

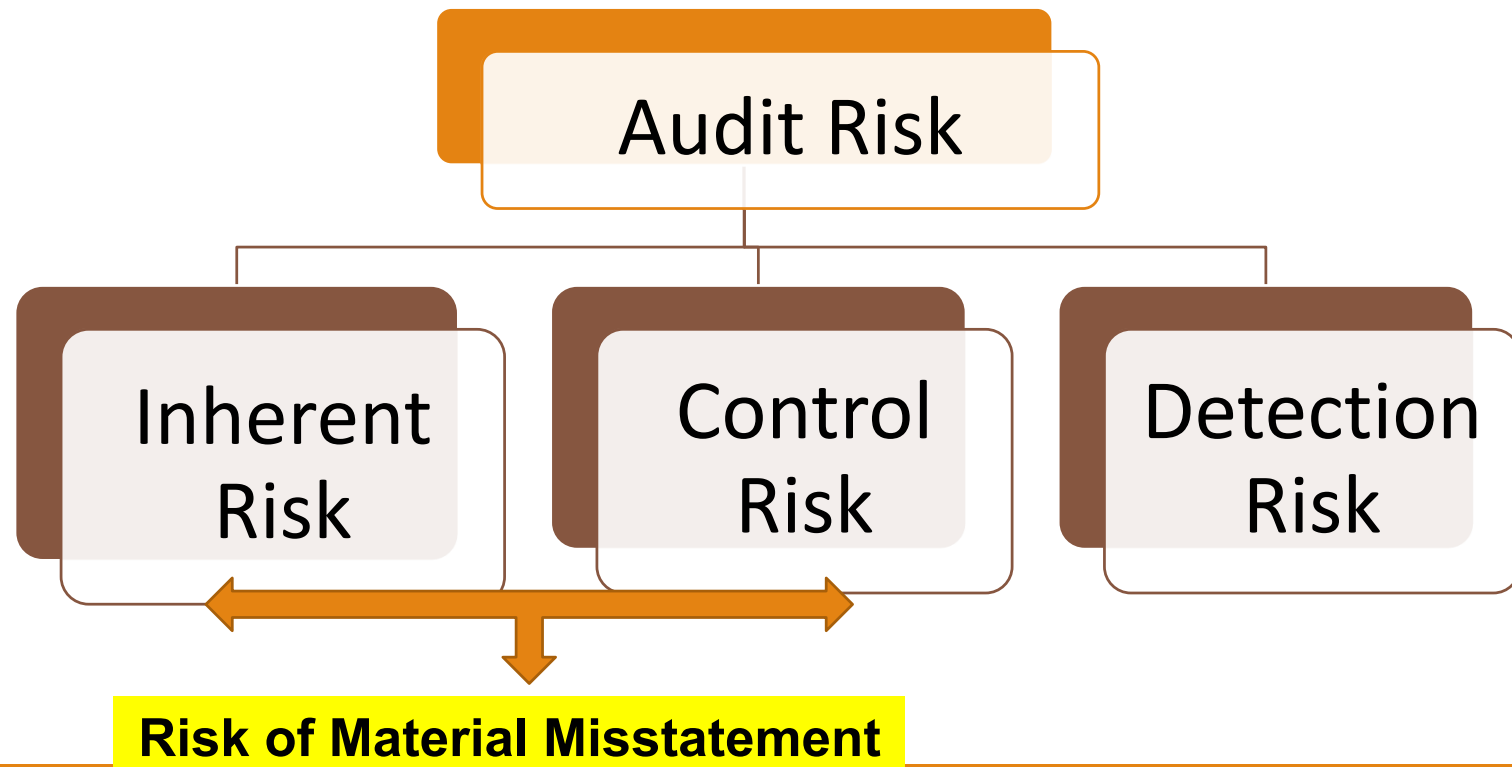
NFRA Orders, Audit Documentation & Audit Quality Practical Insights

CA R S BALAJI, B.COM., FCA



Ya Yeshu Suptsheshu jagrithi

Audit Risk



An Audit of Financial Statements

The SAs contain items designed to **support the auditor** in obtaining reasonable assurance.

