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## **AUDIT QUALITY REVIEW (AQR) REPORT**

**Auditor: Deloitte Haskins & Sells LLP**

**(Firm Registration No. 117366W/W-100018)**

**Auditee: IL&FS Financial Services Limited**

**Financial Year: 2017-18**

**Report No. 01/2019**

**Dated: 12th December, 2019**

**NATIONAL FINANCIAL REPORTING AUTHORITY**

**GOVERNMENT OF INDIA**

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**Chapter 1: Introduction**

- 1.1. Section 132 (2) (b) of the Companies Act, 2013, requires the National Financial Reporting Authority (NFRA) to, inter alia, monitor and enforce compliance with accounting standards and auditing standards in such manner as may be prescribed.
- 1.2. Rule 8 of the NFRA Rules, 2018, provides that, for the purpose of monitoring and enforcing compliance with auditing standards under the Act, the 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.
- 1.3. Pursuant to the duty cast upon the NFRA, and the mandate given in this connection, the NFRA has taken up the **AQR** of the statutory audit of ILFS Financial Services Limited (IFIN) for the financial year 2017-18 (the “**Engagement**”) carried out by **Deloitte Haskins & Sells LLP (Firm Registration No. 117366W/W-100018)** (“**Audit Firm**”). This **AQR** has the objective of verifying compliance with the Requirements of Standards on Auditing (SAs) by the **Audit Firm** relevant to the performance of the **Engagement**. The **AQR** also has the objective of assessing the Quality Control System of the **Audit Firm** and the extent to which the same has been complied with in the performance of the Engagement.
- 1.4. The **AQR** process was started by asking the **Audit Firm** to provide to NFRA the **Audit File** (as defined by Para 6(b) of SA 230). Thereafter, the **Audit Firm** was issued a questionnaire on 2<sup>nd</sup> May, 2019. The **Audit Firm** provided its response to the questionnaire on 13<sup>th</sup> May, 2019, detailing therein the relevant sections of the **Audit File** pertaining to the several questions. The matters raised in the initial questionnaire of the NFRA dated 2<sup>nd</sup> May, 2019, were examined by referring to the portion of the **Audit File** relevant thereto as pointed out by the **Audit Firm**. Subsequently, the NFRA conveyed its prima facie observations/comments/ conclusions on the various issues in the questionnaire to the **Audit Firm** vide its letter dated 28<sup>th</sup> June, 2019. The **Audit**

**Firm** provided its detailed response to the NFRA's prima facie observations/comments/conclusions vide its letter dated 3<sup>rd</sup> August, 2019. A **Draft Audit Quality Review Report (DAQRR)** was issued on 25<sup>th</sup> September, 2019. The **Audit Firm** made a presentation in response to the **DAQRR** to the NFRA on 30<sup>th</sup> October, 2019, and followed it up by submitting their written response to the **DAQRR** on 4<sup>th</sup> November, 2019. This has been examined and taken into account while preparing the final **AQR** Report.

A detailed chronology of the events mentioned in the above paragraph as well as the references to the earlier interim findings of the NFRA in this case is placed at **Annexure II**. All this material would need to be consulted to provide the background to the present **AQRR**, and, when found necessary, to support the reasoning in the present **AQRR** in respect of any issue. Wherever the **Audit Firm** has provided satisfactory responses to the conclusions of the **DAQRR**, or has pointed out inaccuracies in the **DAQRR**, those issues have been dropped from the summary findings of the **DAQRR** that have been included in this **AQRR**. The detailed discussions on the evidence in the Audit File and in the responses of the **Audit Firm** to the prima facie conclusion/**DAQRR** on any matter, and NFRA's analysis and conclusions thereon, is not repeated here in the interest of conciseness.

- 1.5. NFRA has examined only some select issues arising out of the statutory audit of ILFS Financial Services for 2017-18 in detail in the current **AQRR**. It, therefore, reserves the right to follow up this **AQRR** by a supplementary report, if found necessary, covering any other issues which have not been covered in this report.

## Chapter 2: NFRA's Conclusions

### 2.1 General

- 2.1.1 The NFRA has gone through the responses of the **Audit Firm** sent vide their letter dated 3<sup>rd</sup> August, 2019, along with all its enclosures, their presentation on 30<sup>th</sup> October, 2019, and their written response dated 4<sup>th</sup> November, 2019, to the **DAQRR** and has concluded as in the subsequent sections of this AQR in respect of the several issues raised by NFRA.
- 2.1.2 While the discussion in this **AQR** on individual issues refer to SAs most directly bearing on the issues/facts under consideration, it needs to be borne in mind that certain generally applicable requirements of the SAs, such as the need to exercise professional skepticism, the need to obtain sufficient appropriate audit evidence, performance of procedures to address the assessed risks etc., would have to be read as integral parts of all individual issues, though not specifically included therein.
- 2.1.3 The instances discussed below of failure to comply with the requirements of the SAs are of such significance that it appears to the NFRA that the **Audit Firm** did not have adequate justification for issuing the Audit Report asserting that the audit was conducted in accordance with the SAs. In this connection, the NFRA wishes to draw attention to Response 12 in the ICAI's Implementation Guide on Reporting Standards (November 2010 edition) that says that **"A key assertion that is made in this paragraph is that the audit was conducted in accordance with the SAs"**; and that **"If during a subsequent review of the audit process, it is found that some of the audit procedures detailed in the SAs were not in fact complied with, it may tantamount to the auditor making a deliberately false declaration in his report and the consequences for the auditor could be very serious indeed"** (emphasis added). It bears emphasis that the very serious consequences referred to would ensue irrespective of whether such non-compliance was or was not associated with a disclosed financial reporting misstatement. Failure to comply with any of the Requirements of applicable SAs indicates that the **Audit Firm** has failed to achieve the central purpose of the audit, and that there was not an adequate basis to issue the report that it did.

2.1.4 The **AQR** is designed to identify and highlight non-compliance with the requirements of the SAs and to bring out insufficiencies in the Quality Control System of the **Audit Firm** and the shortcomings in the documentation of the audit process. The **AQR** also evaluates the quality and adequacy of the supervisory procedures of the **Audit Firm**. The **AQR** is, therefore, not to be treated as an overall rating tool. Separately, NFRA will examine whether disciplinary proceeding under Section 132(4) of the Companies Act, 2013 needs to be initiated.

## **2.2 Compliance with Independence Requirements**

**2.2.1 The several stipulations and conditions to be fulfilled pertaining to the independence of Statutory Auditors are laid down in the following:**

- (a) Companies Act, 2013: Section 141 pertaining to eligibility, qualifications and disqualifications of Auditors. Special note is to be taken of clause (i) of sub-section (3).
- (b) Companies Act, 2013: Section 144, which lists the non-audit services that an Auditor is prohibited from providing.
- (c) Companies Act, 2013: Explanation to Section 144 which provides the exact scope of the meaning of the phrase “directly or indirectly”.
- (d) The Chartered Accountants Act, 1949: Sub-section (2) of Section 2, which defines the kind of activities undertaken by a member of the Institute that will result in his being deemed to be in practice. Special note needs to be taken of clause (iv) of Sub-section (2) of Section 2 which empowers the Council of the Institute to specify what services (other than accountancy, auditing, etc.) can be rendered by a Chartered Accountant in practice.
- (e) Regulation 190A of the Chartered Accountants Regulation, 1988: This lays down that a Chartered Accountant in practice shall not engage in any business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council.

- (f) SQC 1 which provides that the SQC is to be read in conjunction with the requirements of Chartered Accountants Act, 1949, the Code of Ethics, and other relevant pronouncements of the Institute (such as the Guidance Note on Independence of Auditors). It is to be noted that the SQC 1 forms part of the Standards on Auditing (SA) and hence has the force of law in terms of Section 143(10) of the Companies Act, 2013. SA 200 (Overall Objectives of the Independent Auditor) also requires that the Auditor comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. This requirement also encompasses the need to comply with the Code of Ethics of the ICAI, and SQC 1.

2.2.2 The Guidance Note on Independence of the Auditors issued by the Institute of Chartered Accountants of India (ICAI) states as follows:

*“It is not possible to define “independence” precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.*

*There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.*

*The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term ‘Independence’ as follows:*

*“Independence is:*

- (a) *Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and*

- (b) *Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional skepticism had been compromised.”*

*Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors’ independence.*

*In all phases of a Chartered Accountant’s work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.”*

2.2.3 All the above provisions of law have to be read together as a coordinated and integrated whole, in a harmonious manner. On doing so, the following position emerges:

- (a) The need to maintain independence in mind, and also independence in appearance, is paramount. The provisions of law should be understood keeping in view this paramount consideration.
- (b) The five categories of threats to independence, as explained by the Code of Ethics, need to be kept in mind. All cases involving provision of any non-audit service to an audit client must be passed through the tests of these threats. In a situation of even the slightest doubt, the conclusion must be that the threat exists and is real.
- (c) While interpreting the scope of the prohibited services listed in Section 144 of the Companies Act, 2013, the interpretation must be biased to the broadest view possible of the scope of such prohibited services, keeping in view the need to maintain independence both in mind, and in appearance. The listed services suffer from an absolute and unconditional prohibition, and there cannot be any requirement imposed to prove the existence of any of the threat categories as a pre-condition to their prohibition.
- (d) Amongst the prohibited services listed in Section 144, the one entry that is the most widely defined is that of “management services”. This is also not confined to the functional areas of finance and accounting to which all the other entries at clauses (a) to (g) seem to be related. There is no definition of “management services” provided in the Act; hence it is to be understood in its literal meaning. “Management Services” has to be taken as services (performed by the statutory auditor) for the management, either (a) in the form of doing actions/functions that would otherwise have to be done/undertaken by the management; or (b) providing any kind of support (inclusive of analysis, research, advice etc.) that is required by management for the performance of those actions/functions.

- (e) Reading Section 2(2)(iv) of the Chartered Accountants Act, 1949, subject to Section 144 of the Companies Act, the conclusion is that as far as any statutory audit client is concerned, a Chartered Accountant cannot provide any service falling even under the category of “management consultancy” services, since all such services would be encompassed by the broader category of “management services” that stands prohibited by Section 144 of the Companies Act, 2013.
- (f) As far as any other service, not falling within the scope of the prohibited services listed under Section 144, is concerned, the **Audit Firm** needs to be put to strict proof that the service provision does not attract any of the threat categories.
- (g) Section 177 of the Companies Act vests with the Audit Committee the responsibility for reviewing and monitoring the independence of the auditor. It is in pursuance of this provision that the non-audit services to be provided by the Statutory Auditor have to obtain the prior approval of the Audit Committee, as laid down by Section 144. This function of the Audit Committee cannot be usurped by the Board of Directors.

2.2.4 In order to examine the extent to which these statutory provisions have been complied with, the **Audit Firm** was asked to provide details of any services rendered to the client company or its holding company or subsidiary company either directly or indirectly. A list of several services thus provided has been furnished by the **Audit Firm**.

2.2.5 Keeping the legal principles outlined above in view, NFRA had examined certain engagements (details are given in **Annexure I**) where services had been provided by the **Audit Firm** and its related entities (as defined by the Explanation to Section 144) to either IFIN, or its holding company, Infrastructure Leasing and Financial Services (ILFS) Ltd. In all these cases, the **Audit Firm** was found to have, either directly or indirectly, provided prohibited services to the auditee company, or its holding company.

2.2.6 The Code of Ethics also requires using different partners and ETs with separate reporting lines for the provision of even permitted and duly authorised non-

assurance services to an assurance client (Section 200). However, NFRA had observed two engagements in the examined list (c, f) where the team was led by CA Shrenik Baid, said to be one of the EPs, and had concluded that this was a clear violation of this requirement.

**2.2.7 In all the cases examined in the DAQRR, Audit Committee approval as mandated by Section 144 of the Companies Act, 2013 was NOT found. Hence, the DAQRR concluded that the Audit Firm had violated the requirements of Section 144 of the Companies Act, 2013, on this count also in every case.**

2.2.8 The **Audit Firm's** submission to the NFRA vide letter dated July 17, 2019, confirms using the same senior personnel, i.e. CA Nishit Udani and CA Rakesh Jain, on the audit engagement since 2008-09. Paras 25-27 of SQC 1 requires the **Audit Firm** to establish criteria for determining the need for safeguards to reduce this familiarity threat. Since SQC 1 clearly restricts an EP on an engagement for maximum of seven years, the engagement of senior personnel who contribute significant duration of time on audit cannot override this time limit. The **DAQRR** had found that the **Audit Firm** had failed to counter the familiarity threat or impairment of quality of performance of audit due to using the same senior personnel over a prolonged period.

