

HOT SPOT Analysis of Inspection Reports issued by NFRA on Audit Firms



CA Milan Mody

Background

Section 132 of the Companies Act, 2013 (the Act) empowers the National Financial Reporting Authority (NFRA) to

- monitor compliance with Auditing and Accounting Standards
- oversee the quality of audit services and suggest measures for improvement in quality

NFRA initiated audit quality inspection of:

- Deloitte Haskins and Sells LLP,
- M/s BSR & Co LLP,
- Price Waterhouse Chartered Accountants LLP,
- SRBC & Co LLP and
- M/s Walker Chandiook & Co. LLP.

The inspections were initiated in December 2022. The inspection reports were issued after a gap of almost one year i.e. in December 2023. The chronology of events forms part of the inspection reports.

The inspection covered a review of firm-wide quality controls, adherence to Standard on Quality Control (SQC)-1, Code of Ethics, applicable laws and rules and a review of individual Audit Engagement Files for the annual statutory audit of financial statements March 31, 2021. The 2022 inspection emphasized crucial aspects of the Firms'

quality control systems, including leadership responsibilities, auditor independence, the acceptance and continuation of audit clients, engagement quality control and the internal quality inspection program of the Audit Firms.

Three significant audit areas - Revenue, Trade Receivables and Investments - were identified due to their higher risk of material misstatement in each inspected audit engagement.

Factual content

Findings in the reports are classified into five categories, namely,

- Independence,
- Deficiency in audit procedures,
- Documentation,
- Internal policies & practices and
- Regulatory non-compliance.

The findings in the inspection reports are summarized within the mentioned categories as follows:

A. Independence

- Audit firm did not furnish to NFRA information regarding network entities and the non-audit services rendered by those entities to the firm's audit clients. In absence of which compliance with independence requirement of

code of conduct and SQC could not be evaluated.

- The independence policy did not recognize the direct and indirect relationship between the audit firm and its network members. This resulted in violation of section 141 and 144 of the Act.
- Audit firm was engaged in providing non-audit services that posed a self-review threat.
- Network firms offered non-audit services to the overseas holding companies of NFRA-governed audit clients.
- In respect of Network agreement, the observations were:
 - not provided
 - no board to oversee the network as per network agreement
 - absence of legally enforceable network agreement resulting in a lack of clarity regarding the assignment of responsibilities
 - An audit firm's assessment of independence compliance revealed that 35% of the Partners, the sole Executive Director, 55% of the Directors and 38% of the Senior Managers/Managers had failed to report financial relationships as mandated by the firm's independence policies.
 - It was additionally discovered that in one audit firm there was no established system for assessing the proportion of fees derived from non-audit services in comparison to the statutory audit fee, with the aim of identifying potential threats to independence.

B. Deficiency in audit procedures

- An audit firm did not conduct necessary audit procedures related to impairment

of investment where they neglected to execute any audit procedures to identify impairment indicators, instead, erroneously relied on valuation reports that were two years old.

- In a different instance, while performing an audit of impairment of investment in subsidiary for Standalone Financial Statements, an audit firm mistakenly assumed 100% ownership by the auditee, overlooking the actual 84.18% equity share. This error resulted in the incorrect conclusion that no impairment loss was needed. Furthermore, the audit file lacked the detailed calculation sheet for the Enterprise Value, adding to the audit deficiencies in this case.
- In yet another case, the audit firm determined that no impairment was necessary for the investment in an associate company of an auditee company, citing the issuance of shares to unrelated market participants at a value higher than the carrying value. However, no audit procedures were conducted to confirm the independence of these market participants from the auditee company.
- Audit Firms were noted to be in violation of SQC-1 and Standards on Auditing. Regarding SQC-1, one audit firm failed to document the basis or rationale for consultation decisions, while another audit firm exhibited non-compliance with SA 700 by having a Signing Partner different from the Engagement Partner.
- One audit firm neglected to reassess and reclassify audit risk during interim audit in accordance with SA 315 and its internal policy manual.
- The financial exposures of an auditee company were comprised of loans, share investments and corporate guarantees for subsidiaries' obligations.