The SAs **require**, that the auditor exercise professional **judgment and maintain professional skepticism** and **shall**:

1. Identify and assess **risks of material misstatement**, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
2. Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to **assessed risks**
3. Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

Inspection of Audit Firms by NFRA (PU's)



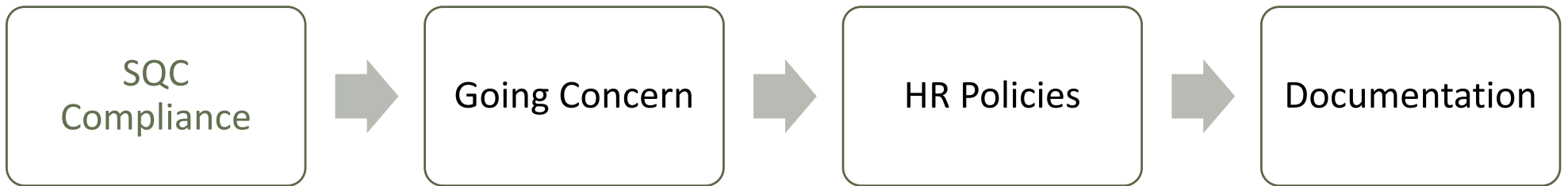
NFRA Inspection Reports

Scope:

Review of firm-wide **Quality controls** to evaluate Audit Firm's adherence to SQC-1

Review of selected **Audit Documentation** of the annual statutory audit of financial statements.

Significant Audit Areas for review –



Key Observations by NFRA

INDEPENDENCE

Partner Shareholding in Audit Client Group

An audit firm network was engaged as statutory auditor for a company (Company A). Company A was part of a larger corporate group with a holding company. Partners of the audit firm network held securities in that holding company.

Multiple partners across the audit network held securities (shares/financial interests) in the holding company of A Company an audit client.

The breach was not just at the time of accepting the engagement — partners continued to acquire securities even after the audit relationship was established.

The firm's independence monitoring system (CES— Central Entity System) failed to detect the breach in real time.

The firm self-detected the breach, but with a significant delay. By that time, the audit had already been conducted with the conflict in place.

Remedial action (divestment of securities) was taken before the NFRA inspection.

Independence:

Should be visible:

Firm intimated the steps taken by it after the inspection, to enhance independence compliance like arrangements with certain depositories for automated updating of securities held by the employees of Firm

INDEPENDENCE

Eligibility Letter — 'Relative' vs 'Immediate Family Member'

Before an auditor is formally appointed at a company's board meeting, the firm must issue an eligibility letter confirming it is not disqualified under Section 141.

The firm's tool for generating these letters used the term 'immediate family member' when checking independence.

The firm's eligibility-checking tool — used to generate the Section 139 eligibility letter — was configured to check only 'Immediate Family Member' rather than 'Relative' as defined in the Act.

'Immediate family member' is typically understood as spouse and dependent children only.

'Relative' under Section 2(77) of the Companies Act includes: father (incl. step-father), mother, son and son's wife, daughter and daughter's husband, brother (incl. step-brother), sister (incl. step-sister), and HUF members.

By using the narrower term, the firm's pre-appointment check systematically missed disqualifying interests held by siblings, in-laws, and step-relatives.

Every eligibility letter issued under this tool was potentially non-compliant with the Act.

HUMAN RESOURCES

Person With Fake CA Credential — 3,937 Hours of Audit Work

A major audit firm hired an individual as a Chartered Accountant at the Associate level in January 2021.

The individual was deployed on audit engagements immediately.

Verification of their qualification with ICAI was initiated two-and-a-half years later, in August 2023.

ICAI responded confirming the CA degree certificate submitted by the individual was FAKE.

January 2021: Individual hired as CA (Associate). Deployed on audit engagements from the start.

January 2021 to August 2023: Individual worked for approximately 2.5 years, clocking 3,937 hours of audit work across multiple client engagements.

7 August 2023: Firm initiated formal verification of the CA qualification with ICAI — over 2.5 years after hiring.

11 August 2023: ICAI responded confirming the CA degree certificate submitted by the individual was FAKE.

31 August 2023: Individual resigned from the firm after the fake credential was discovered.

Signing by Partner and not by EP:

The Firm has a system in which the signing partner can be different from the engagement partner. In FY 2020-21, there were 40 cases in which the engagement partners did not sign the audit reports, which were signed by some other partners. The Inspection team noted that such practice is not in compliance with para 6(b) of SQC 1, and paragraph 46 & A56 of SA 700 (Revised).