2.2.9 WP 11104 in the Audit file says that “the visibility of Deloitte leadership with the Senior Management of the company and IL&FS Group is extremely strong. Our partners and directors, who have industry experience of more than 15 years, have access to the Senior Management of the Company. Udayan Sen (Lead Client Service partner), Shrenik Baid (EP) and Nishit Udani (Engagement Director) **have direct access to the Chairman, Managing Director and CFO of the Company. Hence there is a regular communication with the Senior Management on one to one basis**” (emphasis added). Ironically, this statement had been made to support the **Audit Firm's** assessment that there was no ROMM due to fraud. The **DAQRR** concluded that this clearly indicated a familiarity threat to independence that was not properly and adequately dealt with.

2.2.10 The **DAQRR** noted that in situations where no safeguards are available to reduce the threat to an acceptable level, the **Code of Ethics says that the only**

**possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement (Section 290.24).**

**2.2.11 On a consideration of all the above evidence, NFRA concluded in the DAQRR that:**

- (a) The **Audit Firm** had grossly violated the provisions of Section 144 of the Companies Act, 2013;
- (b) The **Audit Firm** had been in serious breach of the Code of Ethics;
- (c) These violations had continued over several years;
- (d) The violations had undoubtedly fatally compromised the independence in mind required of the **Audit Firm**;
- (e) Independence in appearance stood completely destroyed since no unbiased person could conclude, on an objective assessment of the circumstances, that there had been no abridgement of the auditor's independence; and
- (f) The **Audit Firm**'s QC Policies and Practice relating to independence had been shown to be severely inadequate and not fit for purpose.

**2.2.12 The Audit Firm has responded to the observations of NFRA in their written response dated 4<sup>th</sup> November, 2019. This has been examined by NFRA carefully and the NFRA's final conclusions are as follows on the three specific issues discussed in this section:**

**2.2.13 (A) Prohibition of Non-Audit Services**

On this subject, the **Audit Firm** has made the following points relating to the issues of law involved:

- (a) In the absence of any definition/guidance for the term “management services”, the interpretation of “management services” can be derived using the following aids, prevailing at the time of enactment of the Companies Act, 2013:
  - (i) Various Committee Reports/Bills;
  - (ii) Independence policies of professional bodies;
  - (iii) International laws/rules. (Page 29)
- (b) Based on the language of the prohibited services, it appears that the prohibited services have been recommended by the Committees based on Section 201 of the SOX Act, 2002 (Page 30).
- (c) The intent of the legislature was not to prohibit provision of “any other kind of consultancy services”; as a corollary, the intention of the legislature was that some management consultancy/similar services were permissible (which also aligns with ICAI guidelines on permissible services for auditors) (Page 30).
- (d) The suggestion to define “management services” using AICPA Code of Ethics of Professional Conduct was rejected by the Standing Committee Report of 2012 stating that the guidance on management services is internationally followed and therefore, there is no need for further explanation/guidance on “management services” (Page 30).

- (e) “Based on the above, it is clear that the intention of the legislature for “management services was to follow internationally followed practices that were prevalent at the time of enacting the Companies Act, 2013. Accordingly, in the absence of any definition of “management services”, we have followed “management services” to mean as services **that comprise or include management responsibilities** as defined in IESBA Code of Ethics, 2010 and as amended from time to time” (emphasis added).

**2.2.14 NFRA has examined the above contentions of the Audit Firm and has concluded as follows:**

- (a) Admittedly, the term “management services” has not been defined in the Companies Act, 2013. In such situations, the settled principles of statutory construction require that the words used in the statute must be understood in their normal or dictionary sense and be given their literal and direct meaning. While doing so, the context in which the words are used will clearly be important. At the same time, the principles of interpretation would require that no extraneous matter should be brought in as part of the interpretation. Similarly, all the words used in the statute would have to be given their full meaning and no part of the statute can be rendered otiose.
- (b) Using these principles, it is clear that the context, which is one of prohibition of provision of non-audit services by the auditor of a company, would mean that “management services” should be interpreted only as services that can be, or potentially can be, provided by the auditor to the management of the company. Given the context, it would be entirely repugnant thereto to interpret the term “management services” as “services performed or rendered by management”. If this were to be the interpretation, the question would then arise as to the person/entity for whom management is performing or rendering any services. The argument of the **Audit Firm** that the term “management services” implies the equivalent of “management responsibilities” is unacceptable since “management responsibilities” would mean actions to be done/functions to be undertaken **BY** management and not services rendered **TO**

management, which is what is required by the context in which the term appears. “Management responsibilities” have to be discharged **ONLY** by management and cannot be done by others. All others, including auditors, can help management in discharging such responsibilities by providing them services of various kinds.

- (c) Hence, the definition of “management services”, read in the context in which the term has been used in the statute, can be only understood to mean “services performed by the statutory auditor” for the management, either (a) in the form of doing actions/functions that would otherwise have to be done/undertaken by the management; or (b) providing any kind of support (inclusive of analysis, research, advice etc.) that is required by the management for the performance of those actions/functions.
- (d) As explained above, it is completely impermissible in all accepted norms of statutory construction to import concepts, meanings, and definitions from extraneous sources in a situation where a plain reading of the words of the statute does not indicate that this is either permissible or has necessarily to be done.
- (e) It is this definition of “management services” that has been applied by the NFRA to the individual cases listed in **Annexure I**.
- (f) As far as the contention of the **Audit Firm** that the intention of the legislature was not to prohibit provision of “any other kind of consultancy services” and that, it was indeed, on the contrary, to permit such provision, it is seen that the **Audit Firm** has based this argument on the Report of the Parliamentary Standing Committee on Finance, 2012. On an examination of the source documents (namely the Parliamentary Standing Committee on Finance Report of 2010 on the Companies Bill, 2009, and the Report of 2012 on the Companies Bill, 2011), it is clear that not only is the understanding by the **Audit Firm** of the Committee’s recommendations completely wrong, but that the **Audit Firm** has also seriously misrepresented the recommendations of the Committee.

The **Audit Firm** has said that a suggestion was received by the Standing Committee, 2012, to define “management services” using AICPA Code of Professional Conduct. It has also been stated that the quotation (on page 31 of the response dated 4<sup>th</sup> November, 2019, to the **DAQRR**) is the Committee’s rejection of this suggestion stating that the guidelines on management services is internationally followed and that, therefore, there is no need for further explanation/guidance on “management services”.

The Standing Committee Report, 2012 [Para 84 of Chapter IV of Part I of the Report (Suggestions on the Companies Bill, 2011)], clearly shows that the suggestion regarding the AICPA definition was one of 7 suggestions relating to Section 144, all of which were clubbed together and considered. These suggestions were all intended to curb/restrict/relax the proposed prohibitions. In fact, the suggestion at Sl. No.(vii) of the list was that if at all the Bill needs to cover any non-audit services, the Bill itself should contain only minimum restrictions and further restrictions may be prescribed through the Code of Ethics.

It is seen that the quote on page 31 of the response that is attributed by the **Audit Firm** to the Committee is, in fact, only a truncated part of the comments of the Ministry. The **Audit Firm** is, therefore, clearly guilty of deliberate misrepresentation, both by attributing the quotation to the Committee, and also providing only a truncated portion of the comments of the Ministry so as to present a completely misleading picture.

In fact, the Ministry, in its comments, had referred to the provisions of Clause 127 of the Companies Bill, 2009, which was examined by the Committee and recommendations on which are at Para 34 and Para 10.50 in its 2010 Report thereon. The Ministry had suggested that the provisions in the new Bill (namely Companies Bill, 2012, which has now become Companies Act, 2013) were in accordance with the recommendations of the Standing Committee Report, 2010.

It is seen that Para 34 of the Standing Committee’s Report, 2010 (page 31 of the pdf file) listed out suggestions received by the Committee about the need to make provisions relating to audit and auditors more stringent. The

suggestions included (a) prohibition of rendering of non-audit services both “directly as well as indirectly”, and suitably defining the term “directly or indirectly” in the Bill itself; (b) the prohibition should apply not only to the audit client company but also for its holding company, subsidiary company, and associate company; and (c) through a residual clause, prohibit the provision of “any kind of consultancy services” to take care of any non-audit services not covered in already provided clauses. Para 10.50 of the Report recommended that the Ministry should consider extending the scope of Clause 127 to cover specified services rendered to subsidiary companies as well.

In its comments to the Standing Committee 2012, the Ministry had referred to all this background, and the fact that the recommendations of the Standing Committee 2010, had been accepted virtually in toto. It is in this context that the Ministry, drawing attention also to international practices, had emphasized the need for such prohibition for auditors in India as well and urged a rejection of any suggestions for curbing/restricting/relaxing such prohibitions.

It is seen, therefore, that the conclusions drawn by the **Audit Firm**, ostensibly relying on the Report of the Parliamentary Committee, are completely unfounded and are an attempt at deliberate misrepresentation. Given the basic framework and principles governing statutory interpretation explained above, NFRA would have been fully within its right to ignore the extraneous matter such as statutes in other countries, Codes of Ethics prescribed by International Bodies etc., as well as the Reports of the Committees quoted by the **Audit Firm** in a situation where the plain meaning of the words used in the statute is clear and does not require any such additional aids to interpretation. Nevertheless, NFRA has considered in detail the arguments of the **Audit Firm** in order to both demonstrate their complete lack of merit as well as to highlight their attempts at deliberate misrepresentation of the material relied upon.

- (g) After re-examining the matter in the light of the responses of the **Audit Firm** to the **DAQRR**, NFRA reiterates and confirms its stand, for the reasons explained above, on the scope of the term “management services”.

2.2.15 **(B) Approval of Audit Committee**

- (a) The **Audit Firm** has contended that Section 144 requires approval by the Board of Directors or the Audit Committee in a situation only when permissible services are rendered by the **auditor** to the **auditee company**. It has further argued that where non-proscribed services are **provided by an entity other than the auditor**, the approval of the Board of Directors or Audit Committee is not required. Accordingly, the **Audit Firm** has contended that the engagements referred to in Paras 2.3.5 (c) and (h) of the **DAQRR**, which are cases where services have been rendered by DHS LLP as the Auditor of IFIN to IFIN, alone would require the approval of the Board of Directors or Audit Committee (page 106 and 107 of their response dated 4<sup>th</sup> November, 2019).
- (b) The **Audit Firm**'s argument is that where the non-prohibited services are provided by any entity other than the auditor (i.e. any entity other than DHS LLP), the approval of the Board of Directors or the Audit Committee of the company is not required (Page 106 and 107 *ibid*).

2.2.16 **NFRA has examined these contentions of the Audit Firm and has concluded as follows:**

- (a) When Section 144 provides that the approval should be granted by the Board of Directors or Audit Committee, **as the case may be**, this is not a situation where the choice of the approving authority is entirely at the discretion of the auditee company or its auditor. As is well known, all companies are not required to have Audit Committees. Audit Committees are prescribed as compulsory only for every listed public company and companies falling in specific categories mentioned in the rules. The prohibitions specified in Section 144 are not restricted only to such listed or specified companies. A plain reading of the phrase “**as the case may be**” in this context would mean that the approval of the Audit Committee

would be required in the case of all companies that are mandatorily required to have an Audit Committee. The reference to approval by the Board of Directors would apply only to companies that do not have an Audit Committee. If the Audit Committee gets by-passed and approval is obtained from the Board of Directors in a case where a company is mandatorily required to have an Audit Committee, then this would go clearly against the specific mandate and responsibility given to the Audit Committee in terms of Section 177 to review and monitor the auditor's independence. It would also render totally irrelevant and useless the reference to the Audit Committee in Sec 144. It is to be noted that Section 144 of the Act, and the prohibition on provision of non-audit services, that is contained therein, is a key element of the framework for maintaining the auditor's independence. Any other interpretation of these prohibitions would be completely contrary to the Scheme of the Act.

- (b) The contention of the **Audit Firm** is that Section 177 of the Companies Act only prescribes the responsibility of the Audit Committee to review and monitor the independence of the auditors. It has been argued that this does not deal with the requirement of obtaining Audit Committee approval for the services (page 38 *ibid*).

The **Audit Firm** has also contended that the requirements of such approval can be provided by the Board of Directors **OR** the Audit Committee, as the case may be (page 39 *ibid*).

For the reasons explained above, NFRA concludes that this stand of the **Audit Firm** is completely wrong and contrary to the plain wording of the law.

- (c) The second limb of the **Audit Firm**'s argument, that where the proscribed services are provided not directly by the auditor (though by an entity that falls in a related party category as per the explanation) the approval of the Board or the Audit Committee will not be required, is also not acceptable since it seeks to defeat the plain wording of the law. Where a non-audit service is sought to be rendered by the auditor, **either directly or indirectly**, it has to be decided, at the threshold, if such service falls within

any of the prohibited categories as per Section 144. The authority to decide this matter, in the Scheme of the Act, is vested only in the Audit Committee in the case of listed companies. It is not open to the auditor, or any of its related entities that undertakes the formal provision of the service, or even of the Board of Directors, to make this determination as to whether a service falls within the prohibited list or not.

