ADVANCED AUDITING AND PROFESSIONAL ETHICS

CA FINAL

CHAPTER 17

SPECIAL AUDIT ASSIGNMENTS

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AUDIT OF MEMBERS OF STOCK EXCHANGE

STOCK EXCHANGE

Stock exchange is an ORGANISED MARKET for the **purchase & sell** of the listed industrial & financial securities.

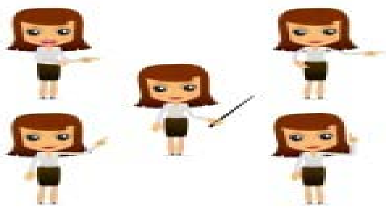
Before conducting the audit of the stock exchange, it is imperative for the auditor to **understand the functioning of the stock exchange:**

I. Regulation of Stock Exchange:

- **SEBI is the apex, statutory regulating body for the securities market.**
- **SEBI = The Securities and Exchange Board Of India.**

II. Governing body:

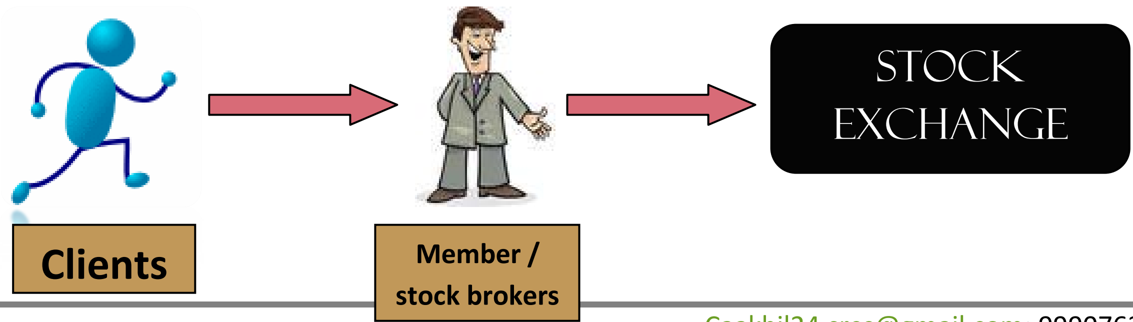
- **Governing body of stock exchange --------→**



Elected representatives of the members of stock exchange, nominated public representatives.

III. Membership:

- **Business at stock exchange can be transacted only by MEMBERS.**
- **MEMBERS =** *Stock / Share Brokers.*
- **Functioning :**



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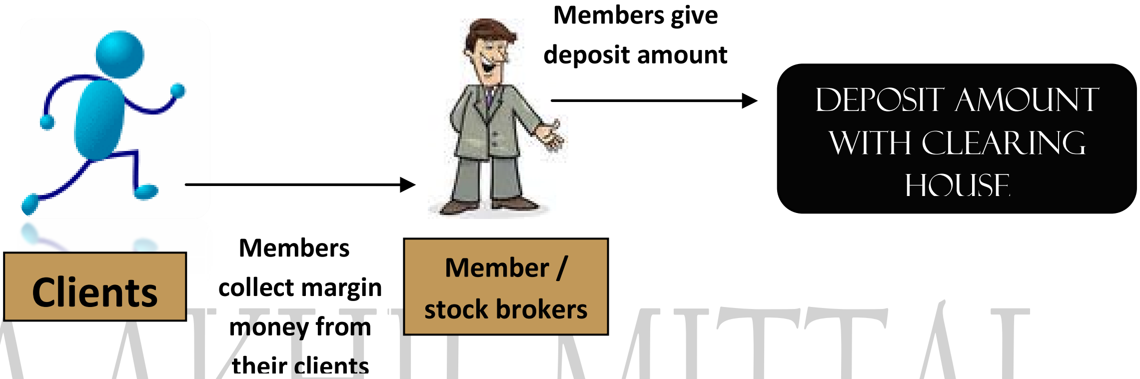
1. Members enter into transaction on the behalf of their clients.
2. The transaction can take place directly or indirectly by the sub-brokers.
3. A stock exchange can have **membership** in multiple trading segments.

