. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays in paying the amount or is unable to meet his commitments. Margins also help prevent excessive speculation as clients would be required to invest some funds and not indulge in speculation without adequate resources. A member is required to pay or deposit different margins such as Gross Exposure Margin, Mark to Market (MTM) Margin, Volatility Margin (VM), Additional Volatility Margin (AVM), Special Margin and Ad-hoc Margin. The members are required to compute margin payable for all securities traded by them and make the margin payments on the due date to the Stock Exchange authorities. Different types of margins are payable at stipulated time, as decided by the Exchange or Clearing House of the Exchange.
Three types of margins, viz., Mark-to-Market Margin, Volatility Margin and Gross Exposure Margins have been explained in the following paragraphs.

(i) **Mark to Market Margin:** MTM margin is the notional loss, which a member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client’s level.

(ii) **Volatility Margin:** Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

(iii) **Gross Exposure Margin:** Gross exposure margin is computed on the aggregate of the net cumulative outstanding positions (purchases or sales) in each security. Each Exchange determines its own rates of Gross Exposure Margin and Additional Volatility Margin based on its own risk perception of the market and other risk containment measures such as deposits and collaterals in its possession.

A Stock Exchange may also collect the following margins -

(i) **Special Margin** in securities where price manipulation is suspected.

(ii) **Adhoc Margin** where it is felt that the margin cover vis-à-vis the exposure of the member is inadequate or a member has a concentrated position in some securities or has common clients along with other members.

**17.2.7 Trading System**

As stated earlier, a member can transact business at a stock exchange either on his own behalf or on behalf of his clients / sub-broker. Thus, a non-member can purchase or sell shares and other securities only through member or through their authorised and registered sub-broker. The relationship between the client and the member is of a fiduciary nature. When, therefore, the member receives securities from his client for sale, he is obliged to sell the securities as per instructions and to remit the sale proceeds thereof, after deducting brokerage and other related expenses, to his client. Similarly, when on member buys securities for his client, he has to ensure that the shares/securities so purchased are delivered to the client after he has received from the client the payment for the same which includes the
brokerage and other incidental expenses in connection therewith. Thus, a member acts as a custodian and handles the securities of his clients on their behalf. Therefore, the member must ensure that he has received payment from other stock brokers for the securities sold on behalf of his clients. The procedures followed by various Stock Exchanges in the purchase and sale of securities vary. In order to provide a basic understanding of trading on Stock Exchanges, trading systems at National Stock Exchange and the Stock Exchange, Mumbai have been discussed in this Chapter.

17.2.8 Trading on the National Stock Exchange

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully computerised screen-based trading system. It enables members from across the country to trade simultaneously with enormous ease and efficiency by keying the order into the system. A single consolidated order book for each stock displays, on a real time basis, buy and sell orders originating from all over the country. The orders are executed only if the price-quantity conditions match.

17.2.9 Types of Market

The NEAT system has four main types of market. They are-

- **Normal Market**: All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

- **Odd Lot Market**: An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

- **Spot Market**: Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

- **Auction Market**: In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.
17.6 Advanced Auditing and Professional Ethics

17.2.10 Order Books

The NSE trading system provides flexibility to members in the kind of orders that can be placed by them. Orders are first numbered and time-stamped on receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different ‘books’ in price-time priority in the following sequence:

- Best Price
- Within Price, by time priority.

Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered, the order that is entered first gets the higher priority.

The capital market segment has following types of books:

**Regular Lot Book** - The Regular Lot Book contains all regular lot orders that have none of the following attributes or conditions attached to them:

- All or None (AON)
- Minimum Fill (MF)
- Stop Loss (SL)

**Special Terms Book** - The special terms book contains all orders that have either of the following attributes or conditions attached:

- All or None (AON)
- Minimum Fill (MF)

**Stop-Loss Book** - Stop loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the regular lot book. The stop loss condition is met under the following circumstances:

- Sell Order - A sell order in the ‘stop loss book’ gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.
- Buy Order - A buy order in the ‘stop loss book’ gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

**Odd Lot Book** - The odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders that have quantity less than or equal to 500 (Quantity more than the market lot) for trading. This is referred as the Limited Physical Market (LPM).

* Conditions are explained later in the Chapter.
Spot Book - The Spot Lot Book contains all spot orders (orders having only the settlement period different) in the system. The system attempts to match an active spot lot order against the passive orders in the book.

Auction Book - This book contains orders that are entered for all auctions.

17.2.11 Trading on The Stock Exchange, Mumbai (BSE)

The Exchange, which hitherto, had an open outcry trading system, switched over to a fully automated computerised mode of trading known as BOLT (BSE On Line Trading) System. It facilitates more efficient processing, automatic order matching and faster execution of trades. Above all, the system is more transparent for investors, while allowing members to keep their clients’ positions confidential as compared to the earlier regime where the counterparty was always known. The members now enter orders/quotes on the Trader Work Stations (TWSs) in their offices instead of assembling in the trading ring. The trading system of The Stock Exchange, Mumbai also provides more or less the same features as those provided by the trading system of the National Stock Exchange.

17.2.12 Depositories and Dematerialisation

The entire transaction of purchase or sale of securities can be said to be completed only after the buyer becomes the rightful owner of the securities and the seller gets the sale consideration. Traditional settlement system on the Indian stock markets gave rise to settlement risk due to the time that lapsed before trades were settled. Further, transfer of securities involved sending the same along with sellers’ endorsement on transfer deed for registration to the issuer. In many cases, the process took much longer than two months and significant proportion of transactions ended up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant and in addition to the issuers right to refuse the transfer of security. To obviate these problems, the Depositories Act, 1996 was enacted to provide for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:

(a) making securities of public limited companies freely transferable subject to certain exceptions;
(b) dematerialising the securities in the depository mode; and
(c) providing for maintenance of ownership records in book entry form.

In order to streamline both the stages of settlement process, the Depositories Act, 1996 envisaged transfer of ownership of securities electronically by book entry without making the securities moving from person to person. The Act made the securities of public limited companies freely transferable by restricting the company’s right to use discretion in effecting the transfer of securities, thus, dispensing with the transfer deed and other procedural requirements under the Companies Act.

In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done...
through simple account transfers.

**Advantages of Depository Services -**

(i) High liquidity of scrips due to immediate transfer and registration.
(ii) Receive bonus and right as direct credit to the account thereby eliminating the risk of loss in transit.
(iii) Much lower risk of bad deliveries.
(iv) Reduction in brokerage.
(v) Saving of stamp duty worth 1% of transaction price.
(vi) Saving of courier, notary charges.
(vii) Saving of expenses to be incurred on obtaining duplicate certificates as no threat of original shares getting mutilated or misplaced.

**17.2.13 Depositories in India**

National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) provide depository services to investors and clearing members through Depository Participants (DPs). They do not charge the investors and clearing members directly but charge their DPs, who are free to have their own charge structure for their clients. The charges for the investors are, therefore, market determined.

**17.2.14 Clearing and Settlement Mechanism**

When a trade has been executed, the shares and money should be transferred to the respective parties on settlement date. When an investor enters into a transaction with a broker, shares or funds, as the case may be, are delivered to the broker. In turn, the broker delivers these on settlement day to the settlement agent. In BSE, the settlement agent is known as ‘Clearing House (CH)’ whereas in NSE it is ‘National Securities Clearing Corporation Ltd. (NSCCL)’.

Settlement of trades transacted on an Exchange requires smooth, preferably instantaneous, movement of securities and funds in accordance with the prescribed schedule of pay-in/pay-out. Movement of securities has become almost instantaneous in the dematerialised environment. Two depositories, namely, National Securities Depository Limited and Central Depository Services Limited, are in place to provide electronic transfer of securities. All actively traded scrips are held, traded and settled in demat form. The securities pay-in obligations of members / custodians are downloaded by the clearing agency. The members / custodians make available the required securities in their pool accounts with Depository Participants (DPs) by the prescribed pay-in time for securities. The depository runs an electronic file to transfer the securities from the pool accounts of members / custodians with DPs to the DP account of the clearing agency. As per the allocation schedule determined by the clearing agency, the securities are transferred on the pay-out day by the depository from the DP account of the clearing agency to the DP accounts of members / custodians. In case of trades settled under account period settlement, the pay-out of securities are effected on the same day in case of trades settled under rolling settlement. The ownership vests with the buyer as soon as the securities move from DP account of the member /
custodian to his DP account.

SEBI has directed that the brokers can issue contract notes authenticated by means of digital signatures, provided the broker has obtained the digital signature certificate from Certifying Authority under the IT Act, 2000.

Select banks have been empanelled by clearing agency for electronic transfer of funds. The members are required to maintain accounts with any of these banks. The members are informed electronically of their pay-in obligations of funds. The members make available required funds in their accounts with clearing banks by prescribed pay-in day.

The securities can move instantaneously from the seller to seller’s broker to clearing agency to buyer’s broker to buyer since all these have accounts with either of the two depositories which are connected to most of the Stock Exchanges. The depositories have been obligated under the Depositories Act, 1996 to transfer securities electronically.

