

Auditors' Role in an Initial Public Offering



India's primary market saw a lot of activity in the year gone by, with companies raising a record amount of money by means of initial public offerings (IPOs). As many as 153 initial public offers hit the Indian stock market in 2017, raising USD 11.6 billion. With the plethora of IPOs in the pipeline for the year 2018 as well, the task for the chartered accountants have increased significantly to cater to the compliance requirements for these IPOs. This article outlines the process to be followed by a company for bringing out an IPO and the role of chartered accountants as auditors at each stage during the IPO process. Read on to know more...

Below is the list of the various activities that are involved in the IPO process:-

- The Company planning to launch an IPO needs to assess that it fulfils the eligibility criteria for listing prescribed by the Securities and Exchange Board of India (SEBI) vide Issue of Capital and Disclosure Requirements (ICDR) Regulations, 2009, as amended.
- Once the eligibility criteria are met, the Company appoints the investment bankers and the lawyers who commence drafting of the draft red herring prospectus (DRHP). The DRHP includes information about the company's financial statements, business and other corporate and legal information. It does not include details of the price at which the shares would be offered or the period when the issue would be open for subscription but states the number of shares on offer or the total issue size.
- The DRHP is required to be approved by the Board of Directors of the Company, after which it is filed with the SEBI. SEBI issues observations on the DRHP. Management is required to address these comments and file an updated DRHP with the SEBI, incorporating SEBI's observations.
- Once SEBI clears this updated DRHP, the updated DRHP now termed as the red herring prospectus (RHP), is filed with the Registrar of Companies (RoC). The RHP states the period for which the issue will be open for subscription.
- The investment banks commence marketing of the issue and the price band (that is the price range within which the public may apply for the shares) is disclosed through a public advertisement. The issue is opened and applications are collected after which the issue closes and the price at which maximum applications have been received is the issue price.
- The RHP, now termed as the prospectus, is filed with the RoC. The prospectus states the issue price at which shares would be allotted. Allotment of shares at the issue price is made to the investors and application for listing is made to the recognised stock exchanges. Listing



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Auditors' Responsibilities

Below are the broad responsibilities of the auditors in the entire process: -

- Preparation of Restated Financial Information
- Issue of Examination Report
- Entering into an Arrangement Letter
- Issue of Comfort Letter/Bring Down Comfort Letter
- Participation in Due Diligence Calls
- Issue of Certificates
- Issue of Consent Letter
- Providing Circle up Comfort

These responsibilities have been discussed in more detail in the below paragraphs.

Preparation of Restated Financial Information

Based on the audited financials of the last 5 financial years immediately preceding the issue, the auditor is required to prepare restated financials. It may be noted here that in case the Company has been in existence for less than 5 financial years, information needs to be given only for the actual period of its existence in the Offering Document. Also, where the five financial years immediately preceding the issue of the prospectus cover a period less than five years, i.e., 60 months (this can happen if the Company has changed its accounting period), the report should cover as many financial years as may be necessary, so that the aggregate period covered is not less than five years, i.e., 60 months.

Below are the steps involved in the preparation of the restated financials from the audited financials:-

1. The auditor needs to scan the audited financials including the notes of the last 5 financial years and identify any prior period errors reported, reclassifications to be made in any accounting caption in the financial statements or any other unusual item requiring rectification.

The auditor needs to quantify the impact of these adjustments and incorporate these in the restated financial statements. All the material reclassifications should be explained in detail in the notes forming part of the restated financial statements.

2. The auditor should compare the accounting policies of the said 5 financial years and identify

the accounting policies which changed during any of the five financial years or accounting policies not appropriate as per the generally accepted accounting principles prescribed and requires correction.

Where there has been a change in accounting policy, the profits or losses of the earlier years (required to be shown in the Offer Document) and of the year in which the change in the accounting policy has taken place shall be recomputed to reflect what the profits or losses of those years would have been if a uniform accounting policy was followed in each of these years.

The auditor needs to quantify the impact of the adjustments and incorporate these in the restated financial statements.

3. The auditor should scan audit reports to the respective financial statements of the said 5 financial years for modifications or qualifications made by the respective auditors for the prior years. The auditor should segregate all such modifications/qualifications into those which can be quantifiable (and accordingly adjustment effect for the same can be given in the restated financials) and ones which cannot be quantified. For qualifications, if any, which cannot be quantified need to be reported in the examination report to the restated financial statements and management responses for the same needs to be explained in detail in the notes forming part of the restated financial statements.

4. The auditor will also need to prepare certain additional annexures to be included in the Offering Document along with the restated financial statements namely annexure on capitalisation (showing total debt, net worth and the debt/equity ratios before and after the issue is made), annexure on accounting ratios (includes return on net worth, net asset value per share etc.), annexure on statement of tax shelter (required only for standalone) etc.

The restated financial statements and the annexures are together referred to as restated financial information.

