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SECTION 43B(h) - A CRITICAL ANALYSIS

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**NFRA INSPECTION
REPORTS OF 2023 ON
AUDIT FIRMS - AN
OVERVIEW**

**ACCOUNTING FOR
RECYCLING OF WASTE**



OVERVIEW OF NFRA INSPECTION REPORTS OF 2023 ON AUDIT FIRMS– II

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This is the second and final article to cover an overview of the first five NFRA inspection reports. The inspection process, timelines and the structure of the inspection reports were covered in the February 2024 issue of *The BCAJ* on page 21, including the summary of NFRA observations related to governance and leadership structures or lack / non-disclosure thereof, international and domestic network / affiliations. The article also covered issues pointed out by NFRA related to non-audit services provided to audit clients and SQC 1.

This second part is on the remaining observations of NFRA on audit quality control systems, independence, engagement quality control and points arising from the review of engagement files based on selected areas. From these two articles, one will be able to draw practical nuances relating to Standards on Auditing and other applicable laws and regulations.

At the cost of repetition, the purpose of this compilation is to enable auditors and audit firms to understand the focal points and key issues arising from these inspections. By understanding key features, firms can take the necessary steps to be compliant with applicable regulations.

The five reports covered are as below and referred to with the **last two digits** to identify the reports:

Report Number	Name of the Firm	Engagements Selected
132.2-2022-01	SRBC & Co LLP (SRBC)	Five
132.2-2022-02	Deloitte Haskins and Sells LLP (DHS)	Five
132.2-2022-03	BSR & Co LLP (BSR)	Five
132.2-2022-04	Price Waterhouse Chartered Accountants LLP (PWC)	Four
132.2-2022-05	Walker Chandiook & Co. LLP (WCCL)	Five

PART B OF REPORTS

The **subheadings in all five reports are different in both sequence and content.** Excluding leadership,

structure, and Independence matters, which are covered in *The BCAJ*, vide article of February 2024 on page 21, let us consider Documentation, Engagement Quality Control and some observations arising from the review of the audit files.

FIRM WIDE AUDIT QUALITY CONTROL SYSTEM

1) EQCR Partner: The firm's procedures fall short of SA 220 and SA 230 and the Firm's Policy. Two samples selected contained incomplete work papers without sufficient evidence of EQC review done. (Para 30, Report No 01)

2) The practice of deleting all review comments should be reviewed as they may constitute a discussion between the Engagement Team and EQCR, which is mandatory under SQC 1 and SA 220. (Para 31, Report No 01)

3) Evidence of performance of EQCR, i.e., the EQCR docket (summary of EQCR work performed) was not made part of the Engagement Management System (EMS). However, EQCR clearance was obtained prior to the issuance of the audit report. This is despite the firm's Policy of generating the EQCR docket via the EQCR portal to be incorporated in the EMS. (Para 26 & 27, Report No 02)

4) There was an instance of lack of reassessment of audit risk upon finding some suspicious transactions, etc., which was not in accordance with Para 31 of SA 315 and Firm's Policy Manual. This matter led to reporting under Section 143(12) to the central government, adverse opinion and eventual resignation from audit later that year whereas suspicious transactions were noticed in the second quarter itself. (Para 18–22, Report No 02)

5) Consultation was taken, a decision taken on that basis, but the rationale was not recorded which is not in accordance with Para 56 of SQC1, which is not in accordance with the firm's own Policy Manual. (Para 30–32 Report No 02)



6) Engagement Management System (EMS) required annual and engagement level independence confirmations. However, EMS permitted access to audit without obtaining the engagement level independence confirmations (which is an additional control), which is in violation of the Audit Firm's Policy Manual and Para 18 of SQC 1. (Para 17 Report No 02)

7) An Independence compliance audit done by a network firm partner identified that "35% of the Partners, the sole Executive Director, 55% of the Directors and 38% of the Sr. Manager/Managers had not reported the financial relationships, required to be reported in accordance with the Firm's independence policies". Such high rates of non-compliance with the firm's own independence policies were of serious concern to the NFRA. Despite such significant violations, the sample size was reduced compared to the prior year. The firm failed to provide the complete Independence Compliance Audit Report for FY 2020–21. A sample test of five audit engagements revealed that independence confirmations were absent in the case of some members of the engagement team and in some cases, independence declarations were obtained after the issue of the audit report. The Independence Compliance Tool is not aligned with Indian laws. (Para 22–26 Report No 03)