**17.2.15 Disclosure of Proprietary Trading by Broker to Client**

With a view to increase the transparency in the dealings between the broker and the client, SEBI has directed that every broker shall disclose to his client whether he does client based business or proprietary trading as well. The broker shall disclose this information to his existing clients within a period of one month from the date of this circular. Further, the broker shall disclose this information upfront to his new clients at the time of entering into the Know Your Client agreement. In case of a broker who at present does not trade on proprietary account, chooses to do so at a later date, he shall be required to disclose this to his clients before carrying out any proprietary trading.

**17.3 Rolling Settlement**

A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within “X” business days from the transaction date. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis (T+2). The transactions in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis, i.e., both pay-in and pay-out of monies and securities for transactions in scrips on transaction day (T day) would take place on the day after immediately following day.

However, transactions in ‘Z’ group securities are settled only on trade to trade basis on T+2, i.e., the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under ‘Z’ group. In other words, if an investor buys and sells X no. of shares on the same day then he shall first have to actually deliver and then receive the securities on the settlement day.
Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips with effect from July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further, the mark-to-market differences are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the Exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the Exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

♦ Highest price recorded in the scrip from the settlement in which the transaction took place up to a day prior to the auction.

OR

♦ 20% above the closing price on a day prior to the auction.

In this case, the auction price/close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/close out price is less than sale price, the difference is not given to the seller but is credited to Investor Protection Fund.

17.4 Derivatives

Derivative is a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset.

17.4.1 Derivatives Market at NSE

The derivatives trading on the NSE commenced with S&P CNX Nifty Index futures on 12th June, 2000. The futures contract on NSE is based on S&P CNX Nifty Index. Currently, it has a maximum of 3 month expiration cycle. Three contracts are available for trading, with 1 month, 2 months and 3 months expiry. A new contract is introduced on the next trading day following the expiry of the near month contract.

The Futures and Options trading system of NSE called NEAT-F&O trading system, provides fully automated screen based trading for S&P CNX Nifty futures on a nationwide basis and an online monitoring and surveillance mechanism. The NEAT-F&O trading system is accessed by two types of users. The Trading Members (TM) have access to functions such as, order entry, order matching, order and trading management. The Clearing Members (CM) uses the trader workstation for the purpose of monitoring the trading members for whom they clear the trades. Additionally, they can enter and set limits to positions, which a trading member can take.
There are Two Types of Clearing Members

♦ Trading Member Clearing Member (TM-CM) is a CM who is also a TM. TM-CM may clear and settle his own proprietary trades and clients’ trades as well as clear and settle for other TMs.

♦ Professional Clearing Members (PCM) is a CM who is not a TM. Typically banks and custodians could become a PCM and clear and settle for TMs.

Nifty index futures contracts are cash settled on a daily basis by marking to market all open positions on the basis of the daily settlement prices. Members are required to pay the mark to market losses by T+1 day and the same is in turn paid to the members who have made a profit. The contracts are finally settled on expiry of Nifty index futures contract, when NSCCL marks the open positions of a CM to the closing price of underlying index and resulting profit / loss is settled in cash.

For settlement purposes, the daily settlement price is the closing price of futures contract. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of NSE.

17.4.2 Derivative Trading at BSE

The derivatives trading on the BSE commenced with BSE Sensitive Index futures on 9th June, 2000. The futures contract on BSE is based on BSE Sensitive Index (Sensex). The trading and settlement mechanism is more or less on the same lines as in NSE. However, for settlement purposes, the daily settlement price is calculated as the weighted average price of trades during the day. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of BSE.

17.5 Circuit Filters or Circuit Breakers

Circuit Breakers or circuit filters are the price bonds that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading day's closing. SEBI has directed the exchanges to apply circuit filters on scrips traded in Rolling Settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However, feeling the threat of high settlement default in scrips forming part of sensex or in which derivatives and futures are available, because of these filters, SEBI has restricted the fluctuation to 10% instead of 20%.

Price bands restrict extreme price movements and thereby resist price manipulation. These protect investors from extreme fluctuations in a panic market created by rumours and short term fears.

Market Wide Circuit Breakers (MWCB) - Market wide circuit breakers do the same job for the entire market what circuit filters do for individual scrips. MWCB has been introduced to control excessive market movements in BSE sensex and Nifty. SEBI has introduced MWCB at 10-15-20% of the movements in these indices. The stock exchange on a daily basis shall translate the 10%, 15% and 20% circuit breaker limits of market-wide index variation based on the previous day's closing level of the index. These breakers provide the time to participants to
react to the movement by way of the trading halt. Additionally, a 15 minutes pre-opening session post each trading halt has been introduced vide SEBI Circular dated September 3, 2013. The auditor need to ensure the compliance of the trigger limit, trigger time, halt duration and pre-opening session duration post each halt.

17.6 Accounting for Stock Exchange Transactions

A trading member is required to keep proper records and accounts for securities and monies receivable from and payable / transferable to both his clients as well as the Stock Exchange. The trading member is firstly required to enter the order into an Electronic Order Entry Book which then transfers the order to the Stock Exchange's trading system. As soon as the same is matched by a corresponding order by another trading member, the trade is said to be confirmed. A trading member is then required to pay margins (Mark-to-Market, Volatility, Gross Exposure) which are required to be collected from respective clients, wherever applicable. Since it is not feasible to collect margins from a client on a frequent basis, the trading member, generally, collects sufficient margin against each transaction at the point of execution of transaction. This margin is finally adjusted against outstandings in case of settlement of buy positions. If the client fails to pay for the securities purchased, the margin is used to take delivery and subsequently adjust the loss incurred in squaring off the transaction. In case of execution of sale order, the entire margin is refunded back along with the sale value of securities (net of brokerage and other costs) after the funds pay-out is received for securities delivered by the client. In case, the client fails to deliver the securities, the securities are required to be bought by the selling trading member to deliver to the buying trading member through auction. The margin is then used to adjust the loss on account of the difference between the buying price in auction and the price at which the security was original sold.

No entry is required to be passed by the trading member at the time of entering the order in Order Entry Book. Again on execution of trade, no entry is required to be passed in the books of accounts. All the transactions of each client are cumulated for an entire settlement before passing the entries in the ledger. However, it may be possible that a client may have made only one transaction in a given settlement.

Presuming that the client Mr. A (Client Code A0001) is the only client of the member for Rolling Settlement No. 200102151 and has done the following transactions in the said settlement -

<table>
<thead>
<tr>
<th>Bought / Sold</th>
<th>Qty</th>
<th>Scrip Name</th>
<th>Transaction Rate (₹)</th>
<th>Brokerage @ 1% (say) (₹)</th>
<th>Effective Rate (₹)</th>
<th>Total Value (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bought</td>
<td>10</td>
<td>Infosys Technologies</td>
<td>3,000</td>
<td>30</td>
<td>3,030</td>
<td>30,300</td>
</tr>
<tr>
<td>Bought</td>
<td>100</td>
<td>TISCO</td>
<td>100</td>
<td>1</td>
<td>101</td>
<td>10,100</td>
</tr>
<tr>
<td>Sold</td>
<td>100</td>
<td>Reliance Industries</td>
<td>300</td>
<td>3</td>
<td>297</td>
<td>-29,700</td>
</tr>
</tbody>
</table>
In the above case, it may be noted that the client has to pay \( ₹ 10,700/- \) to the trading member. The trading member earns a brokerage of \( ₹ 700/- \) (i.e. \( 10 \times 30 + 100 \times 1 + 100 \times 3 \)) and is required to pay \( ₹ 10,000/- \) (\( 10 \times 3000 + 100 \times 100 - 100 \times 300 \)) to the Clearing Corporation/Clearing House towards his outstanding position for the settlement. The trading member would also have to add 5% as service tax on brokerage earned amounting to \( ₹ 35/- \) on the net settlement position which is required to be paid to the Service Tax authorities.

It may be noted that the gross value of transactions done in the abovementioned example is \( ₹ 70,000/- \) (i.e. \( 10 \times 3000 + 100 \times 100 + 100 \times 300 \)). Considering the margin requirement @ 10% on gross value of transactions done, the trading member may collect \( ₹ 7,000/- \) from the client and for onward remittance to the Clearing Corporation / Clearing House.

In case, the client is unable to deliver the securities sold on the securities pay-in date, the same are auctioned by the Exchange (Auction Settlement Type A). This means that the Exchange allows any other Trading Member or his Client (through the Trading Member) bid for delivering the same. The client who has not been able to deliver the securities is required to treat the same as a buy order in his behalf and is bound to pay for the same.

Thus, if Mr. A (through his Trading Member) was unable to deliver 100 shares of Reliance Industries Ltd. on or before the pay-in day for securities and these shares were auctioned at a rate of \( ₹ 320 \) each, a fresh purchase entry would be passed in the books while no effect would be given to the original sales.

In case there are no bidders for selling the securities in an auction settlement for a particular auction scrip and quantity, then the original sale is closed out by squaring as per the rules of the Exchange. The entries nevertheless remain the same.

