

*Internal Audit of Stock Brokers
– Methodology, Reporting & Responsibility*

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Host: WIRC of ICAI

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Agenda

Responsibility

- Legal Framework
- ICAI Code of Conduct for CA

Methodology

- Audit Methodology
- Critical Audit Areas

Reporting Aspects

Responsibility

Legal Framework

Legal Framework

- SEBI Act, 1992 & Rules framed there-under
- Securities Contract (Regulation) Act, 1956 & Rules framed there-under
- Rules, Regulations & Bye laws of Respective Stock Exchanges
- Income Tax Act, 1961

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Legal Framework

- Companies Act, 1956
- Indian Stamp Act and Relevant State Laws
- Finance Act, 1994 - Service Tax
- Other Labour Laws
 - e.g. P.F., E.S.I.C., Gratuity etc.

Legal Framework

- Accounting Standards (AS 1 to 31)
issued by ICAI
- Standards on Auditing (SA 1 to 34)
issued by ICAI (Knowledge of the
Business, sampling, frauds & Errors etc.)
- Standards on Internal Auditing issued
by ICAI

Responsibility

ICAI Code of Conduct

ICAI Code of Conduct

Whether the Statutory Auditor can be appointed as Internal Auditor

Whether statutory auditor of holding company be appointed as Internal Auditor

ICAI Code of Conduct

Whether peer review is applicable for internal audit of stock broker (whether internal audit of stock broker is an attestation function)

Whether tax auditor can be appointed as Internal Auditor

ICAI Code of Conduct

Whether internal auditor can undertake consultancy assignments of the broker where he is also an internal auditor

Is there any cap/ restriction on the value/ fees of the consultancy assignments that could be undertaken by internal auditor

ICAI Code of Conduct

Whether Tax auditor/ internal auditor can represent the clients before statutory authorities like Income tax, SEBI etc. Would it be considered as conflict of interest

Methodology

Audit Methodology

Methodology

Scope of Audit

Appointment Letter

Sending Pre Audit Questionnaire to obtain basic details about the auditee

Review of Questionnaire received from client to decide the areas applicable and the Sample Plan

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Methodology

Sending the list of documents required for audit and sample document/ records to be kept ready before commencement of audit

On site visit to review the documents kept ready by the client

Commencement of audit

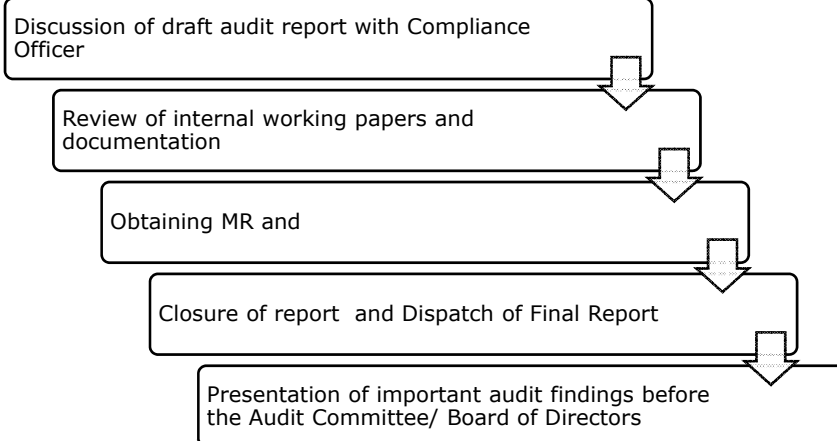
Discussion of queries with HOD

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Methodology



Scope of Audit

SEBI

- Circular no. MIRSD/ DPSIII/ Cir-26/ 08 dated August 22, 2008
- Circular no. MRD/DMS/Cir-29/2008 dated October 21, 2008

BSE

- Notice no : 20131101-11 dated November 1, 2013

NSE

- Circular no. NSE/INSP/24872 dated October 31, 20013

MCX-Sx

- Circular no. 1562 dated November 1, 2013

Scope of Audit

To ensure that the books of account, records and documents are being maintained and

To ascertain whether adequate internal control systems, procedures and safeguards have been established and are being followed by the intermediary to fulfill its obligations under Securities and Exchange Board of India Act, 1992, Securities Contracts (Regulation) Act, 1956, SEBI (Stock brokers and Sub-brokers) Regulations, 1992, Securities Contracts (Regulation) Rules, 1957, circulars issued by SEBI, agreements, Bye laws of the Exchanges, data security and insurance in respect of operations of trading member/clearing members.