REVENUE RECOGNITION

EOM Used Instead of Qualified Opinion — The Most Critical Reporting Error

A significant receivable was disputed by the buyer and rejected. The dispute had been pending before an appellate tribunal for an extended period, with further legal remedies still available.

No provision was recognised in the financial statements for this receivable. The auditor issued an unmodified audit opinion with an Emphasis of Matter (EOM) paragraph.

WHAT HAPPENED

A buyer disputed and rejected a large receivable. The matter was pending before an appellate tribunal.

Management obtained a legal opinion from their own lawyers stating the receivable was recoverable.

Based on this legal opinion (and the management's own representations), the audit team concluded no provision was required.

An Emphasis of Matter paragraph was added to draw readers' attention to the uncertainty described in the notes.

No SA 450 evaluation of the misstatement was performed. No communication to those charged with governance about potential need for provision.

AUDIT DOCUMENTATION

Material Q4 PPE Additions — No Working Papers

A company made material additions to Property, Plant and Equipment in the fourth quarter of FY 2023-24.

The audit file contained no working papers evidencing any substantive audit procedures for these additions.

Material PPE additions occurred in Q4 of FY 2023-24 — within the audit period.

The audit file: no invoice testing, no capitalisation criteria verification, no vendor agreement review, no comparison with capital budget, no physical verification evidence for Q4 additions.

NFRA asked the firm to explain the absence.

Firm's response: the work was performed but the relevant audit work papers 'could not be assembled in the audit file at the time of assembly.'

Certain other Key Observations in NFRA's findings

Key Observations PU 1

1. **Absence of formal documentation relating to SQC 1**
2. Non Provision of details of Network entities
3. Inadequate Documentation relating to - creation, changes, and review of audit work papers - documentation allows for the inclusion of blank Audit Working Papers.
4. CARO Reporting Non Compliance
5. **Final Independent Auditor's Reports not found in the Audit File. The Draft Financial Statements and Draft Independent Auditor's Reports in the Audit File differ from those on the Bombay Stock Exchange's website.**
6. In three out of five selected company audits, the Firm's audit procedure relating to impairment of investment was found deficient.

Key Observations PU 2

1. Engagement level independence confirmations from Engagement Team not obtained
2. **Audit Risk Reassessment not made as per SA 315**
3. Networking Guidelines not followed - Not disclosed
4. **Engagement Quality Control Review falls short of the requirements of the standards**
5. Audit Firm did not record the basis/rationale of the decision arrived.
6. Audit Firm provided non-audit services – Sec.144 Violation

Key Observations PU 3

1. Identifying Audit Committee as Those Charged with Governance (TCWG)
2. Electronic audit documentation and physical file not in one place
3. Internal Quality monitoring Inspection - rationale or criteria for selection of samples not available
4. Non issuance of Modified opinion on ICoFR
5. Final evaluation of the uncorrected misstatements based on average profits of previous years.
6. Fundamental error in the disclosure entity's accounting policy for revenue

Key Observations PU 4

1. Integrity in Audit Documentation – After Signoff requires improvements

2. Documents are signed off as completed before the completion of the audit procedures.
3. Audit Firm provided non-audit services – Sec.144 Violation
4. Engagement Quality Control Review falls short of the requirements of the standards
5. Presumptive fraud risk – Inadequate Documentation

Key Observations PU 5

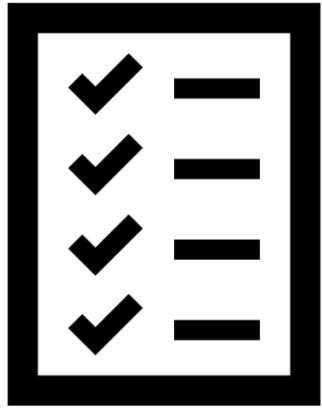
1. **Electronic audit documentation and physical file not in one place**

2. Networking Guidelines not followed – Indirect Relationship between firms
3. Audit Firm provided non-audit services – Sec.144 Violation
4. **‘Client acceptance and continuance’ prerequisites not complied**
5. Engagement Quality Control Review falls short of the requirements of the standards

Key Observations PU 5

6. Reliance on the management experts' and the auditor's experts' without evaluating the appropriateness of the assumptions used by those experts.