In case any amount is charged by the Exchange or clearing house towards any pay-in or pay-out defaults, the same is debited and collected from the client to the extent attributable to default committed by the client. The Member is also liable to pay transaction charges and various other charges, fines, interest, etc. to the Exchange or Clearing Corporation / Clearing House which along with other expenses are directly debited to the profit & loss account through respective expense accounts.

**17.7 Conduct of Audit**

As stated earlier, in exercise of the powers vested in the Central Government under Rule 12 of the Securities Contracts (Regulation) Rules, 1957, the Government issued a notification dated 29th January, 1983 requiring the accounts of active members of stock exchanges to be audited by chartered accountants. The audit comes into effect from the financial year commencing after 31st March, 1984 as per the Notification dated 11th January, 1984. Thus, accounts of members in respect of the financial years beginning on and after 1st April, 1984 are required to be audited by chartered accountants. Subsequent to the corporatisation of the Members of Stock Exchanges, statutory audit is now required under the Companies Act.

**17.7.1 The Nature and Scope of the Audit**

It has been clarified by the Government, vide its letter dated 31st May, 1984, that a member of
the stock exchange, irrespective of the size of his business, would be considered ‘active’ for the purpose of audit if he has conducted business in securities even for a single day in the accounting year. The same letter also clarifies that the annual audit of accounts of a member of a stock exchange will be of the nature of the normal audit, as is conducted in the case of companies, co-operative societies and other entities. It will also hold good for the audits governed under the Companies Act.

Rule 12 of the Securities Contracts (Regulation) Rules, 1957 provides that “Every member shall get his accounts audited by a chartered accountant whenever such audit is required by the Securities and Exchange Board of India”.

A sole proprietor, partnership firm, a corporate body and a financial institution also become members of the stock exchanges. Such members may get their financial statements audited under the statute governing them. For example, a company which is a member of a stock exchange would get its accounts audited under the provisions of the Companies Act, 2013. The members of stock exchanges may also get their accounts audited under the Income Tax Act, 1961.

17.7.2 The Books of Account and Other Documents subject to the Audit

According to the notification, audit is intended to cover the books of account and other documents specified under Securities Contracts (Regulation) Rules, 1957 and SEBI (Stock Brokers and Sub-Brokers) Rules, 1992. The members of the Exchange are required to maintain the following books of accounts and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

♦ Register of Transactions (Sauda Book) / Daily Transaction List
♦ Clients Ledger
♦ General Ledger
♦ Journals
♦ Cash Book
♦ Bank Pass Book
♦ Documents Register/Inward-Outward Register showing full particulars of shares and securities received and delivered
♦ Members’ contract book showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other member
♦ Counterfoils or duplicates of contract notes issued to clients
♦ Written consent of clients in respect of contracts entered into as principals
♦ Margin Deposit Book
♦ Register of accounts of sub-brokers
An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock-broker and such sub-brokers

An agreement with the sub-broker and with the client of the sub-broker to establish privity of contract between the stock broker and the client of the sub-broker.

In addition to the above statutory requirements, the Exchange as per its rules, regulations and bye-laws, may also require their Members to maintain the following records / documents:

- Copies of all margin statements downloaded from the Exchange.
- Copies of Settlement / Valan Balance Sheet along with all relevant sheets.
- Details of Spot Delivery transactions entered into (including securities delivered and payments made to the members)
- Client database & Broker Client Agreement.
- Copy of Registration Certificate of each Sub-broker issued by SEBI.
- Copy of approval for each Remisier given by the Exchange.
- Copy of the Power of Attorney/Board Resolution authorizing Directors/employees to sign the Contract Note.
- Copies of Pool Account Statements.

If a member of the Stock Exchange also holds’ membership of any other recognized Stock Exchange or in a different segment of the same Exchange, (e.g., Derivatives Segment) then such member is required to maintain a separate set of books of accounts, records and documents for trades executed on each recognized stock exchange or each segment of the exchange. The auditor should verify whether the member is maintaining all the above books, documents, etc. and they are up to date.

Considering the extent of computerisation at the level of Stock Exchange as well as at member’s end, an auditor may determine the extent and depth of verification of the audit. For this, the auditor needs to study and understand the various manual and computerised accounting processes employed by the Member and various controls and checks embodied therein. On the basis of same and the materiality thereof, the auditor may decide his audit procedures, extent of checking required and exercise his diligence for the purpose of reporting. Some of the important books of accounts, documents and relevant auditing procedures / tests are discussed below.

**17.7.3 Daily Transactions List (Sauda Book) / Register of Transactions**

All members are required to maintain a ‘Sauda Book’, which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained datewise. This register contains all the transactions, which may be of any of the kind mentioned below:

- member's own business on the Exchange
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♦ member’s business on the Exchange on behalf of clients
♦ member’s business with the clients on principal-to-principal basis
♦ member’s business with the members of other Stock Exchanges
♦ member’s business on behalf of his clients with the members of other Stock Exchanges
♦ Spot transactions, etc.

17.7.4 Contract Notes

Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The contract notes are required to be issued to the Client within 24 hours of execution of the trades. Members are also required to preserve counter-foils or duplicates of the copies of contract notes issued to clients. The member is also required to maintain written consent of clients for the contracts entered into as Principal. Contract notes issued to clients should show the brokerage separately. The total brokerage charged by the member should not exceed the specified value of the trade. It may be noted that the brokerage percentage is prescribed from time to time. The Contract Notes are required to be signed either by the member himself or his constituted attorney. In case of a sole proprietor / partnership firm wishes to authorise another person to sign the contract notes, then the member is required to submit a power of attorney to the Exchange. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

The member then prepares a Contract Note in the prescribed form after adding the brokerage and sends the original Contract Note to the client. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that -

♦ Contract notes have been serially numbered.
♦ No serial number has been left blank.
♦ Format of the Contract Note is as prescribed by the Regulations of the Exchange.
♦ Duplicate copies / counterfoils of contract notes are maintained.
♦ Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.
♦ Contract notes have been signed by an authorised person.
♦ Contract notes have been issued in respect of all transactions.
♦ Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.
♦ SEBI Registration number, Settlement number, Settlement dates have been mentioned.
♦ PAN number of the member and client has been mentioned on Contract Note where if required.
♦ All clauses specified by the Exchange have been printed on the reverse of the contract notes.

17.7.5 Service Tax

Service Tax on a member of a stock exchange had been introduced by the Government in union-budget 1994-95. Service tax is levied on the value of taxable services which shall be the gross amount changed by the service provider of such service provided or to be provided by him at the rate prescribed from time to time by the Government Taxable Service has been defined u/s 65(105)(a) of the Act as any service provided to any person by a stock broker in connection with the sale or purchase of securities listed on a recognized stock exchange services provided by sub-brokers has also been brought into tax net by Finance (No.2) Act, 2004 w.e.f. 10.09.2004.

17.7.6 Security Transaction Tax (STT)

In the Union Budget for 2004-05, Government has introduced Securities Transaction Tax to be levied on all transactions done on stock exchange. As per the provisions of the Finance Bill, the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India. SEBI vide its Circular No.MRD/DOP/Cir-28/2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy collection and remittance of STT.

17.7.7 Client Bills

Client Bills represents the summary of all trades executed on behalf of the client during a particular settlement. It also reflects the net amount receivable or payable to the Member from / to the client. This amount is normally posted to the individual ledger account. The auditor may call for the bills for verification and check whether the same have been properly posted to client’s ledger.

17.7.8 Clients Ledger

Every broker is required to maintain a clients’ ledger. This ledger contains the details of the bills raised and the payment received from or made to the clients. As mentioned earlier, Client Ledger is required to be maintained separately for different Exchange or for different Trading Segment of the same Exchange. It may be noted that SEBI Rules provides that payment is to be made to the client within 24 hours of pay-out by the Exchange. He should further verify that the clients receipts / payments are made through designated “Client Bank Account” of the Member. It may be mentioned here that payments not made or received since a considerable period or the amount of payment made or received is consistently different for bills raised over a period of time in respect of some clients. These may represent some financial or accounting irregularity which would require further attention of the Auditor. The auditor may also scrutinise
the client ledger to identify accounts whether loans or deposits received from a paid to the clients have been passed through this account. The client may also obtain from member clients the letters confirming their balances at the end of the financial year as appearing in his books of account on a test basis. Preferably, such letters of confirmation should be sent to the clients directly by the auditor. The auditor should carry out scrutiny of the accounts appearing in the Clients’ Ledger with a view to ascertain the age of clients’ accounts and in case of old debit balances for determining provision for bad and doubtful debts.

17.7.9 Settlement / Vallan Control Account

At the end of the settlement, Client Bills are posted to Client Ledger account as mentioned above. At the same time the net amount receivable from or payable to the Exchange, Clearing house is posted to the Settlement / Vallan Control Account. The payment made to / received from Clearing House for a particular settlement should match with the pay-in / pay-out entries. The auditor should verify that the balance in this account after his settlement should ideally be nil and in case of any balance in this account, the reconciliation statement from the member should be obtained.