Investments accounted for nearly 76% of the Balance Sheet size and the total exposure to specific subsidiaries and associates amounted to Rs. 4,037.91 crores, representing 41.40% of the auditee company's net worth as of March 31, 2021. In this case, an audit firm erroneously considered the impact of potential adjustments as 'material' instead of acknowledging it as 'material and pervasive, 'which would have led to an 'Adverse' or 'Disclaimer of Opinion'.

- An audit firm failed to provide documentation for the review of management's 12-month cash flow projections and obtaining financial support assistance and management agreement from the ultimate holding company, as stated in the Key Audit Matter section of the auditee company's Independent Auditor's Report. Additionally, the audit firm submitted an unsigned and undated document, an extract from the Management Agreement with the ultimate holding company, with its validity remaining uncertain.
- In one case, an audit firm determined materiality levels using the average Profit before Tax (PBT) over the past 3-5 years and did not revise overall materiality and performance materiality based on actual PBT resulting in inadequate audit work and non-compliance with SA 450.
- The audit firm overlooked a fundamental error in the disclosure of an auditee company's accounting policy for revenue. The significant accounting policy related to the recognition and measurement of revenue at the fair value of consideration received or receivable did not align with the Ind AS 115 requirements, which requires revenue recognition and measurement at the Transaction Price.
- There were cases where audit firm failed to conduct substantive audit procedures to verify the accuracy and correctness of the price details applied to the actual generated invoices, neglected to assess the control for verifying invoice-wise matching of customer collections, chose sample size that did not align appropriately with the level of risk, those engagement team members interviewed by the inspection team lacked clarity on the process of selecting the value for the Assurance Factor used for sample selection.
- Engagement Quality Control Review (EQCR) Partners did not comply with SQC-1 and SA 220 that requires the EQCR partner to document the performance of the procedures for the quality review and the Firm's Engagement Quality Control Manual requirements, which mandate the EQCR Partner to review and approve crucial documents.
- An auditee company performed an impairment assessment on its investments, calculating the recoverable amount following Ind AS 36. This involved estimating future cash flows using Value-in-Use, considering factors like business growth rate and discount rate. However, an audit firm did not independently assess the reasonableness of the recoverable amount derived with inflated growth rates, despite the company's historical growth rate being substantially lower.
- When the results of integrity testing on auditee companies by reviewing their backgrounds in the audit firm's database were unfavorable, there were no alternative procedures performed by the audit firm to evaluate the integrity of potential or current clients. Sole reliance on the firm's database as the exclusive source for assessing the integrity of

client personnel was inadequate and did not meet the standards outlined in SQC-1. Additionally, there was a lack of audit documentation related to the assessment of the audit firm's competence and capabilities to undertake the engagement.

- The disclosed accounting policy of an auditee company indicated the utilization of a provision matrix derived from historical default rates adjusted for forward-looking estimates. However, in practice, no provision matrix was applied. Additionally, an audit firm did not verify how the management adjusted historical default rates to incorporate forward-looking estimates.

C. Documentation

- All relevant information were not consolidated in one location, the physical files were neither scanned and incorporated in the electronic files, nor cross-referenced to the electronic files, the date of procedure completion was not recorded within the document. Any audit evidence once reviewed and signed as final, could be altered, edited or modified in the audit documentation tool without impacting the initial signoff. Moreover, the tool did not mandate a sign-off for any necessary modifications and also allowed the inclusion of blank audit working papers.
- In one instance, audited Financial Statements and Auditor's Reports were not located in the Audit File. Additionally, independence declarations from certain engagement team members were not present in the audit file. Further, evidence related to the performance of the Engagement Quality Control Reviewer was absent from the audit file. In one particular case, audit files included incomplete working papers without sufficient evidence of the EQCR being conducted.