The auditor should also ensure that the restated financial information conforms with the requirements of Section 26(1)(b) the Companies Act, 2013 and the SEBI (ICDR) Regulations 2009, as amended from time to time, issued by SEBI in pursuance to Section 11 of SEBI Act, 1992 and related amendments.

Issue of Examination Report

The auditor is required to issue an examination report on the standalone and consolidated restated financial information of the Company wherein an opinion is required to be given that the restated financial information has been prepared in accordance with Section 26(1)(b) of the Companies Act 2013, read with Rules 4 to 6 of Companies (Prospectus and Allotment of Securities) Rules, 2014, SEBI ICDR Regulations and the Guidance Note on Reports in Company Prospectuses (Revised 2016) issued by ICAI.

Entering into an Arrangement Letter

An arrangement letter sets out the scope and limitations of the services to be performed by the auditor in connection with the proposed offering by the Company. It is addressed to the Board of Directors of the Company and the Lead Managers who would participate in the Offering and also sign this arrangement letter. Issuance of comfort letter is covered under the scope of services in an arrangement letter.

Issue of Comfort Letter/Bring Down Comfort Letter

The underwriters and lead managers to the issue face a lot of risk while dealing in public issues and the securities regulations provide heavy penalties in case any of the market players is found wanting on the grounds of the issue process or the information provided to the investors in the prospectus. As a consequence, underwriters and lead managers normally undertake a due diligence process on the information contained in the prospectus. As a part of that process, they also seek to obtain an added level of comfort from the auditors on various aspects of the prospectus (in the form of a comfort letter),

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in addition to the report of the auditors already contained in the prospectus.

The auditor will have to provide negative assurance on the interim financial statements, if included in the Offer Document and will need to comment on changes in key financial statements line items such as share capital, long term debt, etc. as at a specified date (as agreed with merchant bankers, known as “cut-off date”) when compared to the period of latest financial statements included (known as the “change period”).

Below points must be kept in mind by the auditor while issuing the comfort letter:-

- The auditor(s) should carefully read the underwriting agreement and the agreement with the lead manager(s) to ascertain the scope of the comfort letter.
- Draft comfort letter should be shared for the review of the merchant bankers before the final comfort letter is issued.
- Comfort letters need to be issued as on the dates of the Offer Document. In addition, auditor is required to issue a bring down comfort letter as on the Closing of the Offering.
- The auditor should read the comfort letters and bring down comfort letters in respect of entities audited by other auditors while issuing these letters.

Rule 144A/Regulation S

It may be worthwhile to mention here in brief about Rule 144A of the U.S. Securities Act of 1933, as amended (the “Securities Act”) and Regulation S.

Regulation S provides an exclusion from the Section 5 registration requirements of the Securities Act, for offerings made outside the United States by both U.S. and foreign companies. By availing this Regulation, the Company can raise money through private placement from countries other than US without having to register its securities in these countries. However, it may be noted that the Regulation S is available only for “offers and sales of securities outside the United States” made in good faith and not as a means of circumventing the registration provisions of the Securities Act.

Rule 144A provides that any non-U.S. company which offers securities for sale within the US may only do so pursuant to an exemption from registration. Such an exemption can be availed under Rule 144A. By availing this Rule, the Company can raise money

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Bankers also request to do a due diligence call (as part of the issuance of comfort letter) with the auditors to obtain information in relation to (i) the financial statements/information, (ii) audit or review reporting and (iii) confirmation on certain matters (such as independence, rotation policy of the firm, meeting with audit committee and internal auditors, etc.).

through private placement from within the US without having to register its securities in the US.

In practical scenarios, a restricted offering in the US is often combined with an unrestricted placement of securities outside the US under the provision of Regulation S. Also, it may be noted that there is no need of an arrangement letter in case of a 144A offering since the scope and limitations of the auditors are governed by the Securities Act.

Participation in Due Diligence Calls

Bankers also request to do a due diligence call (as part of the issuance of comfort letter) with the auditors to obtain information in relation to (i) the financial statements/information, (ii) audit or review reporting and (iii) confirmation on certain matters (such as independence, rotation policy of the firm, meeting with audit committee and internal auditors, etc.).

Below points must be kept in mind by the auditor during the due diligence call:-

- The auditors should provide oral responses only and no written response should be provided to the queries made by the bankers.
- The responses by the auditor should be limited only to the work performed by them and the auditor should clearly mention the basis (audit, interim review, inquiries of management etc.) on the basis of which they are providing their responses.
- Auditors should not confirm any matter in relation to prospective financial information.
- The auditor should not answer the questions about matters related to the Company's financial condition which are not disclosed in the audited or reviewed financial statements. Such questions must be directed to the management.
- The auditor should obtain a signed permission from the client for their participation and acknowledgement of their responsibilities in these oral due diligence discussions.