17.7.10 Clearing House Bank Account

At the end of the settlement, the payment related to the pay-in or pay-out is routed through the Clearing House account. This account normally reflects the bank entries which are passed in the Clearing Bank account. The book balance in this account should be reconciled with the balance in Clearing Bank account as per bank statement.

17.7.11 Brokerage Account

At the end of the each settlement, brokerage income is credited to brokerage account appearing in general ledger. The auditor should verify whether brokerage is credited for each settlement or not, failing which the reasons thereof can be inquired into. The brokerage amount should be periodically reconciled with the amount on which the service tax has been paid as disclosed in service tax return. Since brokerage is the main source of income for members of stock exchanges, the auditor should pay particular attention to revenue recognition aspect. Brokerage income is recognised as income on the basis of principles laid down in Accounting Standard (AS) 9, Revenue Recognition.

17.7.12 Margin Deposit Book

A member is required to maintain a margin deposit book wherein details of all the margins deposited with the Clearing House are to be recorded. The book should be verified to ascertain whether the member has complied with all the directives regarding margins, etc. issued by SEBI or Stock Exchange from time to time. The margin payments made by the member may be cross-checked with the daily margin statements downloaded from the Stock Exchange.

The auditor should apply appropriate audit procedures to satisfy himself that margins have been properly calculated, collected and paid. The auditor should examine that margin deposit lying with the Clearing House are supported by the confirmation. The auditor should verify
whether adjustment entries relating to settlement margin and daily margin which is adjusted at the time of settlement are correctly passed or not. The auditor should also ensure that exemptions from payment of margins of Institutional Trades have been claimed correctly.

17.7.13 Members' Own Trading Account

Many a times, member of the Exchange executes the trade on his own behalf. In such cases, the entry related to trades is passed in the same way as it is done for a client. Members own trading account normally appears in general ledger. The auditor should verify the entries appearing in this account with respect to the bills raised for own account trading. The balance appearing in this account should be identified into profit or loss or closing stock-in-hand, as the case may be.

17.7.14 Bank Book

A member of a Stock Exchange is required to maintain separate bank account for the client’s money and their own money. No payment for a transaction in which the member has traded on his own account shall be made from clients account. No money can be paid into clients account other than -

1. Money held or received on account of clients.
2. Money for replacement for any sum which may by mistake or accident drawn from the account.
3. A cheque or draft received from a client.

No money can be paid from client’s account other than -

1. The money required for payment to the Clearing Corporation / House on behalf of clients.
2. Money for replacement for any sum which may by mistake or accident deposited into client account.

The auditor should verify the bank reconciliation statement for all the bank accounts in the usual manner.

17.7.15 Documents Register (Inward / Outward Register)

This register contains the particulars of the securities including their distinctive numbers received from or delivered to clients in a physical form by a member. This is a primary record, which lists and identifies every security available with the member at any given time. Generally, it is observed that members maintain a ledger, which contains only the number received, delivered and balance. This ledger does not provide for the distinctive numbers of the scripts received from or delivered to the clients. It may be mentioned that if distinctive numbers are not recorded properly then the identification of introducer cannot be established.

While scrutinizing this register, the auditor should analyse the balances of stock appearing in this register and segregate the same into client stock and own stock. The auditor should inquire the reasons for client’s stock remaining with the Member. Further, the auditor may also, on a random basis, physically verify the stock available with a member in certain scrips, if so, desired.
17.7.16 Maintenance of Books of Accounts and Other Documents

In terms of Rules 14 and 15 of Securities Contracts (Regulation) Rules, 1957, every recognized stock exchange and its members are required to maintain and preserve the specified books of account and documents for a period of five years. Further, as per regulation 18 of SEBI (Stock Brokers & Sub-Brokers) Regulation, 1992, every stock broker shall preserve the specified books of account and other records for a minimum period of five years.

17.7.17 Dematerialized Securities

On account of compulsory dematerialisation of most of the securities listed on the Exchange, all stock brokers are required to maintain two accounts with their Depository Participants (DP) for handling the receipt and delivery of securities in demat. One account is ‘Beneficiary Account’ wherein the demat securities belonging to the members’ for their own account are held and the other is ‘Pool Account’ wherein the demat securities of the clients are temporarily lodged for transfer to/from the Clients / Clearing House in the Pay-in/Pay-out. In case of sale of securities by clients, the clients transfer the same in the demat form to the member’s Pool Account to the Clearing House on the Pay-in day. In case of purchase of securities by the client, the Clearing House transfers the securities to the Pool Accounts of the members and the members then transfer the same to the accounts of individual clients. The members are required to maintain a proper record of all shares received and delivered from their Pool Account as well as preserve acknowledged copy of the delivery instructions given to their DP’s for transferring the securities from the Pool Account to the Clients’ account after the Pay-out.

The auditor should verify whether the securities received by the member in the Pool Account are regularly transferred to the buying clients’ Demat Accounts within 24 hours of declaration of Pay-out of the relevant settlement of the Exchange. It may be noted that Sometimes, the clients instruct the brokers to retain the shares in the Pool Account either because they have not opened a demat account or because they intend to sell the shares they have bought earlier, in the subsequent settlement and thereby avoid transaction charges. The auditor should check that the shares lying in the Pool Account have not been utilized by the member to meet his own pay-in obligations or used for meeting auction obligations. If the auditor discovers something like this then, he should further enquire into the matter. Such instances might indicate the breach of fiduciary trust by the member of the stock exchange.

Depending upon the nature of the business carried on by the member, the auditor may apply such procedural tests as he considers necessary on major items of income and expense such as, commission, sub-brokerage, underwriting income, interest and dividends, advisory fees, interest, amounts payable towards transactions charges and other charges to the Exchange or Clearing House and other income and expenses.

The auditor should apply analytical procedures on the financial statements of the member. The auditor should compare current operating results with those of the prior period to ascertain that the variations are logical in the circumstances such as volume of business at the stock-exchanges, the brokerage concern’s share of the market, changed business conditions such as volume of new securities issued, changes in the character of the business of the brokerage concern, and trend prices of securities. A discussion of this comparative data
with the officials of the member may highlight areas where added audit emphasis may be directed.

17.8 Auditor’s Report

As per the notification issued by the Government, an auditor should submit his report in the following form:

“We have audited the attached balance sheet of M/s. ABC as at _________ and the profit and loss account for the year ended on that date annexed thereto and report that:

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

In our opinion, proper books of account and records as specified in Rule 15 of the Securities Contracts (Regulation) Rules, 1957 have been kept so far as appears from our examination of such books.

The stock broker has complied with the requirements of the stock exchange so far as they relate to maintenance of accounts and was regular in submitting the required accounting information to the stock exchange.

The balance sheet and the profit and loss account referred to in this report are in agreement with the books of account.

In our opinion and to the best of our information and according to the explanations given to us, the said balance sheet and the profit and loss account read together with the notes thereon give a true and fair view insofar as it relates to the balance sheet, of the state of affairs of M/s. ABC, and insofar as it relates to profit and loss account, of the profit of M/s. ABC for the year ended on that date.”

According to clause (c) of the form of audit report prescribed by the Government, the auditor is required to report whether the member of the stock exchange had complied with the requirements of the stock exchange insofar as they relate to maintenance of accounts and that he was regular in submitting the required accounting information to the stock exchange. The auditor is therefore required to acquaint himself with the said requirements of the stock and / or the Ministry of Finance shall have a right to obtain a copy of the profit and exchange, if any.

The aforesaid Notification further requires that the audit should be completed within 6 months of the date of closing of the books of account. In individual cases, an extension for a period not exceeding 3 months may be granted by the concerned Executive Director / Secretary of the Stock Exchange if he is satisfied that adequate reasons exist for granting such an extension. The audit report should be made out in triplicate and addressed to the member of the Stock Exchange, who should submit quarterly, one of the copies of all audit reports received during the quarter to the Ministry of Finance within one month of the end of the quarter.

The audit reports to be submitted to the aforesaid authorities need not be accompanied by copies of the relevant profit and loss account and balance sheet. However, the said authorities
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have right to demand profit and loss account and / or balance sheet wherever they consider necessary.

It may be noted that in cases where the member is a company registered under the Companies Act, the reporting consideration that apply to other companies shall also apply to the member company. For example, the audit would have to necessarily make the assertions given in sub-section (2) and (3) of section 143 of the Companies Act, 2013.

**Internal Audit for stock brokers/trading members/clearing members:**
SEBI vide its Circular dated 21.10.2008 has decided that stock brokers/trading members/clearing members shall carry out complete internal audit on a half yearly basis by an independent qualified chartered accountants, company secretaries or cost and management accountants who are in practice and who do not have any conflict of interest.

17.9 Audit of Mutual Funds

SEBI (Mutual Funds) Regulations, 1996 provide that every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company. An auditor is a person who is qualified to act as an auditor under the Companies Act. The auditor shall be appointed by trustees. The auditor shall forward his report to the trustees and such report shall form part of the Annual Report of the mutual fund.

**Fig.: Audit of Mutual Fund**

17.9.1 Proper Books of Account

The Regulations require that every asset management company for each scheme shall keep and maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of account, records and documents are maintained. Every asset management company shall maintain and preserve for a period of 8 years its books of account, records and documents. The asset management company shall follow the accounting policies and standards as specified in Ninth Schedule so as to provide appropriate details of the scheme wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unit holder in a fair and true manner.