8) EQCR needs to be a partner who is a member of the ICAI as per SA 220 and SQC 1. However, the Firm's EQCR Policy did not specify that EQCR shall be a member of the ICAI. (Para 23 Report No 04)

9) There is no document explaining the rationale or criteria for the selection of engagement files for internal quality inspection and specific areas for review by the inspection team. (Para 30 Report No 04)

10) Firm persons interviewed by the NFRA inspection team did not have much clarity on how to choose the value of assurance factor for the desired level of testing so far as sampling was concerned. (Para 28 Report No 04)

11) The Firm had a policy of doing background checks of the auditee company from the database of the network entity. In some cases, background check reports were not positive and yet the firm did not carry out alternative tests to assess client integrity for accepting / continuing. The firm's reliance solely on a single source (network entity database) was found insufficient and not in accordance with Para 28 of SQC 1. (Para 25 Report No 05)

12) No audit documentation was found in relation to the evaluation of the competence and capabilities of the audit firm to undertake the engagement. (Para 27 Report No 05)

13) Audit documentation by EQCR is not fully compliant with Para 25, SA 220. (Para 28 Report No 05). Working papers had no documentation of the work done by EQCR. (Para 30 Report No 05)

AUDIT DOCUMENTATION

1) The firm's policies and procedures to ensure integrity of its electronic audit documentation were not fully in accordance with the requirements of SQC 1 (Para 77, 79, 80). (Para 13 Report No 01)

2) The audit evidence, which is reviewed and signed as final, can be edited, altered or modified subsequently without affecting the previously provided signoff. While a report gives information about edits, it doesn't identify the exact changes made in the document. (Para 13 Report No 01). Such weakness can lead to signing a blank folder and then allowing the engagement team to add documents before archival.

3) The electronic documentation system does not meet the requirement of Para 9 of SA 230. Neither the preparer nor reviewer date marks the completion of an audit procedure.

4) The archival process of the firm's electronic work papers lacks integrity as the copy of the achieved file is editable while it is used for other post-archival purposes and, therefore, does not serve the purpose of audit documentation under Para 3 of SA 230. (Para 15, Report No 1)

5) Audit Work papers can be modified after sign-off. The application supports multiple sign-offs by the same and / or different people. It does not mandate modifier sign-off after the modification. A blank paper after sign-off can be filled out later without affecting sign-off. In the instances sighted by NFRA, there was no evidence of why and when documents were modified and who made and reviewed the changes. This was in non-compliance with Para 79 of SQC 1 and Para 8, 9 and 13 of SA 230. NFRA noted that "sufficient appropriate audit evidences are not obtained before issue of audit report as evidenced from large scale modification of AWP's post issue of audit report and without signing off AWP's after such modification." (Para



29–30, Report No 3)

6) Signing partner is not the same as Engagement Partner in violation of Para 46 and 56 of SA 700 and 6.b of SQC 1. In FY 2020–21, there were 40 cases where Engagement Partners did not sign the audit reports. (Para 32, Report No 3)

7) The firm needs to put in place policies to deal with complaints and allegations about non-compliance with professional standards, regulatory compliance or legal requirements or the firm's system of QC to ensure compliance with Para 101 of SQC 1. (Para 34, Report No 3)

8) NFRA desired that there should not be paper files and electronic files and all papers should be scanned and kept in electronic files. (Para 26, Report No 4)

9) Physical files are neither scanned nor incorporated by electronic files via cross-referencing of paper files with electronic files. Files lacked integrity prior to archival. (Para 12, Report No 5)

10) Sources of audit documents — whether from clients, etc., — were not available. This is a potential risk under SA 500, SA 540 and SA 550. (Para 13, Report No 5)

PART C OF REPORTS — NFRA OBSERVATIONS ON REVIEW OF INDIVIDUAL AUDIT FILES

NFRA selected a few Engagement Files for review (Refer to page 21, *The BCAJ*, February 2024) and selected three significant audit areas in respect of those selected engagements: Revenue, Trade Receivables and Investments.

