KEY LEARNINGS FROM RECENT NFRA ORDERS

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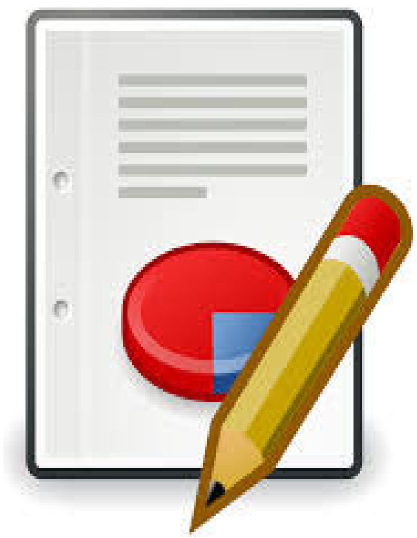


PC

NATIONAL FINANCIAL REPORTING AUTHORITY (NFRA)

Section 132(2)(b) of the Companies Act, 2013, requires the NFRA to, inter-alia, monitor and enforce compliance with accounting standards and auditing standards in such manner as may be prescribed

Rule 8 of the NFRA Rules, 2018, provides that for the purpose of monitoring and enforcing compliance with auditing standards under the Act, NFRA may-

(a) Review working papers (including audit plan and other documents) and communications related to the audit;	(b) Evaluate the sufficiency of the quality control system of the auditor and the manner of documentation of the system by the auditor; and	(c) Perform such other testing of the audit, supervisory and quality control procedures of the auditor as may be considered necessary or appropriate.

PC

POWERS

- Inspect
- Investigate
- Pick up cases where public interest is involved
- Ask for documents – soft / hard
- Levy penalty
- Debarment

PROCEDURE

Disclaimer:
The procedure defined herein are illustrative in the nature.

Responding to the Notice : Upon receiving the notice / Intimation, the Auditor must share the requested information or documents within the specified time frame

Providing Information: Auditors must cooperate with the registrar by providing all necessary information and explanations related to the company's financial statements, audit reports, and other documents.

Producing Documents: Auditors are required to produce any books, papers, and documents they have in their possession or control that pertain to the audit.

Assisting in Inquiry: Auditors should assist in the inquiry by providing answers and insights based on their audit findings and expertise.

PROCEDURE

Disclaimer:
The procedure defined herein are illustrative in the nature.

Maintain Proper Records : Ensure all audit work papers, reports, and related documents are systematically maintained and easily accessible.

Timely Response: Respond promptly to any request from the registrar or inspector. Delays can be seen as non-cooperation and can lead to penalties.

Accuracy and Transparency: Provide accurate and complete information.

Confidentiality: While cooperating with the authorities, auditors must also ensure that they maintain the confidentiality of the information as required by their professional and legal obligations, except where disclosure is legally mandated.

ANNUAL INSPECTION

Review of SQC 1 and related documents – policies / procedures, details, documents

Review of Audit Files

KEY LEARNINGS - ACCOUNTING

REVENUE RECOGNITION

- Appropriate Accounting policies – matching with sources of Revenue
- Point of Revenue recognition – supporting evaluation
- Adequacy of Internal Controls relating to Revenue recognition – Verification of relevant Controls
- Accounting policies followed by previous auditors – re-evaluate
- Reconciliation of Turnover – GST
- Proof of Delivery – point of accounting – meeting the criteria as per Ind AS 115
- Material other income balances to be disclosed separately

EXPECTED CREDIT LOSS

Evaluation of applicability – identification of areas – Ind AS 109

Evaluation of Assumptions

Use of experts – evaluation of supportings

Questioning Mind –assess the underlying – only verifying arithmetical accuracy is not adequate – Management bias

Conclude on the matters – document well – the judgements

Assess based on Materiality

IMPAIRMENT OF NON FINANCIAL ASSETS

Documentation of assessment of indicators – Ind AS 36

Assessment of financial indicators

Assessment of non-financial indicators

Assessment of Value in use Vs Market cap Vs Valuation

Expert help for Valuation – Questioning mind, evaluation of assumptions, sensitivity analysis