7. Qualified audit opinion - instead of 'Adverse' or 'Disclaimer of Opinion' issued - disregarding the pervasive nature of the material misstatement.
8. Serious issues of going concern – PU relied on outdated and unsigned documents regarding financial support assistance purported to be issued.



Documentation

1. Compliance of SA 500
2. Audit Procedures Performed
3. Evaluation of SAAE
4. Conclusions reached

Fundamental flaw in the integrity of the documentation also leaves a possibility of including even a blank AWP which can be filled up later without affecting the signing-off date. The examples of these are:

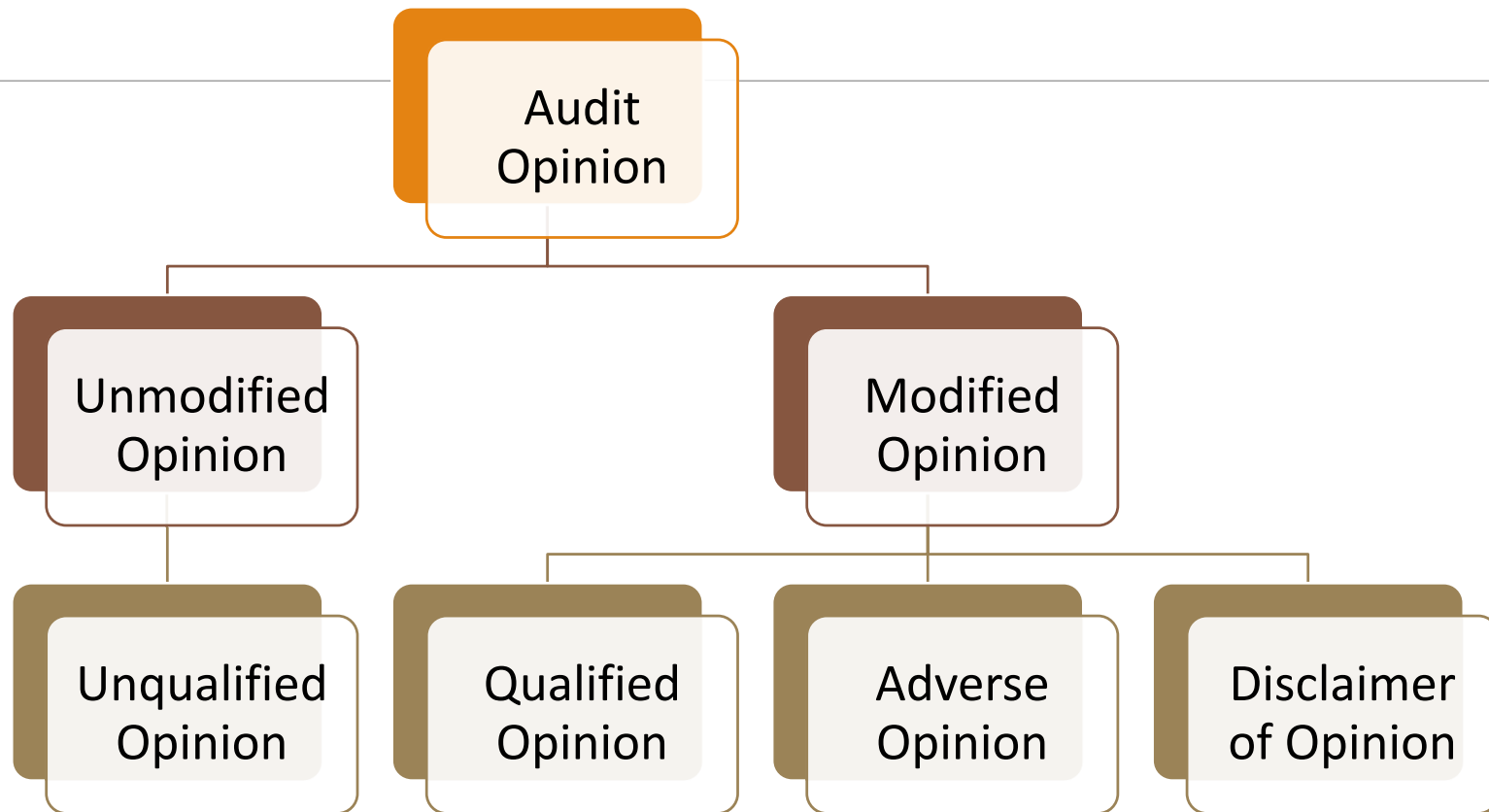
- In one instance, an AWP containing information of a **TCWG meeting conducted on 13.05.2021 was signed off on 12.05.2021**, indicating that the AWP was modified or replaced after the reviewer had signed off
- In another case, **the preparer and reviewer signed off on 16.05.2021 and 17.05.2021, respectively, on an AWP consisting of a representation letter from the Auditee dated 18.05.2021.**
- In another case, AWP containing minutes of meeting with **EQCR was modified after 14 days from the date of issue of audit report.**
- In another case, AWP containing two Excel files "Regulation 52 checklist" & "Director declaration" were created after 8 days from the date of issue of audit report and were modified after 13 days from the date of audit report.