* Source: memeshappen.com
17.9.2 Audit Report

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

Explanation: For the purposes of this sub-regulation and regulation 66 — auditor means a person who is qualified to audit the accounts of a company as per the Companies Act.

(2) An auditor shall be appointed by the trustees.

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

(4) The auditor's report shall comprise the following:—

(a) a certificate to the effect that,—

(i) he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit;

(ii) the balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the Fund for the accounting period to which the Balance Sheet or, as the case may be, the Revenue Account relates;

(iii) the statement of account has been prepared in accordance with accounting policies and standards as specified in the Ninth Schedule.

Below mentioned details of Audit Report is given in eleventh schedule on Annual Report and abridged summary as per SEBI (Mutual Fund) Regulation 1996:

(i) All mutual funds shall be required to get their accounts audited in terms of a provision to that effect in their trust deeds. The Auditor's Report shall form a part of the Annual Report. It should accompany the Abridged Balance Sheet and Revenue Account. The auditor shall report to the Board of Trustees and not to the unitholders.

(ii) The auditor shall state whether:

(1) he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit,

(2) the Balance Sheet and the Revenue Account are in agreement with the books of account of the fund.

(iii) The auditor shall give his opinion as to whether:

1. the Balance Sheet gives a true and fair view of the schemewise state of affairs of the fund as at the balance sheet date, and

2. the Revenue Account gives a true and fair view of the schemewise surplus/deficit of the fund for the year/period ended at the balance sheet date.
17.9.3 Inspection and Audit

The SEBI has a right to conduct inspection and audit the books of account as per Regulation. Some of the regulations of the SEBI (Mutual Funds) Regulations, 1996 are discussed below:

Regulation 61: Board’s right to inspect and investigate

The SEBI may appoint one or more persons as inspecting officer to undertake the inspection of the books of account, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and asset Management Company for any of the following purposes, namely:

(a) to ensure that the books of account are being maintained by the mutual fund, the trustees and asset management company in the manner specified in these regulations;
(b) to ascertain whether the provisions of the Act and these regulations are being complied with by the mutual fund, the trustees and asset management company;
(c) to ascertain whether the systems, procedures and safeguards followed by the mutual fund are adequate;
(d) to ascertain whether the provisions of the Act or any rules or regulations made thereunder have been violated;
(e) to investigate into the complaints received from the investors or any other person on any matter having a bearing on the activities of the mutual funds, trustees and asset management company;
(f) to suo motu ensure that the affairs of the mutual fund, trustees or asset management company are being conducted in a manner which is in the interest of the investors or the securities market.

Regulation 62: Notice before inspection and investigation

(1) Before ordering an inspection or investigation under regulation 61 the Board shall give not less than ten days notice to the mutual fund, asset management company or trustees as the case may be.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such inspection or investigation be taken up without such notice.

(3) During the course of inspection or investigation, the mutual fund, trustees or asset management company against whom the inspection or investigation is being carried out shall be bound to discharge his obligations as provided in regulation 63.

Regulation 63: Obligations on inspection and investigation

(1) It shall be the duty of the mutual fund, trustees or asset management company whose affairs are being inspected or investigated, and of every director, officer and employee thereof, to produce to the inspecting officer such books, accounts, records, and other documents in its custody or control and furnish him such statements and information
relating to the activities as mutual funds, trustees or asset management company, as the 
inspecting officer may require, within such reasonable period as the inspecting officer 
may specify.

(2) The mutual fund, trustees or asset management company shall allow the inspecting 
oficer to have a reasonable access to the premises occupied by it or by any other person 
on its behalf and also extend reasonable facility for examining any books, records, 
documents and computer data in the possession of the mutual fund, trustees and asset 
management company or such other person and also provide copies of documents or 
other materials which in the opinion of the inspecting officer are relevant for the purpose 
of the inspection.

(3) The inspecting officer, in the course of inspection or investigation, shall be entitled to 
examine or record the statements of any director, officer, or employee of the mutual fund, 
trustees and asset management company.

(4) It shall be the duty of every director, officer, or employee of the mutual fund, asset 
management company or trustee to give to the inspecting officer all assistance in 
connection with the inspection or investigation, which the inspecting officer may 
reasonably require.

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

The SEBI has also the power in addition to normal audit, to appoint an auditor to inspect or 
investigate, as the case may be, into the books of account or the affairs of the mutual fund, 
trustee or asset Management Company:

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

17.9.4 Ninth Schedule

As per Regulations 50(3), 55(4)(iii) to Securities and Exchange Board of India (Mutual Funds) 
Regulations, 1996, extract of ninth schedule is reproduced below:

Accounting Policies and Standards

(a) For the purposes of the financial statements, mutual funds shall mark all investments to 
market and carry investments in the balance sheet at market value. However, since the 
unrealised gain arising out of appreciation on investments cannot be distributed, 
provision has to be made for exclusion of this item when arriving at distributable income.

(b) Dividend income earned by a scheme should be recognised, not on the date the dividend 
is declared, but on the date the share is quoted on an ex-dividend basis. For investments 
which are not quoted on the stock exchange, dividend income must be recognised on the 
date of declaration.
(c) In respect of all interest-bearing investments, income must be accrued on a day to day basis as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

(d) In determining the holding cost of investments and the gains or loss on sale of investments, the “average cost” method must be followed.

(e) Transactions for purchase or sale of investments should be recognised as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

(f) Bonus shares to which the scheme become entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original; shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

(g) Where income receivable on investments has accrued but has not been received for the period specified in the guidelines issued by the Board, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the Board.

(h) When in the case of an open-ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative be debited to reserves, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

(i) In the case of an open-ended scheme, when units are sold and appropriate part of the sale proceeds should be credited to an Equalisation Account and when units are repurchased an appropriate amount should be debited to Equalisation Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalisation Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the
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distributable surplus. It should, therefore, be reflected in the Revenue Account only after the net income of the fund is determined.

(j) In a close-ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 which provides to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortised initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

(k) The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker’s brought note. In respect of privately placed debt instruments any front-end discount offered should be reduced from the cost of the investment.

(l) Underwriting commission should be recognised as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

(m) In case of real estate mutual fund scheme, investments in unlisted equity shares shall be valued as per the norms specified in this regard.

17.9.5 Non availability of Unit Premium Reserve for dividend distribution

The Ninth and Eleventh Schedule of SEBI (Mutual Funds) Regulations provide the accounting policies to be followed for determining distributable surplus and accounting the sale and repurchase of units in the books of the Mutual Fund. Thus, the format for Scheme Balance Sheet provides for disclosure of Unit Premium Reserve. In this perspective, SEBI vide its Circular, dated March 15th, 2010, clarified that the Unit Premium Reserve, which is part of the sales price of units that is not attributable to realized gains, cannot be used to pay dividend. However, it is observed that some Mutual Funds are using Unit Premium Reserve for distribution of dividend. It is therefore reiterated that:

a. When units of an open-ended scheme are sold, and sale price is higher than face value of the unit, part of sale proceeds that represents unrealised gains shall be credited to a separate account (Unit Premium Reserve) and shall be treated at par with unit capital and the same shall not be utilized for the determination of distributable surplus.

b. When units of an open-ended scheme are sold, and sale price is less than face value of the unit, the difference between the sale price and face value shall be debited to distributable reserves and the dividend can be declared only when distributable reserves become positive after adjusting the amount debited to reserves as per para 2(a)(ix) of Eleventh Schedule of SEBI (Mutual Funds) Regulations.
17.10 Audit of Depositories

The SEBI (Depositories and Participants) Regulations, 1996 empower SEBI to conduct inspection and audit. The regulation requires that depositories shall have adequate mechanisms for the purposes of reviewing monitoring and evaluating the depository’s controls systems, procedures and safeguards. Depositories are required to maintain the following records and documents, namely:

Fig.: Audit of Depositories *

(a) records of securities dematerialised and rematerialised;
(b) the names of the transferor, transferee, and the dates of transfer of securities;
(c) a register and an index of beneficial owners;
(d) details of the holding of the securities of beneficial owners as at end of each year.
(e) records of instructions received from and sent to participants, issuers, issuers’ agents and beneficial owners;
(f) records of approval, notice, entry and cancellation or pledge or hypothecation, as the case may be;
(g) details of participants;
(h) details of securities declared to be eligible for dematerialisation in the depository; and
(i) such other records as may be specified by the Board for carrying on the activities as a depository.

Every depository shall intimate the Board the place where the records and documents are maintained. Subject to the provisions of any other law the depository shall preserve records and documents for a minimum period of five years.

Where records are kept electronically by the depository, it shall ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with and in the event of loss or destruction, ensure that sufficient back up of records is available at all times at a different place.

