

ANNUAL AUDIT AND COMPLIANCE REPORT

1. As per the SEBI Circular no. SMD/SED/0072/92 dated December 31, 1992 members of stock exchanges are required to get their annual accounts audited by Chartered Accountants within 6 months from the closing of books of accounts and submit a copy of the same to stock exchanges within 30 days of the receipt of the audit report. This requirement of conduct of annual audit of stock brokers emanates from GOI directive No. F.1/5/SE/83 dated May 31, 1984 which enjoins stock brokers to get their books of accounts audited by qualified Chartered Accountants.
2. As all the active members of stock exchanges are covered under the annual audit, standards of compliance of these members may be enhanced considerably if apart from financial aspects, the annual audits also cover certain key regulatory aspects relating to financials and member's dealing with clients and major deficiencies/non conformance with regulatory requirements are reported in the form of Annexure to the report.
3. The concept paper contained herein broadly outlines the areas which are to be covered by auditors during annual audit of stock brokers. Public comments on the concept paper are invited and may be sent to **SEBI, Division of Policy and Supervision-1, Market Intermediaries Regulation and Supervision Department, Exchange Plaza, G Block, 4th Floor, Bandra Kurla Complex, Bandra (E), Mumbai 400 051** or emailed to ashishk@sebi.gov.in or faxed to 91-22-26598514/18 within 14 days
4. **Apart from financial aspects, the annual audit report may contain the following points:**

4.1 MAINTENANCE OF BOOKS OF ACCOUNTS:

Auditors may examine if the broker has been maintaining the required books of accounts as per Rule 15 of SC(R) Rules 1957 and Regulation 17 of SEBI (Stock Broker and Sub Brokers) Regulations, 1992. Any non maintenance of books of accounts by the broker may be specifically commented by the auditor.

4.2 LIST OF TRADING TERMINALS:

Auditors may give a city-wise list of all trading terminals granted by the member. It may also be examined by the auditors whether such trading terminals have been given by the member only at its registered office, branch office and the registered sub broker's office. Grant of any unauthorized trading terminal by the broker to its clients etc. may be reported by auditors in their report.

4.3 TURNOVER DETAILS:

The turnover of the member may be given across different exchanges in the following format:

CASH SEGMENT:

Exch.	(Figures in Rs. crore)						
	Pro A/c	As % of Total Turnover	Retail clients	As % of Total Turnover	Inst. Clients	As % of Total Turnover	Total Turnover

DERIVATIVES SEGMENT:

Exch.	(Figures in Rs. crore)						
	Pro A/c	As % of Total Turnover	Retail clients	As % of Total Turnover	Inst. Clients	As % of Total Turnover	Total Turnover

WDM/DEBT SEGMENT:

Exch.	(Figures in Rs. crore)						
	Pro A/c	As % of Total Turnover	Retail clients	As % of Total Turnover	Inst. clients	As % of Total Turnover	Total Turnover

4.4 SEGMENT WISE INCOME STATEMENT

A segment wise break up of income earned by the member may be given to throw light on various activities being undertaken by the broker and their contribution to the overall revenue model of the broker. As a typical example, the audit report may contain income of the broker in the form of exchange-wise brokerage earned, interest income, income from investment consultancy, income from portfolio management services, income from DP operations etc.

4.5 STATEMENT OF CHANGES IN SHAREHOLDING PATTERN:

The statement should give shareholding pattern of the entity. All those holding 5% or above as on the close of year ending for which audit is conducted should be given in the audit report. The report should also indicate all the major changes in the shareholding pattern of the entity during the period under review.

The information to be given may be in the following format:

S No.	Name of persons/entities (To be given for all those holding more than 5% of the total shareholding)	As on March 31, 2003		As on March 31, 2002	
		No. of shares held	% of shareholding	No. of shares held	% of shareholding

4.6 STATEMENT OF NET WORTH:

A statement of net worth as per the formulae prescribed by SEBI/stock exchange may be given under the para. Further the entity's financial position may be judged in terms of its net worth and overall exposure in the market/obligations due to various entities. Financial soundness of the entity would be an important parameter to have an overall view about the operations of the member.

4.7 EXAMINATION OF THE ROLE OF COMPLIANCE OFFICER:

The auditors may examine the role of the compliance Officer, whom all stock brokers are required to appoint as per the SEBI (Investment advice by Intermediaries) (Amendment) Regulations, 2001. The role may be examined in light of the competence, qualifications, experience and seniority of the compliance officer, nature of reporting pattern,

information flow in the organization, especially that related to non conformance as provided by stock exchanges etc., detailed scrutiny if any, carried out by compliance officer during the year and follow up action on the report of the compliance officer etc.

4.8 MARGIN COLLECTION AND PAYMENT:

The system of collection of margins from clients may be examined by the auditors and any deviation from regulatory requirement concerning the same may be reported in the audit report. Vide SEBI circular no. SMD/Policy/Cir-12/2002 dated May 17, 2002, it has been decided that brokers should collect upfront margin from clients. However for the collection of 10% upfront margin from clients, only trades which would result in a margin of Rs 50,000 or more should be considered. In other words, if clients position exceeds Rs. 5 lacs the broker would be necessarily required to collect 10% margin from the clients.