Scope of Audit

To ascertain whether any circumstances exist which would render the intermediary unfit or ineligible for dealing in securities market.

To ascertain whether the provisions of the securities laws and the directions and/or circulars issued there under by SEBI/Exchanges are being complied with

To ascertain, whether the provision of stock exchange, Bye-laws, notices, circulars, instructions or orders issued by stock exchanges are being complied with

To inquire suo motu into such matters as may be deemed fit by the auditor in the interest of investors or the securities market

Scope of Audit

Annexure I

- **Internal Audit certificate**

Annexure II

- **Internal Audit Report and revised guidelines**

Annexure III

- **Sample Size**

Annexure IV

- **List of Indicative Processes and reference of Exchange/SEBI circulars**

Annexure V

- **Actions for non compliance**

Scope of Audit

- ❖ Trading members (Stock brokers) and Clearing members
- ❖ all segments of the Exchange (wherein at least a one/single trade have been executed or cleared by them)
 - ❖ CM
 - ❖ F&O
 - ❖ WDM
 - ❖ Currency Derivatives
 - ❖ Interest Rate Futures
 - ❖ SLBS
- ❖ Audit to be conducted on half yearly basis.

Who can conduct internal audit

- ❖ Internal audit is required to be carried out by
 - ❖ Chartered Accountant
 - ❖ Company Secretary or
 - ❖ Cost and Management Accountant
- ❖ who is in practice and
- ❖ who do not have any conflict of interest.

Sampling Criteria 1

Particulars (as on the end of audit period)	Sample Size
Less than 100 active clients	Minimum of 10 clients or the total number of clients registered during the audit period.
Between 100 to 500 active clients	Minimum of 20 clients registered during the audit period.
Between 500 to 1000 active clients	Minimum of 25 clients registered during the audit period.
More than 1000 active clients	Minimum of 50 clients registered during the audit period.

Sampling Criteria 2

No. of days to be verified : 8 dates

Particulars	Sample Size
Less than 100 active clients	Minimum of 25 clients or the total number of clients per segment whichever is lower.
More than 100 active clients	Minimum of 50 clients per segment

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Sampling Criteria 3

Particulars (as on the end of audit period)	Sample Size
Less than 100 active clients	Minimum of 10 clients or the total number of clients traded during the audit period.
Between 100 to 500 active clients	Minimum of 20 clients traded during the audit period.
Between 500 to 1000 active clients	Minimum of 25 clients traded during the audit period.
More than 1000 active clients	Minimum of 50 clients traded during the audit period.

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Methodology

Critical Audit Areas

Client registration documentation and PMLA

- ❖ No clauses are included in any of the documents executed with the clients-
 - ❖ which dilutes responsibility of member or
 - ❖ which is in conflict with any of the clauses in mandatory documents, Rules, Bye-laws, Regulations, Notices, Guidelines & Circulars issued by SEBI & Exchanges or
 - ❖ which is not in the interest of the Investor.
- ❖ Member has a process to identify the authority of the person who is placing orders on behalf of the client

Client registration documentation and PMLA

- ❖ Trading Member has prominently displayed on account opening kits, Website Advertisement, publication, notice board and display board, portal website (if any) the following details-
 - i) name of the member as registered with SEBI,
 - ii) its own logo, if any,
 - iii) its registration number,
 - iv) its complete address with telephone numbers.

Order management and risk management

- ❖ Member has not funded its clients in contravention to Exchange/SEBI requirement. (Exchange's circular no. NSE/MEMB/261 dated 27-May-97 and NSE/INSP/20638 dated Apr 26,
- ❖ Proper monitoring mechanism is in place to review long outstanding debit balances in clients' account and recovery of the same. Give age wise analysis of debts outstanding for more than 30 days and the recovery pattern for the same. ?

Order management and risk management

- ❖ Initial and other margins are collected from respective clients in the prescribed form of funds, fixed deposit receipts, bank guarantees and approved securities with appropriate haircut
- ❖ Trading member has not outsourced their core business activities and compliance functions and adhered to the provisions of SEBI circular CIR/MIRSD/24/2011 dated 15th Dec 2011

Dealing with clients' funds and securities

- ❖ Client's funds and securities are used only for the purpose of the respective client's transactions. If not instances to be provided.
- ❖ Funds raised by pledging client securities were utilised for respective client only. List of instances to be provided separately in case of non-utilisation of proceeds for respective client
- ❖ Constituent securities received as margin is not utilized for execution of proprietary trades or trades in the name of Directors/ Key Promoters/ shareholders

Terminal operations and systems

- ❖ The member has put-in place a mechanism to limit the cumulative value of all unexecuted orders placed from their terminals to below a threshold limit set by them as per the provisions of SEBI Circular CIR/MRD/DP/34/2012 dated December 13, 2012.