- (d) NFRA also notes that the **Audit Firm** has not been able to provide even a single instance of Audit Committee approvals in respect of the several cases described in the **DAQRR**.

**2.2.17 (C) Staff Rotation and Familiarity Threat**

**With respect to the above subject, the Audit Firm has stated as follows:**

- (a) With regard to the familiarity threat to senior personnel, SQC 1 Para 26 requires the firm to establish criteria for the responses to the familiarity threat. Examples of responses are rotating senior personnel or requiring an Engagement Quality Control Review. The standard, therefore, provides an option of either rotating an EP or conducting a quality control review (page 110 *ibid*).
- (b) We have a policy for conducting engagement quality control review of all entities including listed companies. Besides, there is a policy of rotation of the Engagement Quality Control Review Partners of listed entities after 7 years (page 110 *ibid*).
- (c) During the period from 2008 to 2018, there were between 29 to 51 professionals each year on the engagement. During such period, only 2 professionals (one was a Senior Manager and other was a Director), were on the engagement for 7 or more years. Neither of them was an EP or responsible for Engagement Quality Control Review.
- (d) As far as the contacts with the senior management of the company and the ILFS Group is concerned, CA Udayan Sen and CA Shrenik Baid were assigned only for the last 2 years. For the previous 5 years, the EP was different.

2.2.18 **NFRA has examined the above contentions of the Audit Firm and has concluded as follows:**

- (a) For listed entities, Engagement Quality Control Review is compulsory and not an option. Therefore, the conduct of such Quality Control Review cannot be treated as a substitute for putting in place a policy of staff rotation, or any other such mechanism, for averting familiarity threats. The **Audit Firm** has failed to show the existence of any such policy.
- (b) While the two professionals named may not have been at EP level, they were senior enough, and performed key roles, to be considered under the staff rotation policy. As highlighted by the **Audit Firm** itself, “personnel” means partners and staff.
- (c) Admittedly, for the period of 5 years prior to the last 2 years, the EP was the same person (CA Kalpesh Mehta). In this context, it is seen that Para 72 of the Master Directions – NBFC – SIND and Deposit Taking Company (Reserve Bank) Directions, 2016, (Master Directions, 2016) provides for the partners of the CA Firm who conduct the audit to be rotated every 3 years so that the same partner shall not conduct audit of the company continuously for more than a period of 3 years. Admittedly, the **Audit Firm** has violated this stipulation in the RBI Master Directions by having the same EP for a period of 5 years. While the EP for the year 2017-18 may have been a different person, the past performance of the engagement by the **Audit Firm** clearly shows a serious violation of the RBI Directions designed to counter the familiarity threats.

2.2.19 Applying the above conclusion to the facts of the cases of the 15 engagements examined in the **DAQRR** and after examining the responses of the **Audit Firm** dated 4<sup>th</sup> November, 2019, NFRA’s final conclusions in each case are as given in **Annexure I**.

2.2.20 **In view of the above, NFRA is reinforced in its views that:**

- (a) The **Audit Firm** has grossly violated the provisions of Section 144 of the Companies Act, 2013;

- (b) The **Audit Firm** has been in serious breach of the Code of Ethics;
- (c) There has been a violation of the RBI Master Directions pertaining to mandatory rotation of the EP;
- (d) The above violations had undoubtedly fatally compromised the independence in mind required of the **Audit Firm**. The total fee for the 15 engagements listed in Annexure I was Rs. 666. 63 lakhs in comparison to the Audit Fee for the year 2017-18 of Rs. 401 lakhs for both the auditors. It may be noted that these 15 Engagements were from ILFS Ltd, the holding company of the group, or directly from IFIN, and do not include any of the several Engagements given by other Associates and Group Companies of IL&FS Group.
- (e) Independence in appearance stood completely destroyed since no unbiased person could conclude, on an objective assessment of the circumstances, that there had been no abridgement of the auditor's independence; and
- (f) The **Audit Firm**'s QC Policies and Practice relating to independence has been shown to be severely inadequate and not fit for purpose.

### **2.3 Role of Engagement Partner**

2.3.1 The prima facie conclusion of the NFRA, on the above matter, vide its communication dated 28<sup>th</sup> June, 2019, was that the EP, CA Udayan Sen, being the EP as defined by Para 6(b) of SQC 1, had signed the audit report notwithstanding the documented facts that he had completely failed in discharging his obligations as EP.

2.3.2 This **prima facie conclusion of the NFRA was based on the list of work papers reviewed by CA Udayan Sen, which clearly shows that almost all the important work of audit, i.e., independence evaluation, risk assessment, audit plan, audit procedures, audit evidence, communications with management or those charged with governance (TCWG) was not directed/supervised/reviewed by CA Udayan Sen.**

2.3.3 Further, the date-wise schedule of hours charged by CA Udayan Sen to the engagement as EP was not provided, nor was any reference in the **Audit File** provided in support thereof. The NFRA further noted that the **Audit Firm's** statement that "Udayan Sen has spent about 180 hours (though manually noted as 80 hours in the **Audit File**)" was self-contradictory and therefore, bereft of any meaning.

2.3.4 **The response of the Audit Firm was as follows:**

- (a) An engagement can have more than one EP. **It was decided to have two EPs for this particular engagement in view of the size and complexity of the engagement. Both CA Udayan Sen and CA Shrenik Baid each satisfied the requirements of the Para 6(b) of SQC 1. Having more than one EP can only enhance audit quality.**
- (b) For the purpose of internal identification and convenience CA Udayan Sen was identified by the use of the additional word "Signing" and CA Shrenik Baid was identified by the use of additional word "Review".
- (c) There is no bar in SQC 1 and in the SAs that prohibits more than one partner being assigned to be the EP.
- (d) WP No. 29702 (Manual), Closing Procedures Check list, which was discussed by CA Udayan Sen and CA Shrenik Baid with the Engagement Team (ET) was initialed by both of them.

2.3.5 **NFRA had examined the above contentions of the Audit Firm and had concluded as follows in the DAQRR:**

- (a) It would be a facetious argument to say that neither SQC 1 nor the SAs prohibit more than one partner of the firm from being assigned to be the EP. Not only is no support for such an interpretation provided from anywhere within SQC 1 or the SAs, but also no such position is supported by any part of the firm's own SQC 1 compliant policy manual. Furthermore, the logical question that this position/argument would lead to is the maximum number of such EPs that could be permitted in a

specific engagement. Could it then be 5 or 10, or even more? Clearly, the absurdity of this argument need not be explained further.

- (b) Contrary to the assertion of the **Audit Firm**, SQC 1 clearly provides for only one **EP** for an Engagement. **Para 42 of SQC 1 says that “The firm should assign responsibility for each engagement to an EP”** (emphasis added).
- (c) Para 42(a) of SQC 1 provides that policies and procedures should ensure that “the identity and role of the EP are communicated to key members of the client’s management and those charged with governance”. Para 42(c) says procedures should ensure that “the responsibilities of the EP are clearly defined and communicated to that partner”. Assuming, only for the sake of argument, and not in any way accepting the stand of the **Audit Firm** that there can be more than one EP for an engagement in view of its patent illegality, the **Audit Firm** has not been able to show any provision in its policies relating to Para 42(a) and 42(c) quoted above, or communications to TCWG, or the partners concerned, pursuant to these Paras, in the **Audit File** that support its stand that there could be more than one EP for any Engagement.
- (d) The definition of EP clearly refers to a single individual (this is so in all the cases where SQC 1 or SAs use this term) who bears ultimate responsibility for the performance of the engagement and the report that is issued on behalf of the firm. SA 220 clearly provides that the EP shall take responsibility for the overall quality on each audit engagement to which the partner is assigned (Para 8). Further Paras in the same SA elaborate on the responsibilities of the EP. Having more than one EP may or may not enhance audit quality. In the present case, the failure to discharge the role of EP by CA Udayan Sen clearly shows that audit quality has badly suffered.
- (e) The “integral” designation of CA Shrenik Baid as the engagement/review partner also discloses a great confusion and lack of clarity about the respective roles of an EP and a review partner.

- (f) For all the above reasons, NFRA concluded that CA Udayan Sen alone could be accepted as EP for this engagement in terms of the definition provided in SQC 1 and the SAs.

2.3.6 NFRA had further examined aspects of the engagement that were directed/supervised/reviewed by CA Udayan Sen in his capacity as EP. Contrary to the statement made at document 5/page 10 of the **Audit Firm's** response to the prima facie conclusions, WP No. 29702 (Manual) Closing Procedures Check list had not been initialed by CA Udayan Sen. CA Udayan Sen's initials were seen only in that part of the WP No. 29702 which is designated as the closing memorandum. This is in the form of a report sent by CA Shrenik Baid to CA Udayan Sen. This paper is a summary of the procedures adopted during the course of the audit. **The very fact that CA Shrenik Baid had to send such a memorandum to CA Udayan Sen was itself proof that CA Udayan Sen had not participated in any of the audit processes listed therein. This is for the reason that if CA Udayan Sen had indeed participated in the listed procedures etc., his presence there would have been automatically recorded and the need for such a closing procedures memorandum would not have arisen.** No further evidence had been provided by the **Audit Firm** to counter the conclusions of the NFRA that CA Udayan Sen was not involved with almost all the important work of the audit engagement.

2.3.7 Also, the **Audit Firm's** submission to the NFRA vide letter dated July 17, 2019, states that CA Udayan Sen was not using the time recording system and hence his time spent on this assignment was not available. No estimate of the same was given as it was said to relate to a period many years back. Hence, the **Audit Firm** and the EP were found non-compliant with the requirement of keeping records for minimum seven years as per Paras 82-83 of SQC 1, and monitoring the workload and availability of the EP as per Para 43. Further, it was concluded that the familiarity threat and violation of Para 27 of SQC 1 could not be ruled out based on the submitted responses.

**2.3.8 On consideration of all the above facts, the NFRA, in the DAQRR:**

- (a) concluded that CA Udayan Sen, being the EP as defined in Para 6(b) of SQC 1, had signed the audit report notwithstanding the documented facts that he had completely failed in discharging his obligations as EP;
- (b) concluded that the **Audit Firm** committed a grievous violation of SQC 1 and SA 220 in naming two partners as EPs for this Engagement, thereby leading to disastrous loss of accountability and total disregard of all principles of Quality Control.

**2.3.9 In their response to the DAQRR, the Audit Firm has stated as follows:**

- (a) The combined reading of SA 700 (Revised) with SQC 1 supports the position that there can be **more than one partner on the engagement.**
- (b) The fact remains **there were two audit partners on the engagement** and, as a team, they have performed the audit of the Company. For the avoidance of doubt, Udayan Sen was practically and factually the EP (aka Signing Partner) whilst Shrenik Baid was a partner on the engagement (aka Review Partner).
- (c) It may be noted **there is no mandatory requirement in the professional standards to have a time recording system. We feel extremely demotivated when we read that compromise of quality control measures is alleged in respect of practices that are not even prescribed by the Standards.**
- (d) With respect to familiarity threat referred in Para 27 of SQC 1, it may be noted that both Udayan Sen and Shrenik Baid were partners on the engagement only for FY 2016-17 and FY 2017-18. Prior to FY 2016-17, there was another EP in earlier years. **So there was no familiarity threat as alleged or otherwise.**

- (e) In the table on page 187 of their reply dated 4<sup>th</sup> November, 2019, the **Audit Firm** has, inter alia, stated thus:

Sl. No	Other SAs requirement	As stated in Other SAs	How addressed in the audit work paper file
1	SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements – paragraph 42(a).	Assignment of ET  42. <b>The firm should assign responsibility for each engagement to an EP.</b> The firm should establish policies and procedures requiring that:  (a) The identity and role of the EP are communicated to key members of the client's management and those charged with governance;	This was communicated orally to the management and TCWG; however, there is no specific documentation of the communication. <b>Based on the said communication, either Udayan Sen or Shrenik Baid participated in Audit Committee Meetings in FY 2017 as well as FY 2018.</b> It is also pertinent to point out that there is no mandatory requirement to communicate this information in writing.

- (f) On page 183 of the Annexure of their reply dated 4<sup>th</sup> November, 2019, the **Audit Firm** has, inter alia, stated that:

*“.....we submit that either of the two partners were present in the audit committee meetings and the members of the Audit Committee did not consider them differently but identified each as partners of Deloitte Haskins and Sells LLP, **thereby indicating equality of their role and responsibilities on the engagement.**”*

**2.3.10 NFRA has concluded as follows after examining the above submissions of the Audit Firm:**

- (a) The issue is not the number of partners of the **Audit Firm** engaged on a particular engagement but the number of **EPs** designated by the **Audit Firm** for the Engagement. NFRA had never stated that more than one partner of an **Audit Firm** could not be part of the Audit Team. The argument now made by the **Audit Firm** clearly trivializes the issue in an attempt to wriggle out of an untenable position. NFRA has stated that there can be only one EP for an Engagement;
- (b) The stand being taken by the **Audit Firm** vide their letter dated 4<sup>th</sup> November, 2019 is totally different from that in their reply dated 3<sup>rd</sup> August, 2019 as pointed out in detail above;
- (c) It is clear that the **Audit Firm** had designated two partners as EPs in violation of the SAs, especially SQC 1 and SA 220;
- (d) As per Paras 3, 7 of SQC 1, and Para 2 of SA 220, an **Audit Firm** should have a Quality Policy. As per Para 8 of SQC-1, each individual in the **Audit Firm** is required to comply with the Quality Policy of the **Audit Firm**. The Quality Policy of the **Audit Firm** (Para 36 of Quality Control Policy of DHS – 3110 – Annexure 2.1A) inter alia, states that:

*“...Member Firms should assign responsibility for each engagement to **an EP.**”*

As such, even as per the Quality Policy of M/s DHS, there should be only one EP for an Engagement.