Conclusion and how it is agreeing with the financial statements

RELATED PARTY TRANSACTION

- Ensure disclosure of all relevant transactions and relationships
- Complete Disclosures – as per Ind AS 24 – including changes / terms & conditions / movements
- Cross reference to various notes
- Ensure disclosures required by Sec 186, where applicable

OTHERS

- Non-consolidation of Subsidiary / component
- Recognition of interest on the NPA
- Classification of borrowings
- Evaluation of Contingent liabilities – PPR Analysis
- Writing back of liabilities – supporting and evaluation
- Inappropriate accounting policies
- Ensure disclosure and reporting of charges against assets, and title deeds of immovable properties
- Depreciation is to be charged on assets even if the same was idle/not in use.
- Interest cost may be considered for inventory valuation only if it is considered as a 'qualifying asset'. This must be justified in the documentation and be spelled out in the accounting policies.
- Consolidation adjustments to be ensured – For instance, Income and Expenses in case of intra-group transactions between subsidiaries must be in conformity.

CIRCULAR

The company's discontinuation of the recognition of accrual of interest while calculating the amortized cost of the borrowings was in violation of Effective Interest Method (EIM) and Effective Interest Rate (EIR) principles and concepts underpinning the Amortised Cost measurement. The Statutory auditor who was required to identify and question the company on this change in accounting treatment failed to do so and report this critical non-compliance to the shareholders.

It may be noted that the banks do discontinue, in their accounts, the recognition of interest income on the assets classified as NP As based on prudential guidelines of RBI. However, these guidelines also require the banks to maintain a Memorandum Record of Accrued Interest on the NP As clearly reflecting the fact that the bank has not legally released the borrowers from their contractual iability to pay interest on their borrowings from the bank.

This is the case even when the bank writes off loans for accounting purposes (called Technical Write-off) but continues to maintain memorandum records for pursuing its legal proceedings for recovery of its dues from the borrower. In this connection it is pertinent to bear in mind the prudent and stringent principles of Ind AS 109 for derecognition of any financial liability or part ofit. Para 3.3.1 of Ind As 109 explicitly requires that financial liability shall be removed from the Balance Sheet when, and only when, it is extinguished. Para B3.3.1 further states that a financial liability is extinguished only when the borrower is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. In the present case, the banks had not released the company from the liability of the borrowing as well as the interest.

Ind AS 109 has specific accounting prescriptions as to how to account for the effect ofrevision in estimation of receipt and payment of cashflows other than changes in expected credit losses, whether/how to account for modification of contractual cash flows of financial liabilities, when to revise the EIR etc. Simply discontinuing interest expense accrual, that too unilaterally by the borrower company, is non-compliance with these specific prescriptions of Ind AS 109 resulting in erroneous measurement and presentation of Amortised Cost of a financial liability and the related interest expense in the Balance Sheet and Statement of Profit and Loss, respectively.

CIRCULAR

In view of the above reasons, discontinuation of interest expense recognition on financial liability solely based on the borrowing company's expectations of loan/interest waiver/concession without evidence of the legally enforceable contractual documents results in major non-compliance with the applicable accounting standards, compliance with which is mandated by the Act. In this regard, all concerned may also note the use of word "shall" in the language of the Ind AS, emphasizing their mandatory nature.

Accordingly, all companies which are required to follow Ind AS and their audit committees are hereby advised not to discontinue recognition of the principal or interest merely because of the borrowings being declared NP A or the Management's expectation of a likely settlement with or without concessions from the banks. The auditors are required to ensure strict compliance with this circular while performing audits.

Para 46 of Ind AS 115, Revenue from Contracts with Customers, requires that the entity shall recognise as revenue the amount of the transaction price, excluding the estimates of variable consideration that is allocated to that performance obligation. However, it has been noticed that the significant accounting policies disclosed by many companies wrongly state that revenue is recognized and measured at fair value of the consideration received or receivable.