1) The Audit Engagement team did not document its judgment for not recognising applicable types of revenue, revenue transactions and assertions as a fraud risk as necessitated by SA 240 to determine the risk of material misstatement due to fraud in the audit of revenue. (Para 32, Report No 1)

2) Audit Evidence in respect of year-end balance was not found in work papers and was obtained from the custodian during the course of the NFRA review. (Para 34, Report No 2)

3) Existence Assertion in respect of Investments at year-end, being 1 per cent, was necessary to be obtained

at year-end and not obtaining such evidence was not in conformity with the firm's policy manual and SA 230. (Para 35-36, Report No 2)

4) NFRA appreciated Non-Audit Services (NAS) guidelines voluntarily issued by the firm with effect from 1st April, 2020. At the same time, the firm delivered tax services related to DRP to an audit client in respect of years when such an entity was not an audit client. The firm had in place certain safeguards where the tax and these fell under transitional provisions of its internal NAS Guidelines. (Para 37–42, Report No 2)

5) In the case of two company audits, the financial statements did not disclose full particulars of the loans given, the investment made or guarantee given or security provided and the purpose for which the loan or guarantee or security was proposed to be utilised by the recipient of the loan or guarantee or security, thus not complying with Section 186(4) of the Companies Act 2013. The auditor did not report on it in CARO para (iv) despite its reporting responsibility. (Para 36, Report No 3)

6) Final financial statements (FS) and independent auditors' report (IAR) were not available on the audit file and the draft FS and IAR that were on the file were different from those on the website of BSE in violation of Para 30 of SA 330. The firm accepted this as an inadvertent error. (Para 37, Report No 3)

7) In respect to 3 out of 5 selected companies, the firm was found deficient in performing appropriate audit evidence in respect to impairment of investments. (Para 38–42, Report No 3)

a. In respect of one auditee company, upon acquisition of a group of companies under Ind AS 103 Business Combinations, the firm relied on a two-year-old valuation report in respect of the subsidiary and did not perform any audit procedures for identification of impairment indicators. There was also no working in respect of how the amount in respect of investment was arrived at.

b. In respect of the same auditee, the firm wrongly concluded that no impairment loss was required to be recognised:

i. On the grounds that the subsidiary was in the process of issuing shares to an unrelated MNC which will increase the share price in the near future.



ii. On the grounds that the subsidiary was a dividend paying company and 100 per cent subsidiary, therefore, it did not perform impairment testing.

iii. Since it involved the work of a valuation specialist engaged by another audit team which audited that subsidiary was not evaluated.

c. In respect of another auditee, the audit firm wrongly presumed a subsidiary as 100 per cent owned whereas it was 84.18 per cent owned. NFRA stated that had the correct percentage of investment been considered, the impairment value would have been material to be recognised. The detailed enterprise value relied upon by the firm was also not available on the audit file.

d. In the case of another auditee, the Firm concluded that no impairment was required to be recognised for the investment in an associate, on the basis that the associate company had issued shares to unrelated market participants at a value higher than the carrying value. However, the Firm did not perform any audit procedure to check that the referred market participants were not related to the auditee company.

8) The Audit Firm's Information System Audit Team identified certain deficiencies in the IT Control Environment, i.e., Access to Programs and Data, Entity level controls and Period-end Financial Reporting. The audit firm did not issue a modified audit opinion in respect of the IFC report despite these critical inadequacies and deficiencies. The audit file did not contain any work paper concluding that a modified opinion was not required. (Para 40–41, Report No 4)

9) The Engagement Team's selection of a sample size of only 25 was not commensurate with the risk level. (Para 40–41, Report No 4)

10) ET had planned to obtain a 'Low' level of substantive evidence despite the significantly weak IT General Control environment identified by the Information Systems Audit Team. The total monetary value of transaction testing was ₹19.5 crores, which was 2.09 per cent of Total Revenue of ₹930.14 crores. As a result, the ET did not have sufficient appropriate audit evidence to support its unmodified opinion on the financial statements. The Audit Firm's response was not accepted as it was not in accordance with the SA 530. (Para 44–47, Report No 4)

11) ET did not perform any substantive audit procedure

to check the accuracy and correctness of the 'price details' applied to the actual invoices generated. (Para 48–49, Report No 4)