- (e) Time recording by Auditor (EP and members of the ET) is mandatory in light of Para 9 of SA 230 that requires the auditor to record the nature, **timing** and extent of audit procedures performed in the Audit documentation.

As such, CA Udayan Sen did not comply with the mandatory requirement of recording time as required both by SAs as well as the Quality Policy of the **Audit Firm**.

- (f) The claim of the **Audit Firm** that the identity and the role of the EP were communicated orally to the Management and TCWG, but however no documentation was kept, and that, in any case, this information is not mandated to be conveyed in writing, is completely unacceptable. This is a key communication mandated by SAs and it goes without saying that this had to be in writing. In any case, in the absence of record of oral communication, the claim has no value at all.

**2.3.11 In view of above, NFRA is reinforced in its earlier conclusion that:**

- (a) CA Udayan Sen, being the EP as defined in Para 6(b) of SQC 1, had signed the audit report notwithstanding the documented facts that he had completely failed in discharging his obligations as EP;
- (b) The **Audit Firm** committed a violation of SQC 1 and SA 220 in naming two partners as EPs for this Engagement, thereby leading to a loss of accountability and total disregard of the principles of Quality Control.

**2.4 Communication with Those Charged With Governance (TCWG)**

**2.4.1 The prima facie conclusion of the NFRA on the above matter, vide its communication dated 28<sup>th</sup> June, 2019, was that:**

- (a) No evidence has been produced from the **Audit File** to show what was discussed with the management/TCWG prior to the date of the audit report and the financial statement signing date.
- (b) There is no record of any communication addressed to the Audit Committee/Management/TCWG by the ET.

**2.4.2 The response of the Audit Firm was as follows:**

- (a) Discussions were had with TCWG throughout the audit period;

- (b) Not all discussions are required to be documented in the form of minutes of discussions;
- (c) Our written communications with the Audit Committee are as follows:
  - (i) Engagement letter
  - (ii) Presentation made at the time of the half year review; and
  - (iii) Presentation made at the time of audit for the year ended 31<sup>st</sup> March, 2018, jointly with the joint statutory auditors.
- (d) Our discussions with the Management are embedded within each work paper as, prima facie, all information was provided by the Management and hence would not require separate documentation.
- (e) All work was performed at the client's offices, and hence communication with the Management was on a daily basis.

**2.4.3 NFRA had examined the above contentions of the Audit Firm and had concluded as follows in the DAQR:**

- (a) Clearly the **Audit Firm** had admitted that except for the engagement letter given to the company before commencement of the statutory audit, and the final presentation made to the Audit Committee on 28<sup>th</sup> May, 2018, there was no other communication that was made to the Audit Committee/Management/TCWG. The presentation made at the time of the half yearly review represents action on a different engagement.
- (b) The **Audit Firm's** contention that discussions with the Management are embedded within each work paper, as prima facie, all information obtained by them from the company are provided by the Management, and hence would not require separate documentation is not acceptable, since this is a clear admission that nothing really was communicated to TCWG. This argument completely ignores the requirement of SA 260 (Revised) which is about communication **FROM** the **Audit Firm** to the company on all important and serious issues arising from the audit and which is distinct from the documentation and evidence provided by the company to

the **Audit Firm**.

- (c) The **Audit Firm** has also disregarded and violated the requirements of Para 23 (read with Para A54) of SA 260 (Revised) which provides that “where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. Documentation of oral communication may include a copy of the minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication”.
- (d) Apart from the fact that matters that were required to be communicated (Para 12 to 14 of SA 260 (Revised)) had not, in fact, been communicated, this was also a case where there were serious issues arising out of the RBI’s inspection report that needed to be brought to the attention of TCWG and discussed with them before final decisions on audit evidence, presentation and disclosure in the financial statement etc. were taken. No facts have been provided by the **Audit Firm** that the requirements of SA 260 (Revised) and other relevant SAs have been complied with by the **Audit Firm**.
- (e) Similarly, as regards the argument that all work was done in the company’s office, and hence communication with the Management was on a daily basis, is concerned, this argument, logically, would mean that no documentation at all would be required. Hence, the unacceptability of such an argument is obvious.

2.4.4 NFRA is, therefore, reinforced in its conclusion that the **Audit Firm** has grossly failed in complying with the Requirements of the SAs pertaining to communications with TCWG and the Management.

**2.4.5 In response, the Audit Firm has stated as follows:**

NFRA had requested for the communications with the following:

- Management
- Audit Committee / TCWG

Other than -

- (a) the specific requirements under Para 19 of SA 260; and
- (b) The specific requirements under other auditing standards that are required to be communicated to the TCWG, communications in writing to the TCWG is left to the auditors' professional judgement. It will be seen from our presentations to the audit committee that we have exercised this judgement in making our written communications.
  - (i) We have communicated all necessary matters to TCWG as required under SA 260. Also, oral communications to TCWG have been minuted in the minutes of such meetings, extracts of which are part of the audit file.
  - (ii) It is virtually impossible to document each and every discussion with the management separately;
  - (iii) Regarding the requirements under various SAs:
- (c) There is no mandatory requirement to communicate the identity and role of the EP in writing to TCWG.
- (d) With respect to RBI's inspection report, this matter was discussed by the Management in all the Audit Committee and Board meetings. Our team attended all the Audit Committee meetings where we had received an invitation. In the Audit Committee meeting on 28 May 2018 before the signing of the financial statements, we had discussed our findings on the RBI's inspection report with TCWG through the Audit Committee Presentation.

- (e) During the course of the audit, we did not identify any non-compliance with laws and regulations. On the RBI matter, we communicated the same to TCWG on 6 November 2017 and 28 May 2018. Reference may be made to WP 30010.12 the Company Audit Committee Presentation in half-yearly review file, WP 30301 Audit Committee Presentation WP 21301 (Manual) Minutes of Meetings.
- (f) External confirmations were responsibility of the joint auditor (BSR) as per WP 30301.
- (g) We did not identify any of the following and accordingly did not communicate the same to TCWG:
  - (i) Significant Deficiency in Internal control;
  - (ii) Any material uncorrected misstatements;
  - (iii) Significant matters arising during the audit in connection with the entity's related parties;
  - (iv) Subsequent event which might affect the financial statements;
  - (v) Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; or
  - (vi) Fraud and ROMM

**2.4.6 These contentions of the Audit Firm have been examined and NFRA has concluded as follows:**

- (a) The objective of the SA 260 (Revised) is to provide TCWG with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process. The **Audit Firm** has not been able to show a single communication with TCWG in this regard. Contrary to the claims of the **Audit Firm**, no document minuting discussions held with TCWG is available in the Audit File.
- (b) Reference has been made to WP 30301, WP 11302, 11303 and WP

30010.12. WP 11302, 11303 are engagement letters, WP 30010.12 is not part of the Audit file. As such, none of the said documents pertain to communication of significant matters to TCWG. WP 30301 is the presentation to the Audit Committee on 28 May, 2018, the date of signing the Audit Report.

- (c) The assertion of the **Audit Firm** that they have exercised their professional judgement in making their written communications cannot be taken to justify that nothing was required to be communicated. There were serious issues like non-compliance of RBI guidelines, issues relating to going concern, NPAs, etc. which were very significant and were mandatorily required to be communicated to TCWG as per SA 260 (Revised).
- (d) Non communication of non-compliance of RBI instructions by the **Audit Firm** to TCWG:
  - (i) Para A9 of SA 260 (Revised), inter alia, requires the auditor to communicate significant matters arising from the audit of the financial statements that are relevant to TCWG. Para 23 of SA 260 (Revised) states that where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated.
  - (ii) The **Audit Firm**, by their own admission on page 268 of their reply dated 4<sup>th</sup> November, 2019, admit that the RBI is the regulator as far as the auditee is concerned and that the view of the regulator would be the only guidance for the Auditor. On page 190 of the same reply, the **Audit Firm** have stated that during the course of the audit, they did not identify any non-compliance with laws and regulations, meaning thereby that in case of non-compliance they themselves admit that they were mandatorily required to communicate with TCWG.
  - (iii) Para 22 of SA 250 states thus:

*“Unless all of those charged with governance are involved in*

*management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,<sup>7</sup> the auditor shall communicate with those charged with governance matters involving noncompliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential."*

(iv) Para 23 of SA 250 states thus:

*"If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable."*

(e) Details of some regulatory non-compliances by Auditee as noted by RBI during their inspections vis-a-vis RBI norms:

Financial Parameter	Minimum Requirement as per law	Actual status as on 31.3.15 as per RBI assessment vide RBI letter dated 14.9.16	Actual status as on 31.3.16 as per RBI assessment vide RBI letter dated 1.11.17
NOF (Net Owned Funds)	Minimum Rs. 2 Crores	(-)45.93 Crores INR	(-)4123.76 Crores INR
Overall CRAR  (Capital to Risk (Weighted) Assets Ratio)	Minimum 15%	(-)0.40%	(-)42.61%

- (i) RBI, vide letter dated 14<sup>th</sup> September, 2016, had, inter alia, asked the auditee to submit road map within two months to attain the required NOF and CRAR by 31<sup>st</sup> March, 2017.
- (ii) Non-compliance by auditee was re-iterated by RBI vide their email dated 27<sup>th</sup> March, 2017.
- (iii) Vide its letter dated 4<sup>th</sup> December, 2017, to the auditee, RBI had, inter alia, stated that despite serious regulatory violations in classification of companies coming under the same group having been pointed out in January, 2016, and further re-iterated in supervisory letter dated 14<sup>th</sup> September, 2016, it regretted to note that the company had not yet initiated any effective measures to improve its NOF.
- (iv) RBI vide its letter dated 13<sup>th</sup> March 2018 to the auditee, inter alia, stated that issue of negative NOF and CRAR was flagged to the company in previous inspections but the same had further deteriorated on account of new exposure in group companies against RBI advice.
- (v) It is clear from the table and notes above that the said regulatory non-compliances to RBI norms on the part of auditee were very serious, material and deliberate/willful. Accordingly, as per SA 250, the **Audit Firm** was mandatorily required to communicate about the said non-compliance of RBI instructions by the auditee to all TCWG at the earliest. But the **Audit Firm** did not communicate this to TCWG, even once before the date of signing of Audit report.
- (f) As per the minutes of the meetings of the Board of the Auditee in the Audit file, none of the Board meetings during the period when the audit was carried out was attended by any person from the **Audit Firm**. As such, any reference to discussions in Board Meetings of the Auditee in the context of the responsibility of the **Audit Firm** to communicate with TCWG is totally irrelevant and a deliberate attempt by the **Audit Firm** to mislead this Audit Review by NFRA.

2.4.7 NFRA therefore reiterates its conclusions that the **Audit Firm** has failed to comply with the requirements in the SAs about communication with TCWG.

## 2.5 Evaluation of Risk of Material Misstatement (ROMM) Matters

2.5.1 In its prima facie conclusions dated 28<sup>th</sup> June, 2019, NFRA had, inter alia, stated that:

- (a) WP No.13501 indicates that in contradiction to the requirement of Section 143(9) read with Section 2(7) and Section 143(10) of the Companies Act 2013, the **Audit Firm** had made references to certain other International Standards instead of compliance to Auditing Standards prescribed under section 143(9).
- (b) WP No. 13501 Minutes of the ET discussion did not disclose participation of the EP CA Udayan Sen.
- (c) The **Audit Firm** in their WP No.13501 had made several statements with reference to the assessment of fraud risk factors. There were significant contradictions in the assessment of ROMM which lead to the conclusion that the assessment had been carried out in so casual a manner as to result in a complete sham.
- (d) WP No.13501 on ROMM provides a staggering conclusion that “No fraud risk factors or engagement risk have been identified”.
- (e) Evidence of mismatch in the date of meeting and the date of communication between the ET and EP has proved that assessment of ROMM is a complete sham. Study of WP No.13501 shows that while the meeting for discussion took place on 13<sup>th</sup> October 2017, the matters were already communicated to all concerned in September 2017.
- (f) Based upon the analysis of the working papers, it was observed that certain important issues having been identified from the whistle blower complaints and RBI inspection reports had not been considered at all for the purpose of evaluation of ROMM.