IV. Margin:

- There can be wide fluctuations at time of settlement in securities price.
- In order to restrict the excessive **speculation & to protect the investors, members are required to keep CERTIAN DEPOSITS** with stock exchange authorities.
- 

- Through margin money, members **are able** to cover **anticipated fluctuation in the prices of securities.**

- Types of margin:
  - ***Mark to market Margin***
  - ***Volatility Margin***
  - ***Gross Exposure Margin***

(i) MARK TO MARKET MARGIN:

- **It is notional loss.**

- **It occurs when:**

Net cumulative position
In all securities were
Closed out at the → *closing price* → different from the price
at which transactions
had been entered into.

- **The following can be understood with the help of examples:**

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(SELL option)

Security	**Closing price**	**Price of transaction**	**Amount**
A	1,250	1,110	150.00
B	1,750	1,650	100.00
C	2,000	1,800	200.00
Loss on sale			450.00

(BUY option)

Security	**Closing price**	**Price of transaction**	**Amount**
A	1,110	1,510	400.00
B	1,650	1,850	200.00
C	1,800	1,900	100.00
Loss on buy			700.00

Price of transaction = Price at which I transacted.
Closing price = Market price at the end of day at stock

- The aggregate amount is MTM margin payable by a member.

(ii) VOLATILITY MARGIN:

- This margin is imposed in order to CURB excessive VOLATILITY in the market &
- Prevent in building the excessive OUTSTANDING POSITIONS.

(iii) GROSS EXPOSURE MARGIN:

- This margin is computed on AGGREGATE of NET CUMULATIVE Outstanding position in each security.

V. Trading System:

Tells member

Clients → What to do → **Member / stock brokers** → STOCK EXCHANGE

Client (a non member) Can transact at stock Exchange through the Members.

Members are obliged to do what client says.

Members **remit** to **their clients**:

Proceed of sales to client *less* **Brokerage & related expenses**

VI. Types Of Market:

Code to Remember: S.O.N.A.

Broadly there are **4 types of market:**

1. Spot Market:
   - Here spot orders have DIFFERENT SETTLEMENT PERIOD.
   - These orders don't have any special terms or attributes.

2. Odd lot Market:
   - A order is called an ODD LOT order if,
   - ORDER SIZE < Regular Lot Size
   - These orders don't have any special terms or attributes.
   - In this market,

     PRICE & QUANTITY | OF | BOTH ORDERS (Buy or Sell) | Should match for the trade to take place

3. Normal market:
   - All orders of REGULAR size or multiple thereof, are traded in the normal market.
   - Shares traded in DEMATERIALISED form, market lot of these shares is ONE.

4. Auction Market:
   - Here auctions are initiated by the STOCK EXCHANGE for,
   - Number of shares less deposited by the TRADING MEMBERS.
   - In this way, they complete SETTLEMENT PROCESS.

VII. Types Of Order Books:

Code to Remember: S^3.O.A.R.

Following types of books are **maintained in the capital market:**

1. Special Terms Book:

❖ Special term book **contains all orders that have either of the following characteristics:**

A. All or None: An order with this condition should be **matched either with the entire order quantity or none at all.**

B. Minimum Fill: This is one of the special conditions where a minimum quantity is specified for an order. The quantity of the trade involving an order with a MF **attribute should at least be this minimum quantity specified.**

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2. Stop Loss Book:

- Stop loss orders are **stored in this BOOK till the TRIGGER PRICE** is reached or surpassed.
- When the price is reached or surpassed, **the order is RELEASED** in the **regular lot book.**
- Now explaining the concept of STOP LOSS:

SELL

  - **Suppose I buy a share of ABS ltd. for RS 200.00**
  - **If it is possible that market will go down, I will stop loss @ RS 190.00**
  - **It means if market price of that share gets lower than RS 190.00, then automatically my share will get sold @ Rs 190.00**
  - **As such there is loss of RS 10.00 only, instead of loss that might be suffered by me if I would have not applied stop loss.**

3. Spot Book:

- Contains **all spot orders(Orders having only settlement period different).**

4. Odd Lot Book:

- This book contains **all ODD LOT orders.**
- **System attempts to match ACTIVE odd lot with PASSIVE orders.**

5. Auction Book:

- This book contains **ORDERS that are ENTERED** for **ALL AUCTIONS.**

6. Regular Lot Book:

- Regular book contains all **regular** orders that have **NONE** of the following attributes:

A. All or None(AON)
B. Minimum Fill (MF)

} It is not included in **regular book,** as these are included in ***SPECIAL TERM BOOK***

C. STOP LOSS

} It is not included in **regular book,** as these are included in ***STOP LOSS BOOK***

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VIII. Rolling Statement:

CONCEPT

- It is one in which **trades** (Transactions) *outstanding* ***at end of the*** day have to be settled.
- T+2 rolling statement format is used.
- Here transactions are settled **(Pay In or Pay Out)** would take place on the day after **immediately following day.**
- For example, **transactions entered on MONDAY** will be **settled on WEDNESDAY.**

CASE OF NON SETTLEMENT

- If member **fails** to **deliver the SHARES sold** in **rolling settlement,**
- Stock exchange **conducts AUCTION session on T+2,** to meet the shortfall created by **non-delivery of SHARES.**

IX. Circuit Filters or Circuit Breakers

- It is the **PRICE BAND** that set the ***upper & lower limit*** *within* stock can **fluctuate** on any particular day.
- **SEBI** has restricted the fluctuation under **circuit filters to 10%.**
- ***Benefit of circuit filters:***
  - Restricts extreme price movements.
  - Resist PRICE MANIPULATION.
  - Protects INVESTOR form the extreme fluctuation in market
- This circuit filters **are for individual scrip [SHARES].**

X. Market Wide Circuit Breakers:

- Market wide circuit breakers are **implemented on MARKET as whole.**
- **SEBI** introduced **MWCB at 10%-15%-20% of the** movement.

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XI. Accounting of stock exchange transactions:

❖ The same can be explained with the help of following example:

Mr. DEV is the client

Bought OR Sale	Quantity	Scrip Name	Price Per Share	Amount	Brokerage (2%)	Total amount
Bought	100	ABC Ltd.	500.00	50,000	1,000.00	51,000.00
Sold	50	BS Ltd.	450.00	-22,500	450.00	-22,050.00
Bought	20	XYZ Ltd.	700.00	14,000	280.00	14,280.00
TOTAL				**41,500**	**1,730.00**	**43,230.00**

Following points to consider:

- Mr Dev has to pay **Rs. 43,230.00** to trading member.
- Trading member earn **brokerage of Rs. 1,730.00** & is required to pay **Rs. 41,500.00** to the **clearing house** towards his outstanding position for the settlement.
- In case, **client or trading member** is unable to deliver the **shares** as on due date, **then stock exchange** auctions for the **unrelieved shares.**
- In case, any amount charged by the **clearing house or Exchange** towards **PAY-IN or PAY-OUT** default, then:

AMOUNT OF CHARGES DEBITED& COLLECTED → FROM CLIENT → **To the extent attributable to default committed by the client.**

FROM MEMBER → Members are **liable to** pay **TRANSACTION CHARGES & VARIOUS OTHER CHARGES, FINES, INTEREST** to the **EXCHANGE/CLEARING CORPORATION**

Pay in of funds

Transfer of money by broker to exchange towards settlement dues for that particular day.

Pay out of funds

Transfer of money by exchange to brokers towards settlement dues for that particular day.

XII. Conduct of Audit:

It has been clarified by the government, irrespective of the business, would be **considered "ACTIVE"** for the purpose of audit.

A member of the stock exchange has to get his **accounts audited** by any **PRACTICING CHARTERED ACCOUNTANT.**