- In other cases, documents pertaining to the total investment in securities were absent. An audit firm only recorded observations in 1 out of 4 domains of IT general controls and failed to include these observations in the audit report. The audit firm did not document the rationale for not recognizing applicable types of revenue, revenue transactions and assertions as a fraud risk. Also, sufficient information, such as the source and timing of data acquisition from clients, was not provided.

- An audit firm conducted internal inspections of a sample of audit engagement files and selected areas for review but the basis for selecting the audit areas was not documented.
- The audit file lacked the audited company's policy on related party transactions and the audit firm did not verify the management assertion that the related party transactions were conducted on an arm's length basis.
- The audit documentation did not include an assessment regarding the treatment of the forward contract in respect of subsidiary (80% holding), which was designed to acquire the remaining 20% shares from NCI in the future. It did not address whether this should be incorporated into the business combination accounting at the acquisition date or treated as distinct transactions. Key factors, such as the NCI holder's continuous involvement in value changes and receipt of dividends, were also not taken into account. The consideration for the remaining 20% shares met the criteria for being treated as 'Contingent Consideration' under Ind AS 103.

D. Internal policies & practices

- Concerning inadequate internal policies and practices, an audit firm noted the

Audit Committee as TCWG. Further, policies addressing complaints and allegations related to non-compliance with professional standards, regulatory and legal requirements were absent.

E. Regulatory non-compliance

- Regarding adherence to the Act, an audit firm omitted reporting the violation of Section 186(4) of the Act as the purpose of the loan/guarantee/securities pledged was undisclosed in the Financial Statements.
- An auditee company, having 92 subsidiaries and 52 associate companies, was found non-compliant with Section 186 of the Act and the Companies (Number of Layers) Rules, 2017. Supporting evidence was missing for an audit firm's contention that Section 186 does not apply, based on the holding company's NBFC classification as 'Core Investment Company Non-Deposit taking-Systemically Important' (CIC-ND-SI) with assets exceeding Rs. 100 crores. Accordingly, this non-compliance should have been reported in CARO, 2016.

Views & conclusion

NFRA stated that these inspections were aimed to identify areas and possibilities for enhancing the Audit Firms' quality control system and the weaknesses or deficiencies highlighted in the inspection reports should be viewed as opportunities for improvement.

As a response to the inspection reports, the Audit Firms have stated that they are dedicated to supporting NFRA's mission to safeguard public interest by enhancing audit quality, maintaining trust with stakeholders, making continuous improvements to their quality management system and take necessary actions for compliance with policies, rules and laws.

NFRA's inspection of firms beyond top audit firms may reveal more/diverse observations,

with some holding potential significance. Other audit firms can utilize these reports as a source of guidance to address gaps in their audit procedures and documentation. NFRA, along with the Institute of Chartered Accountants of India can use their collective data to publish relevant literature that can serve as references for appropriate audit procedures and audit work papers. One message which is very clear that the **Auditing Standards should be followed both in letter and spirit. Substance and form both need to be abided.**

Some additional facts in respect of the Inspection Reports:

- o The inspection reports were issued after providing the Audit Firms with a hearing opportunity.
- o The time available for audit vis-à-vis the time available for such inspection should be considered while reaching any conclusion.
- o Presumably, the expectation is to retain audit documentation in electronic format. NFRA does not address the risk of changes with audit documentation when stored physically. This would be especially true for mid-sized Indian CA firms.
- o Inspection reports did not consider evaluation of the sufficiency of the documentation and details provided subsequent to the inspections.
- o The inspection reports state that the sample of individual audit engagement selected is not representative of the firm's total population of audit engagements.
- o The inspection report state that findings should be considered as opportunity for improvement in audit quality. They are not intended to be either rating or a marketing tool for the audit firm.