- (g) The **Audit Firm** had changed the risk assessment of the audit assignment from “Normal” to “Greater than Normal” (GTN) through a memo for change in engagement risk to GTN, taking into consideration four factors. Considering the sequence of events relating to the RBI inspections, it must have been assessed as “Much Greater Than Normal” (MGTN) in the previous FY 2016-17 itself.
- (h) It was observed that the audit responses planned to reduce or mitigate the identified risks and the actions taken based on the audit responses to such identified risks were insufficient, improper and inadequately carried out.
  - (i) Numerous details from the working papers had been provided to substantiate the above conclusions of the NFRA.

**2.5.2 The response of the Audit Firm was as follows:**

- (a) The references to the International Auditing Standards is due to having used the resources of the global network. However, these standards are virtually identical to SAs in force in India.
- (b) WP No. 13501 demonstrates participation by one of the EPs, CA Shrenik Baid.
- (c) The “paperwork” referred to is not a mere formality. The **Audit Firm** has identified and assessed the ROMM due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, and have designed and performed audit procedures responsive to the assessed ROMM due to fraud.
- (d) The Conclusion in the WP 13501 that “No fraud risk factors or engagement risks have been identified,” relates to matters other than the “presumed risks” which have already been identified and should be read in the context of the matters identified and documented in the work paper.
- (e) About the mismatch between the meeting for discussion on ROMM on 13<sup>th</sup> October 2017 and the communication of the same to all concerned already in September 2017, the **Audit Firm** has clarified that

communication dated 30<sup>th</sup> September 2017 was a routine communication since the appointment as auditor had already been done whereas the ET actually had their discussion on 13<sup>th</sup> October 2017. All the detailed memos regarding scope and involvement have been prepared subsequent to that date.

- (f) Some inspection reports/letters were received after the date of ET discussion on 13<sup>th</sup> October 2017; to the extent that these matters were not reflected in the earlier year's inspection reports, the same have not formed part of the ET's discussions. However, matters raised in the RBI inspection report etc. have been included in other work papers.
- (g) **Since the RBI inspection report dated 1<sup>st</sup> November 2017 was not available at the time of initial ET discussion, the same was addressed during the course of the audit.** Accordingly, the engagement risk was finally assessed as "greater than normal" and not merely "normal" during the conduct of the audit and not at the initial stages. This was based on the suggestion of the EQCR and was changed with the concurrence of the risk leader.
- (h) The ET led by the EP has classified management override of controls and revenue recognition as a **"presumed risk"** due to fraud and there is no failure to classify any other specific issue as a possible ROMM due to fraud. The firm has tested relevant controls to address the respective risks, has exercised due diligence and there is no negligence, much less gross negligence, in identification and evaluation of ROMM.
  - (i) The list of various subjects starting with "integrity" and ending with Para titled "professional competence and team .... to be exercised in the audit to be carried out" was meant as advice and recapitulation of standard guidance and instructions to the team members.

**2.5.3 The NFRA had examined the above contentions of the Audit Firm and had concluded as follows in the DAQRR:**

- (a) The company has been incorporated in India. The **Audit Firm** is also registered with the ICAI and is subject to its regulation. Reference to

global standards for any reason, notwithstanding any similarity to Indian standards, does not meet the essence of the engagement and is not in compliance with the section 143(9) of the Act. **It is to be noted that, unlike in other countries, both accounting standards and auditing standards have the force of law in India, and are to be considered as equivalent to subordinate legislation, being notified under the enabling provisions of the Companies Act, 2013.**

- (b) As concluded in the other Paras of the report, in the considered opinion of the NFRA, only CA Udayan Sen could be considered as the EP for this engagement in terms of the definition and Requirements provided in SQC 1 and SAs and therefore it was concluded that the EP CA Udayan Sen had not participated in the discussions of the ET.

2.5.4 The **Audit Firm** had stated that the engagement risk was initially classified as “normal”. At the time of the 13<sup>th</sup> October, 2017 meeting, “only the RBI Inspection Report dated September 14, 2016, was available. The matters raised in such report relating to “companies in the same group”, NOF and CRAR were still under discussion between the Company and the RBI and there was no conclusion or finality regarding the same”. After additional information was obtained (RBI Inspection Report dated November 1, 2017 amongst others), the engagement risk was reassessed on the suggestion of the EQCR Partner and, with the concurrence of the risk leader, the engagement risk was changed to “greater than normal”. “The RBI finally concluded on matters relating to “companies in the same group”, NOF and CRAR and communicated its decision and action required to be taken by the company vide its letter dated November 1, 2017”.

**The NFRA had examined this contention of the Audit Firm and had concluded as follows:**

- (a) The NFRA noted that the client company was identified and notified by the RBI as a Systemically Important (SI) NBFC. Quite apart from all other considerations, and the non-specific and non-relevant details traversed in the various work papers that had been made available to NFRA, the fact that the client company was identified as a SI-NBFC itself should have qualified it for being put into a very high risk category. Nowhere in the

Audit File was there any evidence that the auditors took note of the SI-NBFC character of the Client Company into its risk assessment.

(b) **As an Auditor of a SI-NBFC, the Audit Firm had certain special responsibilities to the RBI. Prominent amongst these responsibilities are:**

(i) A separate report is to be made to the Board of Directors on specific matters. Amongst this is a statement whether the non-banking financial company is meeting the Net Owned Fund (NOF) requirement as laid down in the Master Directions, 2016.

(ii) Where such report is unfavourable or qualified, the reasons therefor need to be given by the auditor. Where the auditor is unable to express any opinion on any of the items, his report needs to indicate the reasons therefor.

(iii) In case the additional report to the Board of Directors is unfavourable or qualified, an obligation is cast upon the auditor, under the aforesaid directions, to report the same directly to the RBI.

(iv) The auditor needs to comment on the correctness of the Capital Adequacy Ratio (CAR) and compliance with the minimum Capital Risk Assets Ratio (CRAR) disclosed in the written submission to the RBI.

(c) All the above requirements have been explained in great detail in the Technical Note on Audits of NBFCs issued by ICAI. It is pertinent to refer to Para A19 and other relevant Paras of SA 250 also in this connection.

(d) Given the special position of the auditor of a SI-NBFC, it was incumbent on the auditor to challenge the management on the matters relating to the RBI Inspection Reports and, in the absence of satisfactory explanation from the management, to directly ascertain and verify the position from the RBI. The actions of the auditor in not having done so, and having accepted the stand of the management without question, shows clearly a gross dereliction of duty and negligence on the part of **Audit Firm**.

- (e) As far as the risk categorization is concerned, there does not seem to be any objective basis for slotting an engagement or client risk into normal, or greater than normal, or much greater than normal categories. The portions of the QC documentation made available in this regard (3210 – Engagement Acceptance and Risk Classification Annexure 2.4D) are worded in extremely general terms. It seemed to be a matter, therefore, the NFRA concluded, left entirely to the decision of the local managements. The check lists available in the audit work papers, though apparently very exhaustive, seemed to be in the nature of proforma check lists without any reference to the specifics of the situation.
- (f) The **Audit Firm** says that it was only on January 19, 2018, i.e. at the time of Audit Planning Committee meeting, that the RBI inspection report November 1, 2017, was available, in which, the **Audit Firm** says, the RBI finally concluded on the matters relating to “companies in the same group”, NOF and CRAR and communicated its decision and action required to be taken by the company. It is only because of this, the **Audit Firm** said, that the audit planning meeting decided to change the engagement risk from normal to greater than normal. **However, it is seen that the RBI had, as early as 27<sup>th</sup> March, 2017, written by e-mail to ILFS Financial Services Ltd. as follows:**

**“This is in reference to your letter dated November 29, 2016, which consisted of compliance to the inspection of ILFS Financial Services Ltd. for the year 2014-15. The compliance submitted by the company pertaining to major issues like group exposure, diminution in unquoted investment, interest reversal on Optionally Convertible Debenture, diminution in quoted equity shares etc. are not accepted. You are advised to take necessary action to bring back CRAR to minimum stipulated requirement of 15%”** (emphasis added).

The above quoted communication from RBI unambiguously conveys the non-acceptance by the RBI of the company’s responses to various issues raised in the 2014-15 inspection report.

- (g) The **Audit Firm** seems to imply that this communication of the RBI was not available to them. **This explanation we held to be unacceptable for the reason that this clearly showed the complete lack of due diligence and professional skepticism on the part of the Audit Firm. Had proper enquiries been made both with TCWG and the RBI, it is certain that this communication would have been formally made available to the Audit Firm.** This is also specifically required by Para 18 onwards of SA 250. The **Audit Firm**'s compliance with this seemed to have been limited only to inquiries with the management, with no attempt at independent corroboration of the position.
- (h) In any event, it is seen that the reply received from the RBI in March 2017 was discussed at the Audit Committee Meeting held on 25<sup>th</sup> April, 2017, at which CA Udayan Sen, CA Shrenik Baid and CA Nishit Udani were present. At the next Audit Committee meeting held on 31<sup>st</sup> July, 2017, at which CA Udayan Sen was present, the same e-mail dated 27<sup>th</sup> March, 2017 was discussed and recorded thus: "Subsequently, the Company received an e-mail from RBI on March 27, 2017 seeking compliance on the supervisory observations of which the key observation was pertaining to exposure to group companies as per Section 370(1B) of the Companies Act, 1956".
- (i) In the light of the evidence of this well-documented position, NFRA held that it was a suppression of vital facts to assert, as the Audit Firm had done, that at the time of the 13<sup>th</sup> October, 2017, meeting, only the RBI Inspection Report dated 14<sup>th</sup> September, 2016, was available and that there was no definitive decision of the RBI on the NOF/CRAR matter.
- (j) It could not also be argued, NFRA said, that the 14<sup>th</sup> September, 2016, Report of the RBI was confined to compliance with NOF and CRAR. It flagged numerous other issues, such as rolling over of loans (and not making the required provisions), evergreening, deficiencies in the credit policy, non-disclosure of restructured loans and advances, non-provisioning for diminution in value of investments etc. Each of these issues individually, and certainly collectively, was serious enough to

warrant upgrading of risk, and the planning and carrying out of appropriate audit responses.

- (k) Even as far as group exposure was concerned, it was seen that the amount (in excess of 10% of NOF) ballooned from Rs. 1470.21 crores as on 31.03.2015 to Rs.5582.42 crores as on 31.03.2016. Clearly the management was going ahead in lending to the group companies in reckless disregard of the RBI's directions. The NOF was recomputed by the RBI at (-) Rs.4123.76 crores as on 31.03.2016 as compared to (-) Rs.45.93 crores as on 31.03.2015. This was clearly very specific evidence of very risky management practices. Given this, the **Audit Firm** should have worked out the NOF (as per the statutory definition as pointed out by the RBI) as on 31.03.2017 and 31.03.2018 to make an assessment of the compliance with the law by the company.
- (l) Subsequently vide their email dated December 20, 2017, regarding the inspection of the company for the position on March 31, 2017, the RBI had assessed the Gross and Net NPAs at 13.17% and 12.34% against the reported Gross and Net NPA of 3.30% and 2.36% and had asked the company to submit their detailed response/submission to these Inspection observations.
- (m) The **Audit Firm** having considered the RBI matters in their WP 29203 i.e., "Memo on RBI Matters" duly noting the above observations had failed to perform substantial audit procedures that would have provided concrete evidence to assess the NPA categorization of accounts done by the Company, and, instead, merely accepted the company's representation made to RBI in response to the inspection report. The **Audit Firm** in its working paper has justified the NPA Accounts by the Company on the basis of the Security Cover and the related exposures.
- (n) It is pertinent to note here that dependence on collateral security for realization, though a factor in classification of assets, cannot be considered as the only factor to justify the non-compliance in NPA categorization of accounts in accordance with the RBI Systematically Important Non-

Banking Financial (Non-Deposit Accepting or Holding) Companies  
Prudential Norms (Reserve Bank) Directions 2015.

- 2.5.5 NFRA was of the view that the obvious lack of clarity regarding ROMM that was highlighted in the prima facie conclusions stood reinforced by the responses of the **Audit Firm** to the said prima facie conclusions.
- 2.5.6 NFRA had observed that since the ET had considered revenue recognition as a presumed risk of fraud, the only inference that could be drawn was that the ET suspected that revenues from interest would be fundamentally inflated by recognizing revenue that should not be recognized either because of (a) NPAs that were suppressed, and defaults ignored; or (b) NPAs that were made “regular” by evergreening of loans.
- 2.5.7 The **Audit Firm** had stated as follows at one place:

“Based on our previous experience with the entity and understanding of the entity’s business, we had not identified any fraud risk factors with regard to revenue (Refer WP 13501 ‘ET based discussion’). Accordingly, your statement that “the only inference that can be drawn is that the ET suspected that revenues from interest would be fundamentally inflated is not correct since no such risk was identified by us in our professional judgement for these matters.