Misstatement

- A difference between the amount, classification, presentation, or disclosure of a **reported financial statement** item and the amount, classification, presentation, or disclosure **that is required for the item** to be in accordance with the applicable financial reporting framework.

Misstatements can arise from error or fraud.

Audit Opinion:



Opinion Matrix:

Nature of Matter giving rise to Modification	Auditors Judgement	
	Material but not Pervasive	Material and Pervasive
FS are Materially Misstated	Qualified Opinion	Adverse Opinion
Inability to obtain Sufficient & appropriate Audit evidence	Qualified Opinion	Disclaimer of Opinion

SA 570 - Going Concern (Revised)

Going Concern – SA 570 (Revised)

Under the **Going Concern basis of Accounting**, The Financial Statements are prepared on the assumption that the entity is a going concern and will continue its operations for the **foreseeable future**. (atleast 12 months from the date of FS)

It is considered that the entity has neither the intention nor necessity of liquidation or closure of its business.

Also refer Sec.134(5) – Directors Responsibility Statement

Objective of SA 570

To obtain sufficient appropriate audit evidence regarding and conclude on the **appropriateness** of Management's use of the Going Concern basis of accounting in the preparation and presentation of the Financial Statements,

To conclude, based on the audit evidence obtained, whether a **material uncertainty exists** related to events or conditions that may cast significant doubt on the Entity's ability to continue as a Going Concern, and

To report in accordance with this SA.

Material uncertainty

“Material Uncertainty” means the **uncertainties related to events or conditions** which may cast **significant doubt on the entity’s ability to continue as a going concern that should be disclosed** in the financial statements.

It is also termed as “**significant uncertainty**” is used in similar circumstances.

Indicators Affecting Going Concern Assumption

- Fixed term borrowings approaching maturity without realistic prospectus to repay.
- Adverse key financial ratios – Excessive reliance on short term borrowings to finance long-term assets. (CARO Reporting Clause - ix)**

whether funds raised on short term basis have been utilised for long term purposes? If yes, the nature and amount to be indicated.

- Substantial operating loss
- Inability to pay creditors on due dates
- Loss of a major market
- Shortages of key raw material
- Huge Labour turnover / Labour unrest
- Pending legal proceeding and claims from which are substantial
- Non-compliance of Law / regulation
- Changes in law or regulation by Government