Issue of Certificates

The Bankers require the auditors to issue various certificates during each stage of the Offering. Some of the most common certificates requested by the Bankers from the auditors includes certificate on whether the funds raised from IPO will be utilised for the objects as stated in the Offering Document, certificate on compliance with the conditions of corporate governance in accordance with the Regulation 17 to 27 of the SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015, as amended and relevant provisions of the Companies Act, 2013, certificate on average cost per share to the promoters, certificate on tax benefits available to the Company under the Income Tax Regulations, etc.

Several important points must be kept in mind by the auditor at the time of issuance of these certificates:-

- Auditors may decide based on professional judgement whether certificate can be issued in respect of Non-GAAP measures or other financial information (e.g., net worth, operating profit, net asset value, accounting ratios, etc.) as requested by the bankers. Auditors may consider performing agreed upon procedures as agreed upon with bankers as per Standard on Related Services (SRS) 4400, "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" for such Non-GAAP measures.
- Unless required by ICDR Regulations or other regulators, auditors may not issue any certificate in relation to account balances, classes of transactions and disclosures of the financial statements for which they have already issued an audit opinion or review report for the purpose of Bankers due diligence obligation towards SEBI. Auditors may consider providing circle up comfort in relation to such items if requested by Bankers or consider performing agreed upon procedures as agreed upon with bankers as per SRS 4400 and submit such agreed-upon reports to the Company and address to the Board of Directors of the Company.
- The auditor should obtain written representations from the management for all the certificates issued by him in connection with the Offering.

Issue of Consent Letter

Auditor is required to issue a consent letter to the Company wherein the auditor consents to the use of their report, and the references to them as statutory



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auditors or as “expert” as defined under Section 2(38) of the Companies Act, 2013, read with Section 26(1)(a)(v) of the Companies Act, 2013, in relation to the financial information, their reports thereon and the Statement of Tax Benefits included in the Offer Document.

Providing Circle up Comfort

Circle up is the process wherein the auditors are required to provide a tick and tie comfort for the numerical information contained in the offering circular, as may be requested by Bankers. The level of comfort which will be provided by the auditor is agreed upon in the comfort letter and each type of comfort is denoted by a separate alphabet/symbol. Below are the different types of comforts that can be provided on the information contained in the Offering Circular, required by the Bankers to be circled up by the auditors:-

- a. Comparing an amount appearing in the Offering Circular to corresponding amount in/to: -
 - the Company’s Restated Consolidated and Standalone financials
 - the Company’s Audited/Unaudited Consolidated and Standalone financials.
 - schedule prepared and derived by the officials of the Company from its accounting records.
- b. Verifying the mathematical accuracy of the ratios and percentages calculated from the above mentioned information.

As a practice, the Bankers normally do a mock circle up round with the auditors before the final circle ups, so as to identify the type of comfort which will be provided by the auditors.

Several important points must be kept in mind by the auditor at the time of performing circle ups:-

- The auditors should only circle up information that has been obtained from accounting records that are subject to their client’s internal control (of which they have obtained knowledge) as it relates to the preparation of financial information. The auditors may perform procedures and comment only on the following types of information:
 - a. Amounts or percentages derived from amounts obtained from accounting records that are subject to controls over financial reporting;
 - b. Information derived directly from such accounting records by analysis or computation; or

The auditors’ responsibilities are not only applicable for IPOs, but would apply to other type of filings as well with some modifications, for the issue of securities (equity shares, debentures and notes etc.) such as letter of offer (in case of rights issue), etc.

- c. Quantitative information obtained from the accounting records if such information is subject to the same internal control as the amounts.

Hence, information such as size of the plant/office and unit of production/capacities, sensitivity analysis and other similar information, number of employees, number of shareholders, available lines of credits etc. should not be circled up.

- Circle up comfort is associated with only “numbers” and hence the auditors should not circle up any words, sentences or paragraphs.
- No circle comfort should be provided for F-pages (Financial Statements section) and auditors should not provide any reproduction comfort of F-Pages in the prospectus. It should be the responsibility of the management of the company to ensure that audited/reviewed financials are appropriately reproduced in the prospectus.

Conclusion

The above discussion clearly highlights the significant role played by an auditor at each stage in helping the Company comply with the procedural requirements for its IPO. It may also be noted that the auditors’ responsibilities as mentioned above are not only applicable for IPOs, but would apply to other type of filings as well with some modifications, for the issue of securities (equity shares, debentures and notes etc.) such as letter of offer (in case of rights issue), placement document (in case of Qualified Institutional Buyers) and filings for the issue of units under SEBI (Infrastructure Investment Trusts) Regulations 2014 as amended and SEBI (Real Estate Investment Trusts) Regulations 2014, as amended, to the extent applicable.

References

- *Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, as amended*
- *Guidance Note on Reports in Company Prospectuses (Revised 2016) issued by ICAI*
- *U.S. Securities Act of 1933, as amended (the “Securities Act”)* ■