The reason that revenue recognition was considered a fraud risk was because Para 26 of SA 240 requires “the auditor to **presume** that there are risks of fraud in revenue recognition and **evaluate which types of revenue, revenue transactions or assertions, give rise to such risks**”.

The ET, in their professional judgement and based on performing the procedures under SA 240 to identify risk of fraud, had considered a component of revenue viz ‘interest income and interest accrued on loans and advances having the risk that periodic interest report is generated/ interest computation are inaccurate incomplete due to manual intervention of interest computation for loans not regularised in the system’ as a “presumed” risk of fraud in accordance with Para 26 of SA 240.

Another component of revenue, Fee income had been considered as a significant risk.

In addition to the above, we had identified another significant risk that “NBFC Prudential Norms wrt Asset classification and provisioning are not adhered to”. Since this risk relates to NBFC Prudential Norms, it would therefore also cover recognition of interest from NPAs which also has been considered in a manner similar to as described above (pages 90 and 91, Para 4 responses).

2.5.8 The ET had earlier said that the conclusion of the NFRA about NPA related risk is not correct, “**since no such risk was identified by us in our professional judgement for these matters**” (emphasis added) (page 80 Para 4 response).

2.5.9 The executive summary of the response to the prima facie conclusions, however, said that “compliance with NBFC Prudential Norms with respect to asset classification and provisioning has been identified as a significant risk.” Further, the **Audit Firm** said that “Based on our past experience with the Company and no specific observations on evergreening noted in the RBI Inspection Reports from the year of inception of the Company, i.e. 2007-08 till December 20, 2017, we had not identified evergreening as a significant risk. However, during our testing of loan sanctions, disbursements and repayments during the year, we considered the inherent risk of evergreening” (page 50, Para 4 responses).

2.5.10 Given this, NFRA concluded that it appeared inconsistent for the **Audit Firm** to disagree with the prima facie conclusions of the NFRA. The extracts from the **Audit Firm**’s responses given above reveal the lack of clarity and confusion around ROMM. Needless to say, this would not have conduced to an effective audit plan.

2.5.11 Having identified compliance with Prudential Norms etc. as a significant risk, the operational responses had, however, been restricted to “interest income” at the account level. The testing had been restricted to verification of the arithmetical accuracy of interest computation.

2.5.12 No testing of interest receipt defaults/delays in the receipt of interest, grant of new loans to enable payment of interest/payment of instalments etc. seemed to have been made, going by the evidence in the Audit file. This was

notwithstanding the reference to improper identification and provisioning for NPAs highlighted in the RBI's Inspection Reports of 14<sup>th</sup> September, 2016 and 20<sup>th</sup> December, 2017. In the latter e-mail dated 20<sup>th</sup> December, 2017, regarding the company's position as on 31<sup>st</sup> March, 2017, the RBI assessment of gross NPAs was substantially higher than the reported gross NPAs, as already pointed out above.

2.5.13 The **Audit Firm** provided details of the working papers that purport to deal with their responses to the presumed ROMM due to revenue recognition fraud. These were at Annexure 4.6 of the responses. NFRA had gone through these details carefully and had concluded as follows:

#### Annexure 4.6 Presumed Risk of Revenue Recognition

The working papers referred in this annexure primarily covered the testing of design and implementation and the operating effectiveness of the controls related to accounting and reconciliation of transactions related to interest income. The working papers did not contain any relevant information to enable the auditor to evaluate the recognition of interest from NPAs and the consideration of interest income generated from various loans and advances depending upon their NPA classification.

2.5.14 As far as the presumed Risk of Management Override of Controls is concerned, the responses of the **Audit Firm** displayed a tremendous amount of confusion.

2.5.15 This was evidenced by the following statements:

“With regard to your observation on management override of controls over sanctioning of loans and advances, the Company's internal control process required the grants to be approved by more than 10 people (Refer WP 12113.05.07 for the sample tested). **As such, in our professional judgement, the susceptibility of sanctioning of loans to management override of controls was remote and hence not considered as fraud risk**” (emphasis added) (page 76, Para 4 responses).

“However, our EMS audit tool which is *inter alia* used to track fraud risk has correctly identified even the management override of controls as a fraud risk. We

invite attention to Annexure 4.5 which has the path, relevant workpapers and screenshots to follow path for presumed risk of management override of controls as per our audit tool (EMS) which correctly identifies the management override of control as fraud risk. It should be noted that all the workflows emanate from the EMS tool and therefore all the work that is required to be done for a presumed risk of fraud had been done and documented” (pages 82/83, Para 4 responses).

2.5.16 NFRA had analysed the details given in Annexure 4.5, and its conclusions were as follows:

**Annexure 4.5 Presumed Risk of Management Override of Control**

The working papers referred in this Annexure primarily cover the testing of design and implementation and the operating effectiveness of the controls related to accounting of transactions as well as serial continuity testing on the COD listing. The working papers do not contain any relevant information to enable the **Audit Firm** to assess the impact of management involvement in the functioning of the company in such a manner as to override the established policies and procedures.

2.5.17 NFRA had considered the following figures based upon the information available in the working papers itself and as mentioned in the financial statements:

Sl.	Particulars	Amount (in Mn.)
1.	Total loans sanctioned manually in the year	74,860
2.	Total loan disbursement made during the year	90,49 6
3.	Total loan repayments received during year	60,236
4.	Loan Disbursed (Net) during the year (As per CFS)	29,953
5.	Total Loans & Advances (Long Term & Short Term) (As per BS)	151,157

The above figures clearly indicated that almost all the sanctioning of loans was done manually and that was afterwards regularized in the system. As has been highlighted in the RBI reports also, the manual overrides essentially have to do with relaxation of the norms and conditions that should normally attach to the sanctions. Apart from the possibility of ROMM due to fraud, such overrides also needed to be examined by the **Audit Firm** in order to do its duties as per Sec 143 of the Companies Act, 2013. The **Audit Firm** had been grossly negligent in considering and evaluating the effect of management override of controls on account of sanctioning of such loans and failed to evaluate the circumstances that required the company to sanction the loans manually instead of following the established policies and procedures. This preponderance of manual overrides should also have alerted the **Audit Firm** to the possibility of fraud that needed to be reported under Sec 143(12). However, nothing was done in this regard.

Also, having analysed the COD listing of manual approvals, NFRA had come across various cases of sanctioning of loans/ modification in the conditions attached to existing loans which were subsequently pointed out by the RBI in their report. The audit documentation clearly indicates that the **Audit Firm** in such cases has relied on the management representations completely instead of performing adequate audit procedures. Some of such cases have been reproduced below:

Sl	Name of Company	Sanctioned Amount (in Mn)	Subject Consideration in COD Listing	RBI Remarks (FY 2017-18)
(a)	ABG International (P) Limited	2,800	i. Modification of security package ii. Facility review and status update	The value of 8.96 million of pledged shares of ABG Shipyard on March 31, 2018 was Rs. 69 million @7.7 per shares, which was less than 10% of loan outstanding. Therefore full provision suggested.
(b)	Sahaj E Village Limited	3,700	i. Extension of facility of Rs. 900 Mn	The facility is unsecured
(c)	Attivo Economic Zone (Mumbai) Private Limited (SREI Group)	3,450	i. Extension of Infrastructure Term Loan Facility of Rs. 1500 Mn	The security is second pari passu by way of hypothecation/mortgage of the entire movable & immovable fixed assets of the borrower, both present and future. Since the charge is second it is considered inadequate.

Cases like the few referred to above provide clear evidence of negligence on part of the **Audit Firm** in performing adequate audit procedures and, where required, substantial audit procedures, to evaluate risk of material misstatement on account of management override of controls.

2.5.18 To summarise,

- (a) The **Audit Firm** had clearly indulged in a deliberate misrepresentation of a material fact;
- (b) There had been a complete lack of clarity, and utter confusion had prevailed, in the ROMM assessment;
- (c) Important aspects of the auditee company's situation, such as its SI-NBFC status, the very disturbing RBI Inspection Reports on the company, the wide discrepancies in reporting of NPAs, etc., had not been given adequate importance in the ROMM assessment;
- (d) Accordingly, the audit responses had been grossly inadequate;
- (e) Such procedures as had been performed have had no link to the real ROMM;
- (f) In crucial matters, the **Audit Firm** had relied completely on the management's representations;
- (g) The **Audit Firm** had totally failed in communicating to TCWG/the management the key issues arising out of the audit.

2.5.19 **In response to the conditions of the DAQRR, the Audit Firm has made following points:**

- (a) The audit was performed as per the Standards on Auditing referred to in Section 143(9) read with Section 2(7) and Section 143(10) of the Companies Act, 2013 and there was no non-compliance with Section 143(9) of the Act, in each case as alleged or otherwise.
- (b) In our detailed submissions regarding the EP **we have clearly stated that for this engagement we had two audit partners assigned to the engagement.**
- (c) Engagement risk:

- (i) There is neither any requirement nor any guidance in the SAs that require the auditor to grade “**engagement risk**” into normal, or greater than normal, or much greater than normal categories. The **Audit Firm** has reiterated at page 210 of its responses to the **DAQRR**, that the risk categorisation of an engagement or client risk into normal, or greater than normal, or much greater than normal categories is **not a requirement** under SQC 1 or the SAs.
- (ii) It is the firm’s internal process to grade engagement risk in such categories, based on professional judgement which factors in objective and subjective parameters, to facilitate engagement acceptance and continuance decisions, to ensure that the appropriate level of professionals, including specialists, are involved in executing the engagement, and appropriate level of EQCR is performed. As far as NFRA’s observations that the policies in DPM 3210 – Engagement Acceptance and Risk Classification Annexure 2.4D are worded in extremely general terms, it may be noted that the criteria therein have been drawn from either SQC 1 or the SAs and after applying professional judgement.
- (iii) Paras A117 to A125 of SA 315 provide Application and Other Explanatory guidance in determining the risks at the financial statement level and assertion level, and the size of an organisation is not cited as a factor in these Paras for consideration in determining such risk classification.
- (iv) If one were to extend the logic that every SINBFC is in a very high risk category, it would mean that we would need to consider every company having an asset base of Rs.500 crores and above as a high risk engagement. Taking this assumption further, since applicability of Ind AS is based on, inter alia, the net worth of a company exceeding Rs.250 crores/Rs.500 crores, as applicable, every company to which Ind AS applies by virtue of such threshold linked to size would have to be classified as high risk. This should not and cannot be the basis of engagement risk classification.

- (d) With reference to NFRA's conclusion that "The **Audit Firm** seems to *imply* that this communication of the RBI was not available to them," the **Audit Firm** denies any such implication on their part. The **Audit Firm** further states, "It is submitted that we have neither implied nor asserted that we were not aware of the 27 March 2017 email. This letter has not been referred to in our planning documentation since these communications were interim ongoing communications as the finality was established only in the Inspection Report dated 1 November 2017."

"It is in the Inspection Report dated 1 November 2017 that a definite timeline i.e. 31 March 2019 for compliance with the regulatory requirements for CRAR and NOF were laid down. Such timeline of 31 March 2019 was not stated in the email of 27 March 2017, clearly indicating that the email was also part of an ongoing communication and therefore was certainly not a final communication on the matter."

- (e) Lending to group companies did not adversely impact either the amounts recognised in the financial statements or the liquidity of the company. The disclosure of NOF and CRAR is not a requirement of the accounting standards. The Company considered such time granted to also be applicable for disclosure of CRAR (supported by their discussions with the RBI officials, as included in the management representations) and disclosed that fact in the financial statements for the year ended 31 March 2018.
- (f) The **Audit Firm** has stated, "We would like to confirm that we have complied with our reporting requirements to the RBI, as applicable." The **Audit Firm** also states that they had examined the Company's responses to the RBI's observations in the Inspection Reports.

It has further been stated that the ET had reached a considered and bona fide view having performed independent analysis and procedures (WP 29203 – Memo on RBI Matters); and that with regard to NPAs such a view had been supported even by the RBI in most cases as could be seen in the Inspection Report dated 19 June 2018 for the year ended 31 March 2017

that was issued to finalise the Draft Inspection Report issued on 20 December 2017.