Some of the regulations of the SEBI (Depositories and Participants) Regulations, 1996 relating to inspection or investigation are discussed below:

* Source: CS Mukesh H Shah
Regulation 59: Board’s right to inspect

The SEBI has also the power to appoint one or more persons as inspecting officer to undertake inspection of the books of account, records, documents and infrastructure, systems and procedures, or to investigate the affairs of a depository, a participant, a beneficial owner an issuer or its agent for any of the following purposes, namely:

(a) to ensure that the books of account are being maintained by the depository, participant, issuer or its agent in the manner specified in these regulations;
(b) to look into the complaints received from the depositories, participants, issuers, issuers’ agents, beneficial owners or any other person;
(c) to ascertain whether the provisions of the Act, the Depositories, the bye-laws, agreements and these regulations are being complied with by the depository, participant, beneficial owners, issuer or its agent;
(d) to ascertain whether the systems, procedures and safeguards being followed by a depository, participant, beneficial owners, issuer or its agent are adequate;
(e) to suo motu ensure that the affairs of a depository, participant, beneficial owner, issuer or its agent, are being conducted in a manner which are in the interest of the investors or the securities market.

Regulation 60: Notice before inspection and investigation.

(1) Before ordering an inspection or investigation under regulation 59, the Board shall give not less than 10 days notice to the depository, participant, beneficial owner, issuer or its agent, as the case may be.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such inspection be taken up without such notice.

(3) During the course of an inspection or investigation, the depository, a participant, a beneficial owner, an issuer or its agent against whom the inspection or investigation is being carried out shall be bound to discharge his obligation as provided in regulation 61.

Regulation 61: Obligations on inspection by the Board.

(1) It shall be the duty of the depository, a participant, a beneficial owner, an issuer or its agent whose affairs are being inspected or investigated, and of every director, officer and employee thereof, to produce to the inspecting officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as a depository, a participant, a beneficial owner, an issuer or its agent, as the inspecting officer may require, within such reasonable period as the inspecting officer may specify.

(2) The depository, a participant, a beneficial owner, an issuer or its agent shall allow the inspecting officer to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books,
records, documents and computer data in the possession of the depository, a participant, a beneficial owner, an issuer or its agent or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting officer are relevant for the purposes of the inspection.

(3) The inspecting officer, in the course of inspection of investigation, shall be entitled to examine or to record the statements of any director, officer or employee of the depository, a participant, a beneficial owner, an issuer or its agent.

(4) It shall be the duty of every director, officer or employee of the depository, a participant, a beneficial owner, an issuer or its agent to give to the inspecting officer all assistance in connection with the inspection, which the inspecting officer may reasonably require.

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

Further the SEBI has power to appoint an auditor to inspect or investigate, into the books of account, records, documents, infrastructures, systems and procedures or affairs of a depository, a participant, a beneficial owner, an issuer or its agent:

Provided that the auditor so appointed shall have the same powers of the inspecting or investigating officer as stated in regulations 59 and 60, and the obligation of the depository, participant, beneficial owner, issuer or its agent and their respective directors, officers and employees, as the case may be, as stated in regulation 61, shall be applicable to the inspection or investigation under this regulation.

Return of deposits to be filed with the Registrar: Rule 16 of the Companies (Acceptance of Deposits) Rules, 2014 requires, every company to which these rules apply shall, on or before the 30th day of June of every year, file with the Registrar, a return in the prescribed Form along with the specified fee and furnishing the information contained therein as on 31st day of March of that year, duly audited by the auditor of the company.

17.11 Environmental Auditing

Environmental reporting is the term now commonly used to describe the disclosure by an entity of environmentally related data, verified (audited) or not, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity) via either-

(a) the annual report and accounts package;
(b) a stand-alone corporate environmental performance report (CER);
(c) a site-centered environmental statement; or
(d) some other medium (e.g. staff newsletter, video, CD ROM, internet site)

Environmental audits are becoming increasingly common in certain industries. The term "environmental audit" has a wide variety of meanings. They can be performed by external or
internal experts (sometimes including internal auditors), at the discretion of the entity’s management. In practice, persons from various disciplines can qualify to perform “environmental audits”. Often the work is performed by a multi-disciplinary team. Normally, “environmental audits” are performed at the request of management and are for internal use.

In Indian scenario, the Regulatory Authorities like Ministry of Environment and Forest (MOEF), State Pollution Control Board (SPCB), State Department of Environment (SDEn.) etc., have come into play to clear the projects from environmental viewpoint before it’s commissioning. The Environmental Impact Assessment (EAI) is a pre-requisite to start an industry. The EAI tries to forecast the expected damage to be caused by the development of the industries to the environmental and the means required to mitigate that damage, incorporating the same in the Project Report for compliance in due course, keeping in view the serious threat to all the living beings in the universe by the rapid industrialisation which is polluting the environmental on an irreparable extent. The Indian Govt. notified by GSR No.329E dated 13.02.1992 that “Every person carrying on an industry, operation or process requiring consent under Section 25 of the Water (Prevention and Control of Pollution) Act, 1974 (6 of 1974) or under Section 21 of the Air (Prevention and Control of Pollution) Act, 1981 (4 of 1981) or both or authorisation under the Hazardous Waste (Management and Handling) Rules, 1989 issued under Environment Protection Act, 1986 (29 of 1986) shall submit an environment audit report for the financial year ending the 31st March in form V to the concerned State Pollution Control Board on or before the 15th day of May every year, beginning 1993”.

With a view to define the Environmental Audit, it may be stressed that it is a critical analysis of (I) policies (ii) principles (iii) systems (iv) procedures (v) practices and (vi) performances of the aspect which relates the environment.

But a standard scope of Environmental Audit, as ought to be defined and adopted by standard companies, should be as follows:

“A management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing with the aim of helping to safeguard the environment by:

(i) Facilitating management control of environmental Process.
(ii) Assessing compliance with company policies, which would include meeting regulatory requirements”.

The objective of the Environmental Audit are to evaluate the efficacy of the utilisation of resources of man, machines and materials, and to identify the areas of environmental risks and liabilities and weakness(es) of management system and problems in compliance of the directives of the regulatory agencies and control the generation of pollutants and/or waste.

As the Environmental Audit, especially in India, is still in its infancy the information usually gathered in the course of Environmental Audit is only what is required for the compliance of the statutory requirements, i.e., for Water Act, 1974, Air Act, 1981, etc., and for environmental clearance required before establishing an industry.

If it is to enumerate, what should be the main areas over which the Environmental Audit should be dealt, the following aspects are to be considered in respect of various industrial units:
Aspects to be considered to enumerate the main areas to be dealt over Environmental Audit

(i) Layout and Design – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up-gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the areas which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.

(ii) Management of Resources – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.

(iii) Pollution Control System – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping ill view the type of industry and its nature of working with respect to its grade of polluting the environment.

(iv) Emergent Safety Arrangement – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically, sufficient staff along with other required
safety amenities should be kept ready. The staff, remained so engaged, must possess
the required awareness and alertness to meet the contingency. The degree of
awareness, however, can be upgraded with proper training provisions.

(v) Medical & Healthcare Facilities – The medical services should be maintained. The
health of the workers should be a big consideration for the management.

(vi) Industrial Hygiene – Proper system should be in vogue to eliminate industrial
unhygienic state.

(vii) Occupational Health – The requirement for safeguarding against occupational health
hazards should be available for all the workers. As the occupational health hazards
varies from industry to industry due to the difference in the nature of working atmosphere
and the pollutants present in it, the concerned industry must pay proper weightage to
those diseases which are prone to that particular type of industry.

(viii) Information Assimilation and Reporting System – The information system should be
strengthened to generate and its reporting system should be proper, keeping in view, the
authorities, responsibilities and subsequent delegations. A report of compliance of all
statutory environmental laws along with other preventive and precautionary measures
should be put to Board at regular intervals.

(ix) EIA Methodology – The Environmental Impact Assessment (EIA) is usually are pre-
requisites to start an industry. This is done considering the known spheres of activities on
the existing environmental conditions. But the predictions necessarily deviate from the
actual happenings when the industry starts working. To accommodate the deviation in
the system is also to be incorporated in the EIA report, if it is noticed that the degradation
to the environment caused on the establishment and running of the industry is much
higher than what was predicted, the mitigatory measures suggested must also be
furthered.

(x) Compliance to the Regulatory Mechanism – As the persons who are directly working
with the system, may be unaware of the latest developments and requirements for the
compliance of stipulations and standards prescribed by the various regulatory authorities,
they should be trained and instructed on regular basis, to avoid making the Board/owner
vulnerable to prosecution and penalty.

(xi) Concern for the Society – The industry very often transforms the agrarian environment
into an industrial environment. The people so displaced by industrialisation feel alienated
and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The
audit should look into this aspect how the industry is making a balance between its own
development and the society’s concern.

17.11.1 Audit Procedure
The small or medium unit does not call for an elaborate and/or formal system, but somebody
is to be given charge to look after the matter. But when the concern is a big one, it needs a
well planned system.
17.34 Advanced Auditing and Professional Ethics

The audit is to be conducted at regular intervals, and internal audit system should also be supplemented to review the efficiency, effectiveness and to identify the training requirements of the audit staff.

17.11.2 Audit Format

The following are the main aspects which may be covered in the probable format of “Environmental Statement”.

