

Special Audit Assignments

Question 1

What are the key functions of an Energy Auditor?

Answer

Key functions of Energy Auditor: 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. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. 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.

Question 2

Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit.

Answer

Main areas to be covered in the case of environment audit of an industrial unit

- (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 area 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 in 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 a pre-requisite 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

Question 3

Write short note on Rolling Settlements

Answer

Rolling Settlements: 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.

17.4 Advanced Auditing and Professional Ethics

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 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 upto 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.

Question 4

State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker.

Answer

SEBI's check list for auditors in respect of contract notes issued by a Stock Broker

- (i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.
- (ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.
- (iii) The Contract Notes should bear SEBI Registration number of the member. It should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.
- (iv) The Contract Note should be signed by the member or his constituted attorney.
- (v) Contract note issued to the clients should show the brokerage separately.
- (vi) In case the broker acts as a principal, the Contract Note should be in Form B.

- (vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.
- (viii) Brokerage should be within the limits prescribed by the exchange.

Question 5

Write short notes on the following –

- (a) *Contract notes.*
- (b) *Sauda Book.*

Answer

- (a) **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 -

- (i) Contract notes have been serially numbered.
- (ii) No serial number has been left blank.
- (iii) Format of the Contract Note is as prescribed by the Regulations of the Exchange.
- (iv) Duplicate copies / counterfoils of contract notes are maintained.
- (v) Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.

- (vi) Contract notes have been signed by an authorised person.
 - (vii) Contract notes have been issued in respect of all transactions.
 - (viii) Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.
 - (ix) SEBI Registration number, Settlement number, Settlement dates have been mentioned.
 - (x) PAN number of the member and client has been mentioned on Contract Note where if required.
 - (xi) All clauses specified by the Exchange have been printed on the reverse of the contract notes.
- (b) **Sauda Book:** 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 date wise. This register contains all the transactions, which may be of any of the kind mentioned below:
- (i) member's own business on the Exchange
 - (ii) member's business on the Exchange on behalf of clients
 - (iii) member's business with the clients on principal-to-principal basis
 - (iv) member's business with the members of other Stock Exchanges
 - (v) member's business on behalf of his clients with the members of other Stock Exchanges
 - (vi) Spot transactions, etc

Question 6

Write a short note on the following

- (a) *Margins (Under Stock Exchange Trading Regulations).*
- (b) *Types of market under NEAT (National Exchange Automated Trading).*

Answer

- (a) **Margins:** Margin refers to deposit made by members with the stock exchange authorities. 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 Adhoc 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.

- (b) **Type of markets under NEAT:** 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.

Question 7

Write a short note on - Circuit Filters (as specified by SEBI)

Answer

Circuit Filters: Circuit Breakers or circuit filters are the price bands 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.

Question 8

Write short notes on the following-

- (a) *Environmental audit.*
- (b) *Probable format of environmental statement.*

Answer

- (a) **Environmental Audit:** Environmental reporting deals with the disclosure by an entity of environmentally related data, 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 the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

- (b) **Probable format of “Environmental Statement”:** The following are the main aspects which may be covered in the probable format of “Environmental Statement”.
 - (i) Name and address of the owner/occupier of the industry, operation or process.
 - (ii) Date of last environmental audit report submitted.
 - (iii) Consumption of water and other raw materials as input during current and previous year.
 - (iv) Pollution generated in air and water along with the output and the types of pollutants and the deviation from standard.
 - (v) 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.

- (vi) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilisation of waste, etc.
- (vii) The disposal practice for different type of waste.
- (viii) The practice sorted for conservation of natural resources.
- (ix) The additional investment proposal for environmental protection including abatement of pollution.

Question 9

Write a short note on Contents of Audit report of Mutual Fund.

Answer

Audit report of mutual fund: It comprises the following:

- (i) the auditor has obtained all information 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.