- (g) The **Audit Firm** has also mentioned that the RBI's final decision on the identified NPA cases was not available at the time of signing the audit report on the standalone financial statements for the financial year ending 31 March, 2018, so the ET had reached a considered and bona fide view having performed independent analysis and procedures in respect of these cases, which view was ultimately supported by RBI in 11 of the 12 cases as evidenced by the report of RBI dated 19 June 2018. With regard to the 12th case, the RBI had recommended a provision on the assumption that the facility was unsecured, whereas it was secured. The report of the RBI dated 19 June 2018 retained only 5 cases which were appropriately addressed in the financial statements for the year ended 31 March 2018.
- (h) In relation to the ET's consideration of the presumed risk of fraud in revenue recognition, the **Audit Firm** states that, based on their professional judgement and experience with the Company, they had not identified any risk in revenue recognition due to fraud pertaining to NPAs that could be suppressed and defaults ignored, or NPAs that could be made 'regular' by ever-greening of loans. "Risk that NBFC prudential norms w.r.t. Asset classification and provisioning are not adhered to" was considered only as a significant risk (and not a fraud risk) and relevant procedures were performed by them to address this risk. These procedures covered the following:
- (i) Non recognition of interest income on NPAs is tested in WP 26101- Interest Recomputation and was verified in conjunction with the NPAs tested and identified in WP 26720.02 - Provisions on Loans and Advances as at 31 March 2018.
  - (ii) Control testing done around this risk helps in the identification of NPAs on which interest should not be accrued. (Refer WP 23300.01.01.01 – Operating Effectiveness –New Format, (Tab 'Provisioning – Significant').

- (iii) Provision for NPAs was substantively tested in WP 26720.02 - Provisions on Loans and Advances as at 31 March 2018.
  - (iv) Working papers that deal with the responses to the presumed ROMM due to revenue recognition fraud do contain relevant information to enable the auditor to evaluate the recognition of interest from NPAs and the consideration of interest income generated from various loans and advances depending upon their risk based classification.
  - (v) The existence of manual entries being passed, has been identified as a presumed risk of fraud and procedures have been performed around the same.
  - (vi) Control testing around this risk is to ensure that NPAs are flagged based on the system generated alerts of overdue accounts (classification of NPAs) and appropriate entry for additional provisioning is passed.
- (i) Regarding the presumed risk of Management Override of Controls, the **Audit Firm** has stated that:
- (i) “We have recognised management override of controls as a pervasive risk at the financial statements level and not at any individual account balance/assertion level. Therefore, we have mentioned that in our professional judgement, the susceptibility of sanctioning of loans to management override of controls was remote and hence not considered as fraud risk, meaning no management override of controls is recognised at the account balance of ‘Loans and Advances’.” Further, the **Audit Firm** has said that SA 240 considers the risk of management override of controls at the financial statement level and not at an account balance level.
  - (ii) Paragraph 32 of SA 240, inter alia, states that the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of

assets. Accordingly, the **Audit Firm** has performed following procedures:

- (a) Test of management override of controls through journal entries, which have been separately tested in WP 21101.05 - JE Testing Sample Testing. The sample size of 60 is for testing the controls over JVs and is not the number of JVs tested. The **Audit Firm** has clarified that the total number of journal entries were 75,662 (Refer WP 21101.05 – JE Testing Sample Testing, Tab - Summary). Of these, they had tested 4,475 journal entries. (Refer WP 21101.05 JE Testing Sample Testing, Tab - Details).
- (b) Test of details of lending and investments (WP 23300.01.02.04 – Test of Details and WP 23150.01.01 – Investment in equity and preference shares).
- (j) About sanctioning of loans done manually and afterwards regularised in the system, the **Audit Firm** states that:
  - (i) A manual approval also requires the approval of all the required approvers as set out in the Unified Approval Framework (UAF) of the Company and represents a transaction that is properly authorised and recorded. Refer WP 12113.05.01 – Process Note.
  - (ii) The NFRA should note that all manually approved CAMs are subsequently again approved through the system and therefore manual approvals get approved twice over.
  - (iii) The RBI Report that reportedly points out to modifications in conditions attached to existing loans through manual approvals may please be provided since we are not aware of any such report.
- (k) The **Audit Firm** has remarked again towards the end of response to point 2.6 that the fact that there were no discussions during the process

of the detailed review by NFRA with them and prior to the issue of **DAQRR** appears to have created confusion in NFRA's observations.

**2.5.20 NFRA has examined the above contentions of the Audit Firm and has concluded as follows:**

- (a) There is a clear non-compliance with Section 143(9) of the Companies Act, 2013. The Companies Act refers only to SAs prescribed by that statute and to no other. Hence, any reference to any SAs other than so prescribed is clearly non-compliant with the Companies Act. NFRA, as a body constituted under the Companies Act, 2013, obligated to consider only what is compliant with that Act.
- (b) The phrases, 'two EPs' and 'two audit partners assigned to the engagement' are entirely different from each other. This shift in the stance of the **Audit Firm** has been taken up in detail in Para 2.3 above.
- (c) Engagement risk:
  - (i) The **Audit Firm**, on page 207 of its responses to the **DAQRR** has stated that "there is neither any requirement nor any guidance in the Standards on Auditing that require the auditor to grade "engagement risk" into normal, or greater than normal, or much greater than normal categories.". In response to NFRA's comment that the criteria for such risk categorization are worded in extremely general terms, the **Audit Firm**'s response, at page 211, is that, "we would like to submit that the criteria specified in the policy have been drawn from either SQC or the Standards on Auditing and after applying professional judgement." The requirement to slot the engagement risk into one of these three categories is seen to arise out of the **Audit Firm**'s Policy document 'DPM 3210 — Engagement Acceptance and Risk Classification'. The purpose of SQC 1 is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality controls for assurance and related service engagements. Based on these standards and guidance, a firm is expected to develop specific and clearly defined

policies and procedures in order to comply with professional standards and regulatory and legal requirements, to ensure that reports issued by the firm are appropriate in the circumstances. Para 26 of DPM 3210 provides that “Each Member Firm should establish and document procedures and guidelines to establish that all Professional Services performed by the Member Firm are properly classified in one of the following categories.” Para 34 lists the kind of users who may rely upon its work. Keeping all these factors into consideration, the **Audit Firm** needed to have established and documented the procedures and criteria for risk categorisation. Despite claims to the contrary, NFRA is unable to find any such criteria listed either in the policy or the Audit File.

- (ii) The ‘Framework for Assurance Engagements’ forming part of Standards on Auditing issued by the ICAI states that in a reasonable Assurance Engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner’s conclusion (Para 47). The said framework further chalks out very clearly the elements and objectives of assurance engagements, components of engagement risk, and reasonable assurance (Para 48-52). Further, considering the established requirement of SQC 1, and the **Audit Firm**’s acceptance of requirement of risk categorisation based on its own SQC policy, it is, therefore, clear that the **Audit Firm** was required under SQC 1 and Standards on Auditing to appropriately deal with categorisation and minimisation of engagement risk. To contend that this is not a requirement of SQC 1 and the SAs is, therefore, not a correct reading.
- (iii) NFRA has already clearly stated that nowhere in the Audit File is there any evidence that the auditors took note of the SI- NBFC character of the Client Company into the risk assessment. NBFCs whose asset size is ₹500 crores or more as per last audited balance sheet are considered as systemically important NBFCs. The

rationale for such classification is that the activities of such NBFCs will have a bearing on the financial stability of the overall economy. (Ref. FAQ No. 8, All you wanted to know about NBFCs, Updated as on January 10, 2017, as provided by the RBI in their website “<https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92>”)

Given the above, it is clear that audit procedures for an SI-NBFC would have to be substantially more rigorous than for a non-NBFC of the same asset size. Clearly, if companies of the same asset size in another industry (non-NBFC) are classified as “normal”, an SI-NBFC would undoubtedly qualify for a higher risk category. In this context, the argument of the **Audit Firm** that “we would need to consider every company having an asset base of Rs. 500 crores and above as a high risk engagement”, and that “every company to which Ind AS applies by virtue of such threshold linked to size would have to be classified as high risk. This should not and cannot be the basis of engagement risk classification” is reflective of an inadequate understanding of the financial and business sectors of the economy.

- (iv) Certainly, it is not merely the size of the business, but its nature, and its linkages with the economy at the macro level, which is relevant for risk categorization of an engagement. Asset size combined with linkages to the rest of the financial sector and the economy are what determine SI nature, not merely asset size alone. The RBI, as the chief regulator of financial and monetary matters, makes this determination, which needs to be respected and not treated cavalierly.
- (d) As far as the calculation of NOF/CRAR is concerned, the statement of the **Audit Firm** on page 213 of their response that, “It is submitted that in any event, the email dated 27 March 2017 does not bring out any new observation and is not in the nature of an Inspection Report”, and that “the finality was established only in the Inspection Report dated 1 November 2017” is clearly incorrect and misleading.

The Inspection Report dated 01 November 2017 was for the year ended 31 March 2016; whereas, the email dated 27 March 2017 was in reply to the company's responses and request for clarification on the concerns raised in the Inspection Report dated 14 September 2016, which was for the year ended 31 March 2015. It is clear from the remark of the **Audit Firm** that the **Audit Firm** is trying to establish a continuity between the two final inspection reports of the regulator for two different financial years by deliberate misinterpretation of the email dated 27 March 2017. The RBI email dated 27 March 2017 clearly states that "the compliance submitted by the company pertaining to major issues like group exposure, diminution in unquoted investments, interest reversal on Optionally Convertible Debentures, diminution in quoted equity shares etc. are not accepted. You are advised to take necessary action to bring back CRAR to minimum stipulated requirement of 15%." In the light of the above, there is no substance in the contention that "finality" was not reached on the NOF/CRAR computation. To say that RBI's position on the definition issue attained finality only when a final date for compliance with NOF/CRAR calculated in accordance with such definition was intimated is to try and imply a sequential connect where none exists. In any event, what was indicated in the 1<sup>st</sup> November 2017 report was only an extension of the time limit set by the 27<sup>th</sup> March email (which was clearly "immediately"). It is also entirely irrelevant to argue that the said email did not bring out any new observation and is not in the nature of inspection report.

- (e) The **Audit Firm** also states, "In any event, the email dated 27 March 2017 has been referred to in our WP 29203 – Memo on RBI Matters". NFRA has found that this is indeed so.

NFRA is, therefore, confirmed in its view that it was indeed a suppression of vital facts to assert, as the **Audit Firm** had done, that at the time of the 13th October, 2017 meeting, only the RBI Inspection Report dated 14th September, 2016, was available.

The **Audit Firm** would have been well advised to conclude that a letter written by the auditee company to the regulator on a final Inspection Report, does not convert matters that had reached finality into ones still under discussion. Furthermore, supervisory concerns that are repeated in the Inspection Report for every succeeding year do not make it an ongoing correspondence or matter under discussion either.

RBI/DNBR/2016-17/45 Master Direction DNBR.PD.008/03.10.119/2016-17 dated 01 September 2016; Chapter – XV; Interpretations, provides as follows “**122. For the purpose of giving effect to the provisions of these Directions, the Bank may, if it considers necessary, issue necessary clarifications in respect of any matter covered herein and the interpretation of any provision of these Directions given by the Bank shall be final and binding on all the parties concerned. Violation of these directions shall invite penal action under the provisions of Act. Further, these provisions shall be in addition to, and not in derogation of the provisions of any other laws, rules, regulations or directions, for the time being in force**” (emphasis added).

The cavalier attitude of the auditee company was such that the RBI had to specifically point out in its letter dated 04 December 2017 that “We would like to emphasise that regulatory/supervisory directions are required to be acted upon promptly by the regulated entities and not to be subjected to review by them. You may also note that the instructions contained in our above letter were issued after a process of due approval by the Bank and the timelines stipulated in our letter needed to be strictly adhered to” (emphasis added). This stand of the RBI should have informed the decisions of the **Audit Firm**. It is indeed ironic that the **Audit Firm** has taken the stand that it has now despite correcting, at page 268 of its responses to the **DAQRR** that “The RBI is the regulator as far as the company is concerned hence, to state that RBI view in respect of definition of calculation of Net Owned Funds has no bearing would be to disregard the regulator as far as auditors are concerned. Kindly appreciate that in the absence of clarity as to the definition of “companies under the same

management” which in turn has an impact on the calculation of the company’s Net Owned Funds (NOF), a view of the regulator would be the only guidance that we would look to.”

Without ambiguity, there is clear evidence of non-compliance by the Auditee Company, and also of the RBI being firm and consistent in its findings and stand. It is also very clear that the **Audit Firm** has sought to rely on interpretations of the law and correspondence that are unjustified and unsustainable.

- (f) Regarding the **Audit Firm**’s argument that disclosure of NOF and CRAR is not a requirement of the accounting standards, it is pertinent to note that the Audit Report, signed by the EP, on behalf of the **Audit Firm**, clearly states in its opening paragraph that “We have audited the accompanying standalone financial statements of IL&FS Financial Services Limited (“the Company”), which comprise the Balance Sheet as at March 31, 2018, the Statement of Profit and Loss and the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and **other explanatory information**” (emphasis added). As per Sec 143(2), the auditor is required to report about whether a true and fair view of the state of the company’s affairs is provided by its “financial statements”. As per Sec 2 (40) (v), “financial statements” includes any explanatory notes annexed to, or forming part of any of the documents listed in that section. The NOF/CRAR disclosure is prescribed to be appended to the Balance Sheet by the Master Direction 2016. Also, the ‘Framework for the Preparation and Presentation of Financial Statements’ issued by ICAI and notified under the Act further establishes the fact that the financial statements contain notes and supplementary schedules and other information. The disclosure of NOF and CRAR being part of the notes and supplementary schedule, and hence, also being an indivisible component of the notes and schedules and other information forming part of the financial statements, is clearly a direct requirement of law and a deemed requirement of the accounting standards. NOF and CRAR are very important indicators for investors, lenders and other creditors of an NBFC, who are defined as the users of the financial statements. Hence,

the **Audit Firm** is not only non-compliant with the requirements of SA 250, but also with SA 700 (Para 47) among other reporting and disclosure related non-compliances.