(a) Name and address of the owner/occupier of the industry, operation or process.
(b) Date of last environmental audit report submitted.
(c) Consumption of water and other raw materials as input during current and previous year.
(d) Pollution generated in air and water along with the output and the types of pollutants and the deviation from standard.
(e) Generation of hazardous waste (in line with the Hazardous Waste Management and Handling Rules, 1989) in current year and previous year from processes or from pollution control facility.
(f) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or re-utilisation of waste, etc.
(g) The disposal practice for different type of waste.
(h) The practice sorted for conservation of natural resources.
(i) The additional investment proposal for environmental protection including abatement of pollution.

17.12 Energy Audit

Energy shortage and the cost of environmental quality control have made the use of energy very costly to many industrial establishments. As a result, many factories have opted for establishing energy management programmes to cope with severe energy shortages and for improving the profitability of their operations. Energy management involves the following basis approaches:

Fig.: Save Energy*

(i) Reducing avoidable losses,
(ii) Improving the effectiveness of energy use, and
(iii) Increasing energy use efficiency

* Source: Alpha Techno Solution
No matter what approach is taken, the steps to be followed are general in nature, e.g., conduct energy audits, implement the energy conservation measures, carry out post installation monitoring and set targets, etc.

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. It is the first step of any energy management programmes. The function of an energy auditor could be compared with that of a financial auditor. At the moment, while energy auditor is not yet a mandatory requirement on an all-India basis, the financial auditor is a pre-requisite for any organisation. Another key distinction is that the energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

(i) Quantify energy costs and quantities.
(ii) Correlate trends of production or activity to energy costs.
(iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
(iv) Advise and check the compliance of the organisation for policy and regulation aspects.
(v) Highlight areas that need attention for detailed investigations.
(vi) Conduct preliminary and detailed energy audits which should include the following:
    (a) Data collection and analysis.
    (b) Measurements, mass and energy balances.
    (c) Reviewing energy procurement practices.
    (d) Identification of energy efficiency projects and techno-economic evaluation.
    (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
    (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

Energy efficiency is achieved through company-wide activities involving administration, purchase, design, engineering, production and maintenance management functions. Since it is an inter-disciplinary activity, energy efficiency must be supported not only by technical division but all other divisions as well. Therefore, in industries where energy cost is substantial or widely dispersed across the plant campus, it has been the experience of some large companies to set up internal energy audit teams. One of the effective ways of setting up an internal energy audit team is to have representation from the various sections with rotating membership and with atleast one team member from the area being audited. The eyes of a stranger very often see things which familiarity has made common place and invisible to the user of the area. To be truly effective, these audits must be made not only during normal working hours hut also during night shifts, weekends and holidays.
17.12.1 Approach to Energy Auditing

The starting point for energy analysis of a factory would be to assess its past performance. The energy manager should first establish the energy efficiency indicator of the factory. To obtain this, the simplest approach is to consider the overall factory as a “black box” and identify the different forms of energies going into the boundary and the products leaving it over a given time period. Thus the evolution in the consumption of these energy inputs and the production rate can be derived. From these, the variation in the specific energy consumption (energy consumed per unit production) with time and production rate can be established. These figures can be compared with the average values or those pertaining to the best practices for similar industries in order to assess the comparative performance of the plant. It is found that there is indeed any scope for reduction in the specific energy consumption, one has to perform preliminary and/or detailed energy audit for analysing the different utility areas where these energies are to be converted into the final forms required by the production processes. The different phases of energy auditing in an industry are given below. All three phases can be included in a single audit or they can be conducted separately, depending on the size of the factory or facility under investigation.

(i) Analysis of historical energy consumption and cost data.
(ii) Preliminary energy audit, with the objectives to identify:
    - Major energy consuming equipment and processes.
    - Obvious inefficiencies and energy wastes.
    - Priority areas for further detailed investigation.
(iii) Detailed technical and economic analyses of energy efficiency measures, especially those involving large capital investment or long payback periods.

17.13 Audit of Accounts of Non-Corporate Entities (Bank Borrowers)

The Reserve Bank of India (RBI), keeping in view the need for bringing discipline in the matter of maintenance of accounts by non-corporate entities, has issued a circular dated 12th April, 1985 to all Banks recommending audit of accounts of all non-corporate borrowers enjoying working capital limits of ₹ 10 lacs and above from the banking system.

For the purpose of computing the above limit, the term borrowing will include borrowing of the following types:

(i) Packing credit facilities
(ii) Cash credit facilities
(iii) Loans-secured and unsecured
(iv) Overdraft
(v) Deferred payment facilities
(vi) Guarantees:
(a) Performance guarantees
(b) Financial guarantees
(vii) Bill Discounting Facilities
(viii) Any other credit facilities (other than loans, guarantees, letter of credit etc.).

This requirement applied in respect of the accounting year of the non-corporate entity commencing on or after 1-4-1984. It is necessary for the non-corporate entity enjoying such credit facility to submit the audited statements and audit report to the concerned bank as early as possible but in any case not later than 6 months from the close of the accounting year. The primary responsibility for maintenance of books of accounts and records is that of the non-corporate entity.

17.13.1 Audit Procedure
(i) The auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the entity. For this purpose the auditor has to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require. Considering the contents of the audit report the auditor has to conduct the audit by applying the same principles which are applicable for an audit in the corporate sector. The audit report is to be given to the lending bank and therefore such report will be in the nature of a special purpose report.

(ii) If he finds that there is no internal control, it would not be advisable for him to conduct the audit by applying test checks. The auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case.

(iii) Section 143 of the Companies Act gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. In the case of audit of a non-corporate entity, it would be in the interest of the entity to furnish all the information and explanations and produce books of accounts and records required by the auditor. If, however, the entity refuses to produce any particular record or to give any specific information or explanation the auditor would be required to report the same and qualify his report.

(iv) The non-corporate entity is free to choose any practising Chartered Accountant to conduct this audit. In the event of any such change it is necessary for the incoming auditor to communicate with the outgoing auditor as explained in the Institute’s publication “Code of Ethics”. He should also ensure that he does not resort to undercutting while accepting any such assignment.

(v) As already noted, the primary responsibility for maintenance of books of account and records and that for preparation of financial statements is of the non-corporate entity. The auditor should obtain the letter of engagement and list of books of account and other records maintained by the entity before undertaking the audit assignment.

(vi) Non-corporate entities are, in certain cases; evidenced by documents/agreements, such as, partnership deed, deed of association, trust deed etc. It would be necessary for the
auditor to check the compliance with the terms of documents, agreements, so far as they relate to accounts and audits and to report all material violations of such terms.

(vii) The figures of the immediately preceding year should be given in a manner so as to enable meaningful comparison. If the accounts of such preceding year are not audited, the fact should be indicated by way of a note and also reported by the auditor.

(viii) The audited accounts should clearly disclose the results of the working of the entity for the year, every material feature, transactions of an exceptional and non-recurring nature and also transactions pertaining to earlier years, if material. The said accounts should be prepared in conformity with the generally accepted accounting principles followed consistently. Any deviation, if material, either from the accepted principles or from the policy/treatment followed in the preceding year should be clearly brought out in the notes and/or the Auditors’ Report.

(ix) The overall consideration should be that the financial statements so prepared should give a true and fair view of the working of the entity. Moreover, these statements should also assist the lending bankers in their evaluation of the loan proposals and in ensuring strict financial discipline, coupled with uniformity, in the existing as well as prospective customers.

17.13.2 Special Audit Report

A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis.

The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the following manner:

(i) Actual production;
(ii) Actual production as a percentage of rated capacity;
(iii) Sales;
(iv) Cost of goods sold/cost of production;
(v) Gross margin;
(vi) Interest on bank borrowing; and
(vii) Interest on others

It is not necessary to work out the actual filed cost for this purpose.
The age-wise classification of raw materials and finished goods is to be given. For this purpose age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately;

(i) Inventory for more than one year;
(ii) Between 6 months and one year;
(iii) Between three months and 6 months; and
(iv) Below 3 months.

Similar information about the work-in-progress i.e. the number of days of production which remains in progress should also be given.

The basis of valuation of raw material and finished goods should be given. For this purpose the following information is to be given:

(i) The manner of determination of cost (i.e. components of cost)
(ii) The method of valuing stock i.e. FIFO, weighted average cost, etc.

It is also necessary to state if there is any discrepancy between the quantity and value of the stock as furnished to the bank and as appearing in the books. The reasons for such discrepancy should be given in the audit report.

Age-wise classification of bills receivable and other receivables with reference to the, bills due from domestic parties and bills in respect of exports should be given. The age-wise classification is to be done on the same basis as the classification for raw materials and finished goods as stated above.