Question 10

Write short notes on the following:

- (a) *Circuit filters/Circuit breakers.*
- (b) *Purpose of appointing Inspecting officer of a Depository.*

Answer**Short Notes****(a) Circuit Filters/Circuit Breakers:**

- (i) This is the price band that set the upper and lower limit within which a stock can fluctuate on any particular day.
- (ii) A price band for a day is a function of the previous days closing price.
- (iii) According to SEBI directions circuit filter is applied on scrips traded in rolling settlement, if their price fluctuate more than 10% of the closing price of scrip on the previous day.
- (iv) Thus circuit filters restrict extreme price movement and resist price manipulation.
- (v) This also protects investor from extreme fluctuations.

- (b) SEBI appoints inspecting officers to investigate or inspect the affairs of a depository for any of the following purposes.
- (i) To ensure that the books of accounts are maintained in the names specified in the regulations
 - (ii) To look into the complaints received from depositors' participant, beneficial owners or other persons.
 - (iii) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied.
 - (iv) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market.
 - (v) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

Question 11

Write short note on Volatility margin.

Answer

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.

Question 12

How is an auditor concerned under the guidelines issued by Securities and Exchange Board of India relating to the following matters, while certifying financial information included in offer documents?

- (i) *Transactions with companies in promoter group*
- (ii) *Bifurcated turnover*
- (iii) *Return on net worth*
- (iv) *Price earning ratio*

Answer

As per the SEBI Guidelines, an auditor is required to report on the financial information to be included in the offer documents. The above four items form part of such information.

- (i) **Transactions with companies in promoter group:** Disclosure is required to be made in the offer document in respect of the following:
- (a) Sales or purchase between companies in the promoter group when such sales or purchases exceed in value in the aggregate 10% of the total sales or purchases of the issuer; and
 - (b) Material items of income or expenditure arising out of transactions in the promoter group. (Sub Para 3.5 of Para 10 of Chapter VI).

The aforesaid information is required to be given by the auditor of the issuer company in his report for inclusion in the offer documents.

- (ii) **Bifurcated Turnover:** The turnover disclosed in the profit and loss statement shall be bifurcated into:
- (a) turnover of products manufactured by the company;
 - (b) turnover of the products traded in by the company; and
 - (c) details of products not normally dealt in by the company but included in (b) above are required to be mentioned separately. (Clause c of Sub Para 2.7 of Para 10 of Chapter VI).

- (iii) **Return on Net Worth:** Clause (f) of Sub Para 2.7 of Para 10 of Chapter VI requires that the offer document to include certain accounting ratios for each of the accounting periods for which information is given. Return on net worth is one of such accounting ratios. This ratio is computed by using the following formula:

$$\frac{\text{Net Profit before extraordinary items but after adjusted tax}}{\text{Net worth excluding revaluation reserve as at the end of the year}} \times 100$$

In the above formula the adjusted tax means the provision for taxation for the period after adjusting tax attributable to extraordinary items. The above forms part of the other financial information required to be included by the management and which should be reported upon the company's auditor by way of separate report to management. The management is required to get this information audited by the company's auditor and obtain an audit report in respect thereof.

- (iv) **Price Earning Ratio:** Clause (a) of Sub Para 4.11 of Para 8 of Chapter VI under the heading 'Basis for Issue Price' requires disclosure of P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken). The pre-issue price / earnings ratio should be calculated by using the following formula:

$$\frac{\text{Issue price per share}}{\text{Earning per share}} \times 100$$

Earning per share is to be disclosed as per Part A-I of clarification XIV is the EPS after taking into account all outstanding conversions and options i.e. diluted earning per share. The auditor should satisfy that the calculations have been made accordingly.

Question 13

Write short notes on the Mark to Market margins.

Answer

Mark to Market Margin (MTM) : MTM margin is the notional loss, which a stock 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.

Question 14

Write short note on-Volatility Margin, its computation and its application.

Answer

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.

Computation 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.

Application 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.