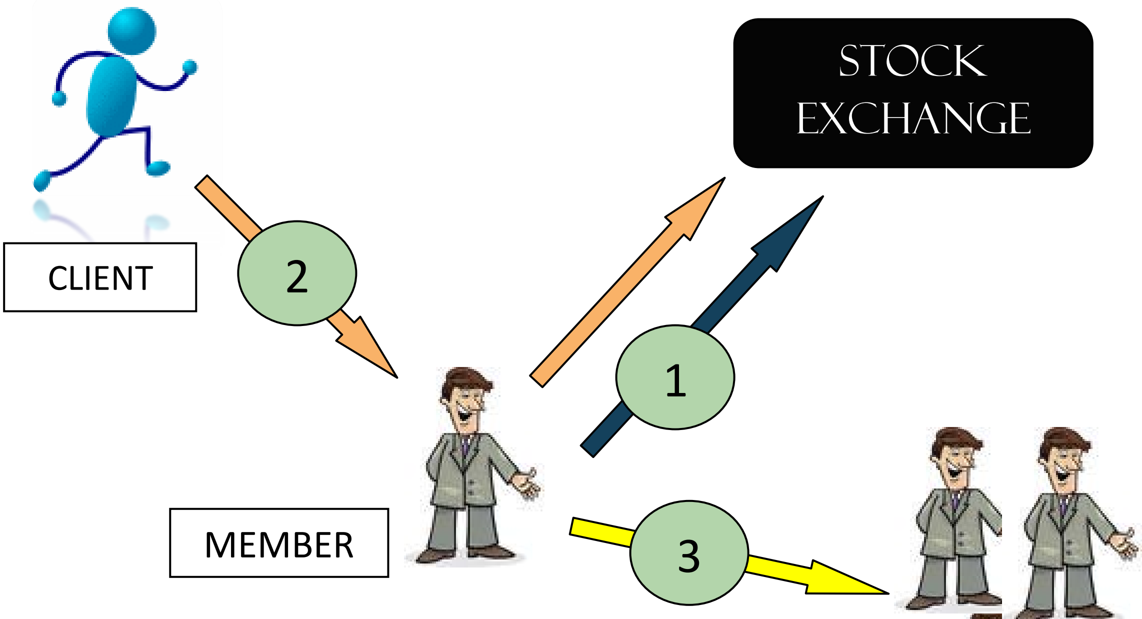
Following books are to be maintained by the member:

1. Daily Transaction List (Sauda Books):

- This is the base record maintained by the members.
- It contains **details of all deals transacted** by them on day-to-day basis.
- It contains information on:

Name of the client	Securities Traded	Rate & Quantity
Akhil Mittal	TCS, GAIL etc	Bought : @200.00 Sold : @400.00

- It contains transactions which may belong to following categories:



1. Member's own business on exchange.
2. Member's business on exchange on behalf of clients.
3. Member's business with members of other exchange.
4. Spot Transactions.

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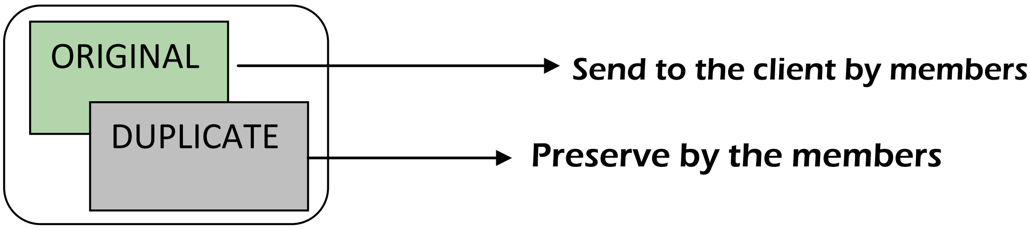
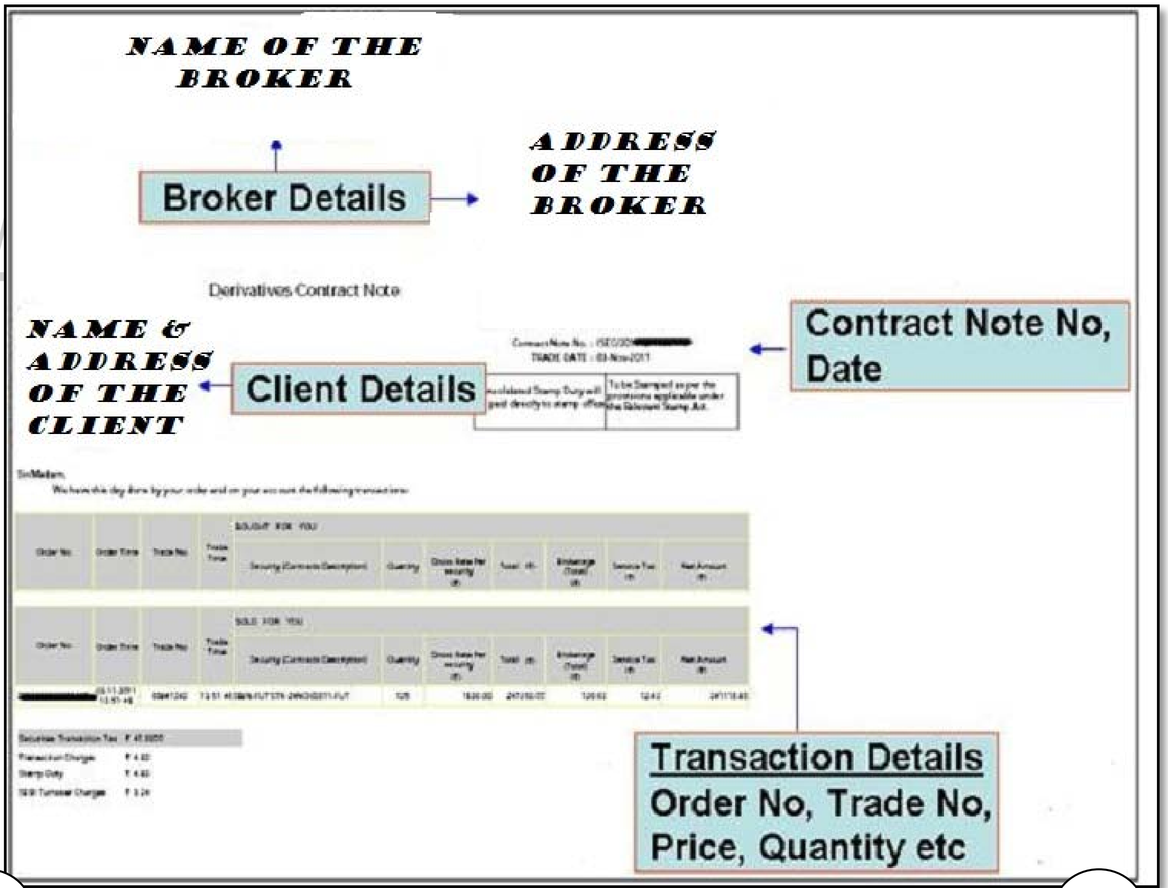
2. Contract Notes:

- Contract notes is a **document through which a CONTRACTUAL OBLIOGATION** is established between a **client & member.**
- Every member has to **issue CONTRACT NOTES** to his clients for the trade executed by him on behalf of the clients.
- Contract notes to be issued **within 24 HOURS** of the execution.



CONTRACT NOTES

- Auditor must consider following while auditing:



S	■ Contracts to be serially numbered. ■ No serial number left blank.	■ Brokerage charged properly in the contract notes.	**B**
F	■ Format of contract note as per regulations of the **exchange.**	■ Contract notes are signed by an authorised person.	**S**
	■ PAN of the member & client.	■ Clauses specified by the exchange have been printed on the **reverse of the contract notes.**	

FORMAT OF CONTRACT NOTE

Name of the Proprietor/Partner

Authorised Signatory

Telephone No./Fax/E-mail

Contract No:

Date:

Name of the Members:

Dealing Office Address:

Tel No./Fax/Email:

Address of the Member:

To,

Client name/Code No. /Order Ref. No.:

Address of the Client:

PAN of the Client:

Sir/Madam,

I/ We have this day, done by order and on your account the following transactions:

Order No.	Trade No.	Trade date/Time	Contract	Bought For you					Sold For You				
1	2	29/2		Qt	Price	Value	Brokerage	Amt	Qt	Price	Value	Brokerage	Amt
				1	200	200	30	230	2	150	300	40	340

3. Client Bill:

- Client bill **represents the SUMMARY** of **ALL TRDAES** executed on the behalf of the client **during a particular settlement.**
- It reflects **NET AMOUNT PAYABLE OR RECEIVABLE** from the client and vice versa.

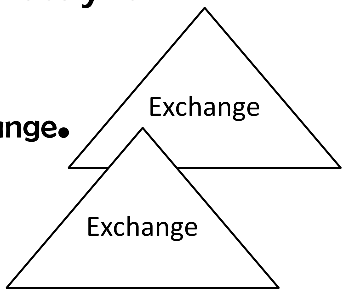
4. Client Ledger:

◈ It contains the **details of the BILL RAISED & payment** *received from or made* to the client.