12) The entity's significant accounting policy in respect to the recognition and measurement of revenue at the fair value of the consideration received or receivable was not in accordance with the Ind AS 115. (Para 50–51, Report No 4)

13) The Engagement Team's audit in respect of verifying and ensuring the entity's recognition and measurement for impairment loss allowance in accordance with the ECL approach of Ind AS 109 was inadequate and inappropriate (Para 8(a), A13, Para 8(c), A24, A25 and Para 19 of SA 5409).

a. The account policy followed was not in accordance with the accounting policy disclosed.

b. The ET did not check how the management had adjusted the historically observed default rates to forward-looking estimates.

a. The entity had not made the disclosures required as per Para 35M and 35N of Ind AS 107 in respect to the credit risk exposure of Trade Receivables.

(Para 52, Report No 4)

14) Invoice-wise matching of customer collections which had an impact on the aging report was not done. This had a direct consequence on the calculation of impairment loss allowance for Trade Receivables. (Para 54, Report No 4)

15) Although the actual PBT benchmark for calculating materiality was significantly lower than planned materiality levels based on the past 3–5 years PBT, the overall materiality and performance materiality were not changed. This was a non-compliance with SA 450. (Para 56–59, Report No 4)

16) While evaluating the impact of misstatements identified during the audit, the ET had, while computing the uncorrected misstatements as a percentage of PBT, considered the number of uncorrected misstatements net of tax instead of gross of tax, leading to erroneous computation of the impact of uncorrected misstatements and the extent of audit procedures. (Para 60, Report No 4)



17) The audit file did not have the auditee company's policy on related party transactions. There was no evidence of obtaining a complete list of related parties at the start of the audit and the audit team having verified management assertion that RPT had taken place at arm's length. The engagement team was, therefore, in violation of SA 550 (Para 24). In one case, the firm also stated that since the RPT were with subsidiaries, they did not pose an elevated risk. NFRA specifically stated that such presumption was not appropriate. (Para 61–63, Report No 4)

18) For evaluating impairment of investments, the audit firm did not independently evaluate significant assumptions of the auditee. Such assumptions of the auditee were found to be not appropriate and in excess. (Para 32, Report No 5)

19) The assessment of the auditor regarding the forward contract to acquire remaining shares from NCI is not separately traceable from the audit file. The disclosures in the financial statements for FY 2020–21 (year reviewed by NFRA) and 2019–20 in respect of the forward contract to acquire additional shares at a future date and the related contingent consideration arrangements are not in compliance with the requirements of Para B64(g) of Ind AS 103. A disclosure of the arrangement and basis of determining contingent consideration was necessary in the CFS of both years. (Para 33–35, Report No 5)

20) There was non-compliance with Section 186 of the Companies Act, 2013 and Companies (Number of layers) Rules as there was no evidence that the auditee met the criteria of CIC-ND-SI NBFC when it had 92 subsidiaries and 52 associates. The audit firm should have reported this

in CARO, which was not done. (Para 36–37, Report No 5)

21) The EP failed to consider the possible effects of misstatements on financial statements, which were material and pervasive and, thus, required consideration of Adverse or Disclaimer Opinion as per SA 705. The possible effect was not only confined to investments but also to other balances such as loans and advances, provisions etc., which indicate their pervasiveness. (Para 38–40, Report No 5)

22) An auditee company having 286 subsidiaries out of which 255 were loss-making. Although there were indicators of impairment, the firm had relied on a management representation letter stating that there was no impairment loss and there was no assessment on AWP. (Para 41–42, Report No 5)

23) AWP did not have sufficient appropriate audit evidence of KAM in respect of the going concern assumption. (Para 43–44, Report No 5)

Part D contained a chronology of events. The appendix at the end of each report carried the actual responses given by each firm.

All five inspection reports make a good read considering they are part of the first set. We can expect several more inspection reports in the coming months and years on the next set of audit firms. I am sure the NFRA reports with time will also become uniform and nuanced and an annual summary of all points brought out during a year will make a good collection for users of such inspection reports. We can expect NFRA to receive a 'follow up action taken' from audit firms inspected as a desirable outcome. ■

My attitude is that if you push me towards something that you think is a weakness, then I will turn that perceived weakness into a strength.

— Michael Jordan

Sales are contingent upon the attitude of the salesman – not the attitude of the prospect.

— W. Clement Stone

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