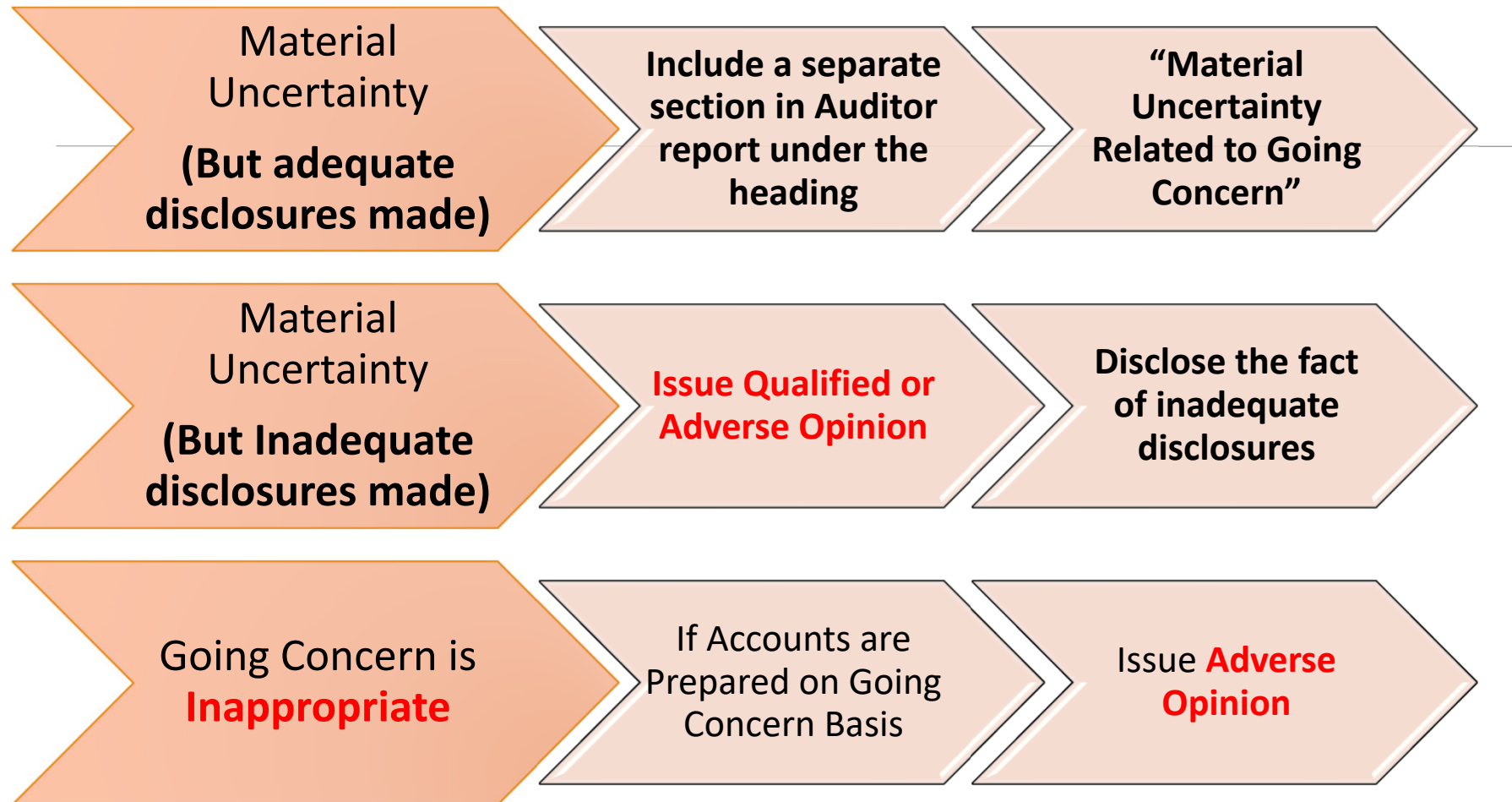
Reporting Change

Instead of the earlier requirement to report material uncertainties within an **Emphasis of Matter paragraph**, reporting of a material uncertainty is now required to be made within a separate section of auditor's report titled as **“Material Uncertainty related to Going Concern”**.

CARO 2020- Clause (xix) – Material Uncertainty

On the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit that company is capable of meeting its liabilities as and when they fall due within a period of one year from the balance sheet date.

Auditors Duty: Reporting on Going Concern



Thanking God for the
Blessings!

CA R S Balaji, B.Com, FCA
Chartered Accountant
Chennai

Certified Peer Reviewer (ICAI)
Co-opted Member AASB of ICAI
(2019-2022)

rs.balaji.raman@gmail.com
9994062916