Appendix A to Ind AS 115 defines the 'transaction price' as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. It is important to note that the transaction price defined in appendix A to Ind AS 115 is different from 'fair value' defined in Ind AS 113 and Ind AS 32, Financial Instruments: Presentation. Under Ind AS 115, the application of fair value is relevant only in a limited set of situations; for example, under para 66 oflnd AS 115, where the customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration at fair value.

CIRCULAR

Trade receivables are financial assets within the scope of measurement requirements of Ind AS 109, Financial Instruments. All financial assets are required to be initially measured at fair value plus or minus the transaction costs. However, those financial assets classified as 'fair value through profit or loss' are required to be measured at fair value (para 5.1.1 of Ind AS 109). Further, as an exception to these principles, according to para 5.1.3 read with para 5.1.1 of Ind AS I 09, financial assets in the form of trade receivables, shall be initially measured (initial recognition amount) at their transaction price (as defined in Ind AS 115) unless those contain a significant financing component determined in accordance with Ind AS 115 (or when the entity applies the practical expedient in accordance with para 63 of Ind AS 115).

It has, however, been noticed that many companies in their accounting policy, either stated separately for trade receivables or stated as part of the accounting policy for financial assets which include trade receivables, are erroneously stating that the trade receivables are initially recognized (or measured) at fair value, which is contrary to the requirements of Ind AS 109.

Further, there have also been instances of inconsistency between the accounting policy for initial measurement of trade receivables and the accounting policy for measurement of corresponding revenue leading to misleading and confusing information to the users of the financial statements.

The above instances of wrong accounting policies by a few companies reflect inadequate understanding of the measurement and disclosure requirements of the relevant Ind ASs. Accordingly, all listed companies and other entities falling with the domain of NFRA which are required to follow Ind ASs are hereby advised to comply with the provisions of lnd AS 115 and Ind AS I 09, as discussed above. The auditors of these companies are required to ensure strict compliance, in the performance of their audits, with the provisions of the Ind ASs as brought out above.

KEY LEARNINGS - AUDITING

SQC 1

SL0

- Formal documentation in regard to various roles to be available.
- Ensure assessment of non-audit services as per local and global regulations, as applicable. To also ensure that no prohibited services (Sec 144 of Companies Act) are provided.
- Timely performance of Client Acceptance and continuance (before any procedures are performed on the engagement) considering all the events and circumstances surrounding the entity,
- Qualified and experienced human resources including use of technology to ensure further improve audit quality and efficiency in the quality systems.
- Audit documentation to clearly evidence details of preparers, reviewers and the dates of review was performed. Minutes of the meeting with EQCR to be documented. EQCR involvement on engagements - to challenge ET/EP judgement.
- Ensure formal documentation and updation of firmwide policies, and ensure that the firm's inspection programmes are methodological and consistent

Materiality

- Adequate documentation must be maintained on the determining of overall and performance materiality.
- Materiality should be based on the actual performance of the entity instead of average performance of the entity in earlier years, especially in cases where there is a significant decline in the level of operations or performance of the entity.
- In case of any doubt relating to selection of appropriate benchmark or percentage of materiality, it is encouraged to raise consultations.

PLANNING

PLANNING

Risk identification and assessment procedures

- Robust documentation of the rationale for risk identification and assessment.
- Inclusion of rationale for rebuttal of presumed inherent risk must be ensured.

Client Acceptance / Re-acceptance Procedures

- To be performed in a timely manner (before any procedures are performed on the engagement) considering all the events and circumstances surrounding the entity,
- Appropriate risk categorization (Normal, More than Normal or High) must be identified for the questionnaires in case of any adverse findings.

Fraud Risk

- Ensure timely reporting of Fraud matters u/s 143(12) of the Companies Act, 2013. Also, include element of surprise in Fraud testing procedures.