Information in respect of the following items is also to be given:

(i) Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables;
(ii) Tax assessments and payments made during the quarter;
(iii) Actual disbursement of capital expenditure during the quarter;
(iv) Outstanding contracts on capital account at the end of the quarter giving the details about the names of parties and amounts outstanding;
(v) The contingent liability which may or may not materialize during the financial year succeeding the relevant quarter;
(vi) Investment made during the quarter and the income from such investments including profit on sale of investments;
(vii) Loans given during the quarter;
(viii) Loans raised during the quarter from banks and from others. Separate figures to be given;
(ix) Overdue statutory liability at the end of the quarter;

(x) Amounts due but not paid at the end of the quarter in respect of (a) loans from banks, (b) public deposits, and (c) other loans; and

(xi) Figures of cash losses during the last 2 years to be stated on the basis of the annual accounts. If such accounts were not audited this fact should be stated.

The funds obtained from the lending banks have to be utilised for the purpose for which they are given by the bank. If the auditor finds that these funds have been diverted for the purposes other than those for which they were given by the bank the auditor will have to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give information about the following ratios:

(a) Current ratio
(b) Acid test ratio
(c) Raw materials-turnover ratio
(d) Finished goods-turnover ratio
(e) Receivables-turnover ratio
(f) Return on investment
(g) Interest cover ratio
(h) Net margin ratio
(i) Capital turnover ratio
(j) Debt equity ratio
(k) Operating cash flow.
## ANNEXURE

### SEBI Checklist for Auditors

#### Books of Accounts & Other Records

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Description</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Maintenance of books of accounts</td>
<td>Rule 15 of SCR(R) Rules, 1957 and Regulation 17 of SEBI (Stock Broker and Sub-broker) Regulations, 1992</td>
</tr>
<tr>
<td>2.</td>
<td>Any other book / record to be maintained by the broker as per the exchange regulations</td>
<td>Rules, Regulations and Circulars of the concerned Exchange.</td>
</tr>
</tbody>
</table>

#### Contract Notes

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Description</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>The member should issue contract notes for all trades done by him</td>
<td>Regulation 7(B)(2) of Schedule II of Code of Conduct of SEBI (Stock Broker and Sub-brokers) Regulations, 1992</td>
</tr>
<tr>
<td>2.</td>
<td>The member should time stamp his order slips/ records and the order time should be reflected in the contract note along with the time of execution of order.</td>
<td>Circular SMD/POICY/IECG/1-97 dated 11th February, 1997</td>
</tr>
<tr>
<td>3.</td>
<td>The contract notes should bear the contract SEBI Registration number of the member. Contract notes should bear pre-printed serial numbers. Contract notes should be issued within 24 hours of trade execution. Appropriate stamps should be affixed on the original contract notes. Duplicates of the contract notes issued should be maintained. Counterfoils maintained should also have adequate details. The duplicates of the contract notes issued should be acknowledged by the client.</td>
<td>Rules and Regulations of the Exchange. Circular SMD/MDP/CIR/043/96 dated August 5, 1996.</td>
</tr>
<tr>
<td>4.</td>
<td>The contract notes should be signed by the member or his constituted attorney</td>
<td>Rules and Regulations of the Exchange</td>
</tr>
<tr>
<td>5.</td>
<td>In case of Form A contract notes issued to clients, the brokerage should be shown separately.</td>
<td>Ministry of Finance Directive - Circular F. No. 4/16/SE/19 dated 19th August, 1991</td>
</tr>
</tbody>
</table>
6 In case the broker acts as a principal, the contracts issued should be in Form B  SMD(B)/104/22775/93 dated 29th October, 1993

7 The consent of the client should be taken for any trade done by the broker while acting as a principal  Regulation 17 J of SEBI (Stock Broker and Sub-brokers) Regulations, 1992. Section 15 of SC(R) Act, 1956.

8 Brokerage should be within the limits prescribed by the Exchange  Rules and Regulations of the concerned Exchange.

### Dealings with Clients

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<tbody>
<tr>
<td>1</td>
<td>The member should maintain client database</td>
<td>Circular SMD/POLICY/IECG/1-97 dated 11th February, 1997</td>
</tr>
<tr>
<td>2</td>
<td>The member should make full payment / delivery within 24 hours of the relevant payout</td>
<td>Circular MIRSD/SE/Cir -19/2009 dated December 3, 2009</td>
</tr>
<tr>
<td>4</td>
<td>Rectification of bad delivery should be done within a reasonable time</td>
<td>Circular SMD/POLICY/4296/96 dated 4th October, 1996</td>
</tr>
<tr>
<td>5</td>
<td>In case of bad delivery because of fake shares, the introducing broker should file the necessary FIRs with the police.</td>
<td>Circular SMD/RCG/PJ/671/96 dated 22nd February, 1996</td>
</tr>
<tr>
<td>6</td>
<td>The member should not charge the clients with rates more than the prevailing market rates</td>
<td>Code of Conduct A &amp; B under Regulation 7 of the SEBI (Brokers and Sub-brokers) Regulation, 1992</td>
</tr>
<tr>
<td>7</td>
<td>The member should take adequate steps for redressal of investors grievances within one month from date of receipt of the complaint</td>
<td>Rule 4(e) of SEBI (Stock Broker and Sub-brokers) Regulations, 1992</td>
</tr>
<tr>
<td>8</td>
<td>The member should maintain a separate bank account for clients’ funds. There should be a clear segregation of the clients’ and brokers’ money. Payments to / from the client should be made from this separate account - there should be a clear segregation of business. The member should not make payments for trades in which he is a principal from the client’s account. The member should keep such records and books of accounts as necessary, to distinguish client’s securities from his own securities. The member should keep such records and books of accounts as</td>
<td>Circular SMD/SED/CIR/93/23321 dated 18th November, 1993.</td>
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necessary, to distinguish client’s securities from his own securities.

### Funds and Resources

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<tbody>
<tr>
<td>1</td>
<td>The member should not be involved in fund lending / borrowing activities except those in connection with or incidental to or consequential upon the securities business.</td>
<td>Regulations 8(1)(f) and 8(3)(f) of SC(R) Rules, 1957</td>
</tr>
<tr>
<td>2</td>
<td>The gross turnover of the member must be in direct correlation with the base capital / additional capital deposited by the member with the Exchange</td>
<td>Circulars SMD/SED/CIR/93/22570 dated 21st October, 1993 and SMD/SED/RCG/270/96 dated 19th January, 1996</td>
</tr>
<tr>
<td>3</td>
<td>The member should collect margin money from the clients in case of large orders / clients with frequent delays in payments deliveries / dispute of deals</td>
<td>Circular SMD/SED/CIR/93/23321 dated 18th November, 1993</td>
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### Trading Operations

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<tbody>
<tr>
<td>1</td>
<td>The member should be paying margin money as per the Exchange requirements on a regular basis. The auditor may also check the authenticity of the deals exempted from payment of margins, as in institutional deals, etc. Margins to be paid include Marked to Market margin, etc.</td>
<td>Circular SMD/RCG/2782/96 dated 16th July, 1996, Circular SMD/RCG/2995/96 dated 1st August, 1996, Circular SMD/POLICY/CIR-2/98 dated 14th January, 1998, Circular SMDRP/Policy/Circular-17/98 dated 2nd July, 1998, Circular SMDRP/POLICY/CIR-19/99 dated 2nd July, 1999 Circular SMDRP/POLICY/ CIR-26/99 dated 17th August, 1999</td>
</tr>
<tr>
<td>2</td>
<td>The member should report all off-market / negotiated deals to the concerned Exchange, within the time limits prescribed by the Exchange.</td>
<td>Circular SMD/RCG/(BKG)/293/95 dated 14th March, 1995</td>
</tr>
<tr>
<td>3</td>
<td>All off-market deals / negotiated deals entered into by the member should result in compulsory delivery.</td>
<td>Circular SMD/POLICY/Circular 3-97 dated 31st March, 1997 and Circular SMDRP/Policy/ Circular-20/98 dated 4th August, 1998</td>
</tr>
<tr>
<td>4</td>
<td>The member should not have entered into any fictitious transactions.</td>
<td>SEBI (Stock Broker and Sub-brokers) Regulations, 1992 - Code of Conduct</td>
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### Regulatory Requirements

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<tr>
<td>1</td>
<td>The member should have submitted the audit report for a financial year by 30th September of the next financial year</td>
<td>Circular SMD/SED/0072/92 dated 31st December, 1992</td>
</tr>
<tr>
<td></td>
<td>The member should not have any dealings with sub-brokers not registered with Securities and Exchange Board of India</td>
<td>Circular SMD/POLICY/CIRCULAR/3-97 dated 31st March, 1997</td>
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<tr>
<td>3</td>
<td>Members of Stock Exchanges acting as sub-brokers should register themselves with Securities and Exchange Board of India</td>
<td>Circular SMD/Policy/CIR-3/98 dated 16th January, 1998</td>
</tr>
<tr>
<td>4</td>
<td>The auditor should look into the agreement entered into by the member and sub-broker, including adherence to the terms mentioned in the contract</td>
<td>Circular SMD/OPG/AA/1020/96 dated 14th March, 1996</td>
</tr>
<tr>
<td>5</td>
<td>The inspecting authority should check if the member has submitted information about himself, sought by SEBI</td>
<td>Circular SMD/Policy/Cir-7/98 dated 16th February, 1998.</td>
</tr>
</tbody>
</table>