◈ **Client ledger is required to be maintained separately for**

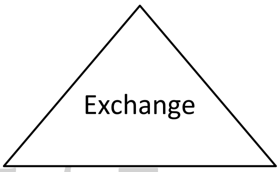
1 CLIENT

For different Exchange.



1 CLIENT

For different trading segments of the same exchange.



◈ **Auditor must verify/examine:**

- **Transactions remained unsettled for a long period of time.**
- That **client receipt/payment** is made through designated **"Client Bank Account".**
- As per **SEBI,** payment is to be made to client within in **48 hours** of pay-out of the exchange.
- Obtain letter from the clients to **confirm their balances** at the end of the financial year as **appearing in his books.**
- To **provide provisions** of bad & doubtful debts **for the long outstanding balances of the clients.**

5. Settlement /Vallan Control Account:

◈ At end of the settlement, **client bills are posted into CLIENT LEDGER** account.

◈ Net amount **receivable from** or **payable to** exchange is posted to **SETTLEMENT/VALLAN CONTROL ACCOUNT.**

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◈ Payment made to/ Receivable from the Clearing house = Pay in /out entries.

◈ Auditor must verify that balance in this account:

1. **Must be nil**
2. **If not matching, then reconciliation statement** to be obtained from the members**.**

6. *Clearing House Bank Account:*

◈ Pay-in & out is **routed through CLEARING HOUSING ACCOUNT.**

◈ **It reflects entries in CLEARING BANK ACCOUNT.**

◈ ***Balance in bank statement = book balance in clearing bank account.***

7. *Brokerage Account:*

◈ At end of each settlement, **brokerage** income **is credited to BROKERAGE account in the general ledger.**

The sane is to be verified by the auditor **that INCOME credited** for each settlement.

◈ BROKERAGE amount is verified by service tax return. Explaining the same in the following manner:

Amount as per books of accounts	Service Tax Return
Amount of service tax recorded as income in the books	**Reconciled** with the amount shown in the service tax return.
Example : **Say Rs. 12,00,000** is being credited in the books of accounts as income.	In service tax return: **Amount Received = Rs 12,00,000** Service tax payable **= Rs 1,23,600 (10.3%)**

◈ Revenue recognition in case of brokerage is **recognised as per ACCOUNTING STANDARD 9.**

8. *Margin Deposit Book:*

◈ A member is **required to maintain MARGIN deposit register,** whereby all the margins deposited with the **clearing House** are to be recorded.

◈ Members have complied with all directives regarding **MARGIN.**

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◈ The auditor should follow the following audit procedures:

- Margins have been properly **calculated, collected & paid.**
- **To verify that margin lying with the CLEARING HOUSE is supported by the CONFIRMATION.**
- **Verify any** EXEMPTIONS **from payment of margins of INSTITUTIONAL TRADERS have been claimed correctly.**

9. *Member's own trading account:*

◈ The auditor must review that **BILL RAISED for OWN TRADING** is accounted separately.

◈ There is proper system of revenue recognition by the member.

10. *Bank Book:*

◈ Members of the stock exchange are required to MAINTAIN **separate bank account for the CLIENT'S** money & their own money.

CLIENT'S money

Member's Own money

◈ No money can be paid into clients account other than:

- *Money held/ receivable on account of CLIENTS.*
- *Cheque/draft received from the CLIENTS.*
- *Amount wrongly drawn from the client account.*

Received in the account of the clients

◈ No money can be paid from clients account other than:

- *Money required for payment to exchange.*
- *Amount wrongly deposited in the client account.*

Paid from account of the clients

11. *Document Register:*

◈ Contains **particulars of securities,** to be delivered to clients in the **physical form.**

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◈ Auditor should analyse the:

- Balance of the stock appearing in this register. → Clients stock / Own stock
- Reason for Client's stock remaining with members.
- Auditor should physically verify the stock.

12. Dematerialised Securities:

◈ In era of electronic trading system, the shares are being converted into dematerialised form.

◈ A member is required to maintain 2 accounts:

DEMAT ACCOUNTS

- "Beneficiary account": Members hold their own securities in this account.
- "Pool account": Meant for trades executed on the behalf of their clients.

◈ Auditor must verify the following:

- Securities received in POOL account is transferred to clients demat account within 48 HOURS.
- Reason for holding securities in POOL account for a long time.
- To verify that transaction of both accounts doesn't mingle.

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