The implementation of gross margining system at the broker level may also be checked in line with SEBI Circular no. SMDRP/policy/Cir-34/01 dated June 21, 2001. Vide this circular no netting across different clients is permitted and the broker is required to pay margins on the basis of gross position across all clients.

Any deficiencies observed in this respect may be reported by the auditors in the form of a para on non compliance.

4.9 SEGREGATION OF CLIENTS FUNDS AND OWN FUNDS

Auditors may carry out a detailed analysis of various bank accounts being operated by the member. The analysis may throw light on the following regulatory concerns:

1. Non- segregation of clients funds and own funds.
2. Misutilisation of clients funds.

A few of the important requirements as laid down in SEBI Circular no. SMD/SED/Cir/93/23321 dated November 18, 1993 issued in respect of maintaining a line of segregation between own funds and clients funds are as under:

Every member broker shall keep such books of accounts, as will be necessary, to show and distinguish in connection with his business as a member -

- ✍ Moneys received from or on account of each of his clients and,
- ✍ the moneys received and the moneys paid on Member's own account.

WHAT MONEYS TO BE PAID INTO AND DRAWN FROM “CLIENTS ACCOUNT”

A. No money shall be paid into clients account other than -

1. Money held or received on account of clients;
2. Such money belonging to the Member as may be necessary for the purpose of opening or maintaining the account;
3. Money for replacement of any sum which may by mistake or accident have been drawn from the account in contravention of para B given below;
4. A cheque or draft received by the Member representing in part money belonging to the client and in part money due to the Member

B. No money shall be drawn from clients account other than

1. Money properly required for payment to or on behalf of clients or for or towards payment of a debt due to the Member from clients or money drawn on client's authority, or money in respect of which there is a liability of clients to the Member, provided that money so drawn shall not in any case exceed the total of the money so held for the time being for such each client;
2. such money belonging to the Member as may have been paid into the client account under para A [2] or A [4] given above;
3. money which may by mistake or accident have been paid into such account in contravention of para A above.

It is generally observed that the balances lying in clients account also contain a portion representing brokerage which members don't withdraw every settlement. However as and when need arises, payments or withdrawals are made from clients account itself for different purposes and it is submitted that such withdrawal is always less than the amount of brokerage attributable to the broker. In such a case auditors may make an analysis of total brokerage due to the broker and total withdrawals made to form a view about the misutilisation of clients funds.

If any non compliance with regulatory requirement in this regard is observed by auditors specific instances may be brought out in the form of Annexure to the auditors report.

4.10 PAYMENT OF STAMP DUTY:

Auditors may verify whether appropriate stamp duty has been paid by brokers in line with provisions of the Stamp Act. An analysis of broker's transactions and accounts may be carried out to arrive at the quantum of stamp duty payable and actually paid by the brokers. Any shortfall in payment may be brought out in the report by auditors.

4.11 BORROWINGS/EXTENT OF LEVERAGE:

Auditors may verify whether the borrowings/lending being done by the broker is in connection with or incidental to/consequent upon securities business. The quantum of borrowings/lending made by the member, terms and conditions and tenor of borrowings may also be analysed by auditors to form a view about the extent of leverage being exercised by the member in relation to his operations. In case the borrowings are excessive, which in the opinion of auditors are likely to impact the safety of operations of the member, auditors may comment on the same. Similarly in case of lending done by the member, quantum and soundness of such lending in terms of quality of assets, age-wise analysis and collectibility may be commented upon by the auditors.

4.12 EXPOSURE LIMIT:

Auditors may on a random and test check basis analyse the total gross exposure of the broker based on its base minimum capital and additional base minimum capital deposited with the exchange. Such an exposure would take into account the position of the member across all the exchanges as well outside the exchange for any spot transactions etc either through his own outfit or through other members as a client.

4.13 RECEIVABLES/PAYMENT AND DELIVERIES TO CLIENTS:

Auditors may examine the practices and procedures of the members in so far as they relate to payment of money and giving deliveries to clients within the prescribed time limit. Such examination would include general observations regarding practices of the member on these aspects. However if delay is on account of default of the client or request by the clients to withhold securities/money, it may be ignored. Auditors may also examine and verify the credit/debit balances lying in books for a considerable period and

should form an opinion if adequate provisioning have been made in the books for those debit balances, which have remained unrecovered for a considerable period of time.

4.14 MODE OF PAYMENT:

As per regulatory requirements, brokers should not accept cash from the client whether against obligations or as margin for purchase of securities and / or give cash against sale of securities to the clients. All payments should be received / made by the brokers from / to the clients strictly by account payee crossed cheques / demand drafts or by way of direct credit into the bank account through EFT. The brokers shall accept cheques drawn only by the clients and also issue cheques in favour of the clients only, for their transactions. However, in exceptional circumstances the broker or sub-broker may receive the amount in cash, to the extent not in violation of the Income Tax requirement as may be in force from time to time.

4.15 RELATED PARTY TRANSACTIONS:

Auditors may make specific comments about the transactions of the member with related parties/associates of the member. Such comments should include the following areas:

- ? Details of outstanding borrowings/lending made to such entities.
- ? Details of transactions done with such entities
- ? Brokerage/other income earned on account of dealing with such entities or any commission/brokerage/interest paid to such entities.