INTERNAL FINANCIAL CONTROLS

- To ensure that the work performed to ensure:

  i. the design and implementation of controls;
  ii. and operating effectiveness of the controls

  is documented, keeping in view sampling calculator, for all material business processes, to enable issuance of opinion on the internal financial controls.

- Evaluation of ITGC should be documented.

- In case of any deficiencies noted, additional procedures must be performed and the evaluation of the effects of the deficiencies must be documented.

REVENUE RECOGNITION

Engagement teams must ensure that the sample size for testing of operating effectiveness of control (including IT dependent controls) is commensurate with the risk level. Default inherent risk in revenue is considered as high, engagement teams must ensure that sampling is done at high level.

Engagement teams to check the accuracy and correctness of the 'price details' applied to the actual invoices

Engagement teams must ensure that the accounting policies of the entities are in line with the requirements of Ind AS 115.

Engagement teams to ensure that sampling procedures cover all significant revenue streams

RELATED PARTY TRANSACTIONS

Identification of RP – completeness, source, verification of Minutes and Registers.

Verification of transactions

Verification of whether the transactions are at Arm's length Price
(irrespective of express statement in FS or otherwise)

Verification of the entire procedure followed by the Company and documentation

Ensure management's compliance with Section 185 and 186 of the Companies Act

LOANS AND ADVANCES

- Engagement teams must ensure the valuation of the Loans and Advances given, including those given to related parties, and must ensure recognition of impairment loss where necessary.

- Ensure understanding of the end use of the funds and rationale for transactions, irrespective of it being a wholly owned subsidiary (Sec 186 exemption).

- Identify conditions that may indicate funds diversion – understanding business relationships, verification of bank statements, advances made to directors or connected persons etc.

- Ensure to verify whether the loan proceeds are utilized for the purpose for which it is taken. Rationale for deviation in the same to be enquired and documented/ reported.

- Ensure Fraud Risk to be covered.

IMPAIRMENT

Engagement teams to ensure compliance of Ind AS 109: that the entity's recognition and measurement criteria for impairment loss allowance is in accordance with the ECL approach of Ind AS 109. Engagement teams must verify the historical data in this regard accordingly verify the assumptions used by the management.
Engagement teams to ensure evaluation of impairment loss on investments. ET to document the basis of the valuations done and ensure that the valuation reports and other documents are included and documented.
Engagement teams must ensure the valuation of the Loans and Advances given, including those given to related parties, and must ensure recognition of impairment loss where necessary.
In case a management expert's work is relied upon, perform assessment of the competence, capability and objectivity of the expert.
Engagement teams to also ensure that the Loans are sanctioned as per the Company's Policy and in compliance with Section 186 of the Companies Act (in case of related party loans). Any loans given to credit impaired entities or non-creditworthy individuals may be an indication of impairment loss.

CONSOLIDATION

- Further impetus on group auditor to verify the work of the component auditors.
- Reliance cannot be placed solely on the work of component auditors; conditions may warrant discussions with the group management.
- Evaluate all material transactions within the components and not only material subsidiaries.
- Mere sending / receiving of Group audit Instructions is not adequate. Work done in respect of these to be demonstrated in AWP.

OTHERS

Management's assessment of Going Concern should be enquired, reviewed and documented. Procedures must be performed to evaluate the base data and assumptions used, and a stress test/sensitivity must also be performed to support it. Engagement teams to ensure consultations are timely raised. Any close call matters must also be consulted.

Engagement teams to ensure compliance with Ind AS 103: Business combinations – to ensure the valuation of the contingent consideration involved in the business combination transactions and ensure documentation.

Engagement teams to ensure that all the documents in the audit file are cross-referenced correctly.

OTHERS

In case of testing Management override of controls, Engagement Team to ensure appropriate documentation of criterias for selection of Journal entry testing is performed. ET to also ensure relevant attributes are documented and underlying supporting evidences are tested and verified. Engagement teams must ensure that the compliances of SA 501 are met
Inventory verification procedures to be performed on all material categories of inventories (incl. WIP or trading stock)
Determination of TCWG and communicating with them in a timely manner
Letter of representation is not considered as a mode of obtaining evidence
Performing work on opening balances and ensuring consistency in comparatives
In case of write-back of any liabilities to other income, engagement teams to ensure that appropriate settlement agreements are verified.