Reporting Aspects

Suggested Audit Report Format

- ❖ Certificate of Internal Audit
- ❖ Overview of operations/ Basic Details
- ❖ Objective & Scope
- ❖ Limitation/ Disclaimers
- ❖ Executive Summary
- ❖ Main Report
- ❖ Management Comments
- ❖ Status of Discrepancies reported in previous Exchange/ SEBI inspection or Internal Audit
- ❖ We Certify.....
- ❖ Annexures

Internal audit report: Additional para

- ❖ We certify that we have conducted the audit by adhering to the samples size as prescribed by the Exchange. We do not validate the management comments provided by the member in the above report.
- ❖ We have taken management explanations wherever the information available on the underlying documents were not sufficient to arrive at a decision on the level of compliance.
- ❖ In addition to the above we would like to draw attention of the concerned persons to following issues which in our considered view is a high risk item

Non-compliance relating to internal audit by the members

- ❖ Where, in the opinion of the Exchange, the quality of the reporting is not satisfactory or the audit is not carried out in accordance with the aforesaid guidelines, the Exchange reserves the right to advise the concerned members to change the auditors and/or submit revised report

Points To be noted

- ❖ The guidelines prescribed hereunder do not limit the scope of the internal audit. The points mentioned are only indicative in nature and not exhaustive. It however, does not limit the scope of the internal audit. This has been prepared based on the regulatory requirement (as per relevant acts, rules, regulations and circulars) which keep on developing from time to time. The auditors should peruse them and update the scope of the audit.

The report shall also include

Management Comments:

- ❖ In case of any non compliances/ findings/ observations/ qualifications by the auditor the management responses should be given to the Exchange against each point.
- ❖ The trading member to mention the date on which the report has been presented to the Board/ Management/ Audit Committee/ Proprietor for their approval and indicate corrective and preventive actions taken by the management for addressing the deficiencies along with the timeliness of when the agreed suggestions would be implemented.
- ❖ In case of receipt of internal audit reports without management comments / only certificate and no report, the same shall be treated as non submissions.

The report shall also include

Others:

- ❖ Improvements brought about in the operations between the last audit and the current audit.
- ❖ Membership number allotted by the affiliated professional body should be quoted at the bottom of the report as provided in the format. Each page of the report shall be signed and stamped by the auditor
- ❖ In case any violations/qualifications/observations are observed by the auditor the same shall be submitted as annexure with complete details and should be quantified specifying the number of instances, value etc. and the evidences should be enclosed with the Internal Audit Report.

The report shall also include

- ❖ Sample size indicated in the format above is minimum sample size. The auditor may increase the sample size as it may deem fit. It is desirable that the sample selected is representative sample of the population. **The auditor may refer to the relevant sampling standards (Standard on Internal Audit (SIA) 5) – Sampling prescribed by the Institute of Chartered Accountants of India. (ICAI).**

The report shall also include

- ❖ In case where internal audit report submitted is incomplete and not as per the guidelines like sample size not given, only certificate submitted without report, same would be treated as non submission of internal audit report. Exchange reserves the right to advise a Member to change it's auditor if quality of the report is not satisfactory or the audit is not carried out as per guidelines.
- ❖ If in the opinion of the auditors, any observation related to any area also possesses a risk relating to Anti Money Laundering (AML) or Combating Financing of Terrorism (CFT) then such observation should be highlighted clearly specifying the risk relating to it.

General Deficiency in Internal Audit Report

- ❖ Some of the reports do not indicate instance wise details of the observations/ violations observed during the internal audit
- ❖ Some of the reports do not indicate the sample size or the adequacy of the sample size drawn with regard to total population.
- ❖ The comments of the management on deficiencies and irregularities are not incorporated in some of the reports.

General Deficiency in Internal Audit Report

- ❖ The compliance or current status of the findings of earlier inspections of the Exchange and / or SEBI has not been commented upon in some of the reports.
- ❖ The investor grievance redressal process has not been adequately covered.
- ❖ The evidences of the violations observed during internal audit have not been given in some of the reports.

Open Forum



Thank You

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