OTHERS

In regard to Accounts Receivables, teams to ensure that confirmations are sent out to the entity's customers unless impracticable, and alternative procedures are performed in case of non-response.

Confirmations must be independent, reliance cannot be placed on management confirmations

To ensure that all external confirmations sent out are included in the audit work papers.

To ensure that proper recording and accrual of expenses, in particular for interest cost on borrowings under Ind AS 109, even if the same is not paid.

FORMING OPINION & REPORTING

To ensure potential 'Material and Pervasive' impact of misstatements and document the assessment of pervasiveness of the misstatements in accordance with the guidance under SA 705 (including qualitative factors).

In case a deficiency is identified in the Internal Financial Controls, the effect of the same should be considered in the main audit report.

KAMs and their assessment should be documented in the audit file.

Uncorrected misstatements must be considered gross of tax and not net of tax.

To ensure CARO reporting with respect to compliance u/s 185 and 186.

Additionally, disclosures for borrowings with related parties are to be appropriately made in the financial statements (eg - rate of interest, repayment terms, due date, collateral etc.).

Reporting a Qualification Vs Reporting an EOM

Reporting a Disclaimed opinion/EOM/OM Vs Reporting a KAM.

In case of a joint audit, engagement teams are required to perform audit procedures and come to an independent conclusion regarding the significant matters that are brought to their notice by the joint auditors. Moreover, the conclusions drawn by the joint auditors must be documented and considered from the perspective of the ET as well.

FILE ASSEMBLY & ARCHIVAL

File assembly should be done in a timely manner within the archival period.(No changes to the archived file).
Note for changes made during housekeeping period (before Archival) should be documented. Edits post sign off should be minimized.
Consultations, if any, to be documented in the file. All necessary facts and circumstances, technical literature relied on, and conclusions arrived at should be clearly mentioned in the consultation memos and the surrounding documentation.
Register to be maintained in case of Hard File.

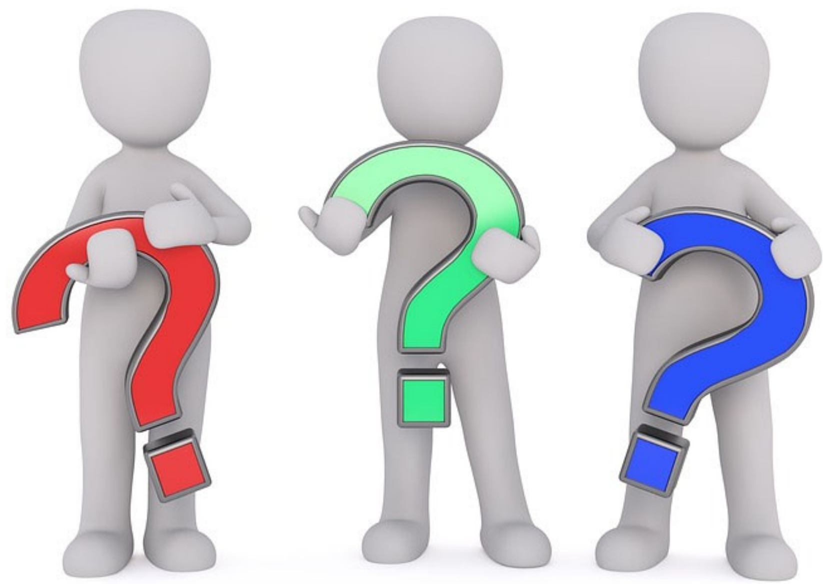
Non- cooperation despite several communications
False information in certificate of 80JJAA
Non consolidation of one subsidiary

OTHERS

FURTHER READING

NFRA Website:

[National Financial Reporting Authority | India (nfra.gov.in)]




THANK YOU :)