- (g) Had the **Audit Firm** complied with their reporting requirements to the RBI, the **Audit Firm** should have had worked out the NOF and CRAR (as per the statutory definition pointed out by the RBI) as on 31.03.2017 and 31.03.2018 to make an assessment of the compliance with the law by the company. As previously stated, similar are the inadequacies found in testing and evaluation of NPAs. Further, Para 107 of the RBI Master Directions, 2016, provides that “Framework for Revitalizing Distressed Assets in the Economy (Framework) as provided for in Annex XXII shall apply to NBFC-D, NBFC-ND-SIs and NBFC-Factors”. Annex XXII is titled “Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy”. The requirement of this Framework is to anticipate NPAs. Before a loan account turns into an NPA, NBFCs are required to identify incipient stress in the account by creating a sub-asset category viz. 'Special Mention Accounts' (SMA) with the three sub-categories as indicated in the Framework. Apart from detailing several steps that NBFCs need to take to detect incipient stress, the Framework lists in Annex A thereto illustrative signs of stress for categorising accounts as ‘SMA-0 category’, In cases where NBFCs fail to report SMA status of the accounts to Central Repository for Information on Large Credits, or resort to methods with the intent to conceal the actual status of the accounts or evergreen the account, NBFCs shall be subjected to accelerated provisioning for these accounts and / or other supervisory actions as deemed appropriate by RBI. These are matters that needed to have been considered by the **Audit Firm** in evaluating the NPA provisions.
- (h) The **Audit Firm** cannot take shelter of any evidence created after the date of audit report. Hence, repeated references to Inspection Report dated 19 June 2018 cannot be accepted as evidence for NPA testing.

- (i) Presumed risk of fraud in revenue recognition:
- (i) The **Audit Firm** has stated that the risks of NPAs being suppressed, and defaults ignored, or of NPAs being made regular by evergreening of loans, indicate a risk of fraud which they had not identified, based on their professional judgement and experience with the company. The risks that NBFC Prudential Norms with regard to asset classification and provisioning are not adhered to was stated to have been considered by the **Audit Firm** as significant risk (and NOT a fraud risk) and relevant procedures were said to have been performed by them to address this risk. Further, based on previous experience of the entity and understanding of the entity's business, the **Audit Firm** had not identified any fraud risk factors with regard to revenue.
  - (ii) The reasons that revenue recognition was considered a fraud risk, the **Audit Firm** contends was because Para 26 of SA 240 requires "the auditor to presume that there are risks of fraud in revenue recognition and evaluate which types of revenue, revenue transactions or assertions, give rise to such risks". Based on performing procedures under SA 240 to identify a risk of fraud, the **Audit Firm** had considered a component of revenue, namely "interest income and interest accrued on loans and advances having the risk that periodic interest report is generated/interest computation are inaccurate, incomplete due to manual intervention of interest computation for loans not regularised in the system" as a presumed risk of fraud in accordance with Para 26 of SA 240.
  - (iii) This presumed risk of fraud in revenue recognition due to fraud pertaining to NPAs that could be suppressed and defaults ignored, or NPAs that could be made 'regular' by evergreening of loans has been rebutted by the **Audit Firm** in terms of Para 47 of SA 240 on the grounds of "professional judgement and past/previous experience". However, in accordance with Para 12 of SA 240 and Para 15 of SA 200, the auditor should have maintained professional

skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and TCWG.

- (iv) SA 240 explains that misstatement in the financial statements can arise either from fraud or error. It further explains that the distinguishing factor between fraud and error is where the underlying action that results in the misstatement of the financial statements is intentional or unintentional. These two categories of the source of risk, viz, fraud and error are therefore, mutually exclusive and collectively exhaustive. A significant risk is defined in the glossary of terms as an identified and assessed risk of material misstatement that, in the auditor's judgement, requires special consideration.
- (v) Para 27 of SA 240 states that the auditor shall treat those assessed risks of material misstatement due to fraud as significant risks. Para A131 of SA 315 explains that significant risks often relate to significant non-routine transactions or judgmental matters. The paragraph further explains that routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.
- (vi) The identification of any risk as significant does not alter the two-way classification of the source of risk as arising either from fraud or error. Applying this principle to the **Audit Firm's** assessment of the risk of NBFC Prudential Norms not being adhered to as a significant risk, the source of the said significant risk should have been considered. Given the nature of the risk, such a risk could have been mainly, if not entirely, due only to fraud. The argument of **Audit Firm** that they considered this risk as not a fraud risk, though significant in nature, leads to the conclusion that the cause of the risk in this case was identified by the **Audit Firm** to be only error.

- (vii) This identification has influenced the testing of controls and the substantive procedures actually employed by the **Audit Firm** in this connection. It is seen that the **Audit Firm** has taken the listing of NPAs provided by the management as given and has subjected the interest calculation and recognition of interest in these accounts to verification to see that credit was not taken for the interest receipts against these identified NPAs. However, the basic question of whether the list of NPAs provided was itself comprehensive and did not leave out any case that needed to be considered has not been subject to testing. This is a clear failure on the part of the **Audit Firm** to maintain professional skepticism throughout the audit as required by Para 12, Para A7 and A8 of SA 240. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and TCWG, the auditor's professional skepticism is particularly important in considering the ROMM due to fraud because there may have been changes in circumstances. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the ROMM due to fraud.
- (viii) The **Audit Firm** has claimed to have obtained the list of NPAs from the company and has claimed that they were verified with financial statements and their classification and computation as per RBI Prudential Norms (WP 26720.02). There does not seem to have been any independent test of those loans and advances which were not classified as NPA by the company. For verifying the classification of NPAs by the company, the **Audit Firm** has claimed to have performed and relied upon test of controls (WP 23300.01.01.01). This control testing checked that NPAs are flagged based on the system generated alerts of overdue accounts. No testing, however, was carried out to check the complete universe of the loans and advances to ensure proper coverage and identification of NPAs. To evaluate recognition of interest, the **Audit Firm** has referred to WP 26101 'Interest Recomputation', which shows in 'Work Done' that the **Audit Firm** has tested samples from the disbursement and

repayment register, documented in WP 23300.01.02.04, but the basis for sample selection has not been explained or documented. Furthermore, WP 23400.01 'Interest Debtors' worksheet – 'Lead sheet' states that, "DHS has identified the interest and principal overdue report as the IPE (Information Provided by Entity) for interest checking. ET has involved Risk Assessment (RA) team to test the same for completeness and accuracy. Refer WP 20000.06." Going further, WP 20000.06 could not be found as it does not form part of the Audit File. Hence, the test of completeness and accuracy has not been established.

As established above, the completeness and accuracy of the listing of NPAs have not been ensured by the procedures used as documented in the Audit File.

- (j) SAs 240, 315 or 330 do not state that management override of controls cannot be a risk of material misstatement at assertion level. SA 240 in fact, inter alia, states that although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a ROMM due to fraud and thus a significant risk. It further establishes the need for the auditor to design and perform audit procedures to, in fact, minimise the risks at assertion level, irrespective of the auditor's assessment of the risks of management override of controls (Para 31 and 32 of SA 240). Therefore, NFRA does not agree with the **Audit Firm's** approach of minimising the ROMM of management override of controls at only the financial statement level and that "the susceptibility of sanctioning of loans to management override of controls was remote and hence not considered as a fraud risk". This seems to have been an a priori conclusion; the Audit File does not provide any substantive test of details having been performed to support any such conclusion.

As far as Test of management override of controls through journal entries tested in WP 21101.05 - JE Testing Sample Testing is concerned, NFRA went through the Working Paper and found that:

- (i) Out of 75662 journal entries, 14890 entries, which were contra entries (Entries with zero effect outside of an FS line) were excluded and were not even considered for control testing.
- (ii) Further, no tests were performed on “*entries made to unrelated accounts and “entries posted after closing date for quarter”*”. This is despite the fact that these events are listed in the **Audit Firm’s** software and are also a requirement under Para A43 of SA 240.
- (iii) No testing was carried out for entries “*made either before or during the preparation of the financial statements that do not have account numbers*”, as required under Para A 43 of SA 240.
- (iv) As per A43 of SA240, when identifying and selecting journal entries for testing, one of the areas of relevance is the nature and complexity of the accounts. “*Inappropriate journal entries or adjustments applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud*” should have been identified for control testing. No such JEs were identified by the **Audit Firm**.
- (k) As far as testing of manual overrides of controls is concerned, the **Audit Firm** has itself quoted Para 32(c) of SA 240 which states that “the auditor shall evaluate whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets”. If it is in fact the case that all instances of decisions where management override of controls took place were again put through the required approval process, with the result that approvals were obtained twice over, the reasons for a manual override in the first place itself would not subsist. The fact that a manual override had to be undertaken is indicative of the need to relax the conditions of viability, creditworthiness of the borrower,

collaterals required etc. in specific cases. This would have been clear from an analysis of the Credit Appraisal Memorandums (CAMs). The Audit File does not provide any evidence in support of procedures performed and CAMs scrutinized to understand the reasons for manual override in specific cases. To this extent, the large number, and proportion of value, of manual overrides was a fraud risk that was not met by adequate response in terms of the audit procedures conducted. This was subsequently brought out by RBI also in its report dated March 22<sup>nd</sup>, 2019.

- (l) The auditor is required to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; the results of the audit procedures performed, and the audit evidence obtained; and significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. The audit documentation, therefore, should be adequate in itself for all purposes. Nevertheless, and quite contrary to the contention of the **Audit Firm** that there were no discussions by the NFRA with them during the process of its review, it is to be noted that right from the beginning, and at every successive stage, the **Audit Firm** has been given sufficient opportunities and time to present their case and clarifications.

## **2.6 RBI Inspection Matters – TTSL Shares and Derivatives Assets**

**2.6.1 With regard to the above matter, the NFRA had communicated the following prima facie observations/comments/conclusions in its letter dated 28<sup>th</sup> June, 2019:**

- (a) The ET had not obtained any justification/explanation as to how the company had accepted the transfer of unquoted shares of TTSL, whose valuation even on the date of transfer was only zero, as settlement as against Rs. 323.15 crores loans outstanding from the Siva Group. Clearly, 100% provision, if not write off, against the said loans was due to be made even on 31<sup>st</sup> March, 2015, in line with RBI directions.

- (b) The so called put option backing the shares was not even a fig leaf for the reasons detailed therein.
- (c) The Siva Group, as a counter party was completely un-creditworthy.
- (d) The Shareholder's and Option Agreements did not form part of the **Audit File**. There is, hence, no evidence that the Auditor had verified or checked the agreements.
- (e) The Guidelines on Derivatives Contracts do not apply to the put option.
- (f) The requirements of Section 143 (1)(a) of the Companies Act, 2013 had not been complied with.
- (g) The Black Scholes Option Pricing Model was inapplicable in the present case.
- (h) The worksheet supporting the option valuation as per the Black Scholes Model appears to be a calculated fraudulent work paper having no audit substance. The calculations seem, for reasons spelt out in detail, to have been made in order to support the company management's attempt to bypass the RBI directions to provide for 100% of the value of the TTSL shares.
- (i) There is a clear conflict of interest in engaging DTTI LLP to verify the valuation of the derivative assets.
- (j) As a consequence of all the above, the valuation of the derivative assets (in the form of the put option) of Rs. 184.31 crores is completely unjustified and not based on any objective evidence and appears to be a calculated fraud in support of the management to inflate the profit.
- (k) Further, there is no disclosure about the details of the valuation of the derivative assets in the financial statements. Note 9 (f) forming part of the financial statements is completely inadequate and misleading.
- (l) Financial statements of the counter party i.e. Shanmugha Real Estate and Properties Private Limited (SREPPL) were not in the **Audit File**. There

was no evidence that this had been examined. There was also no evidence regarding valuation of the land parcels of Hill County Properties Limited (HCPL).

**2.6.2 The response of the Audit Firm in respect of the above matter is summarized below:**

- (a) The Company had considered its investment in TTSL as a long term investment. As per the accounting standards, long term investment is required to be valued at cost and assessed for other than temporary decline in the value of such investments. As per the valuations done during 2014-15, 2015-16 and 2016-17, no provision was required to be made since the independent valuation of the investment in the TTSL shares supported the carrying value of the long term investment in TTSL shares in the books of the company.
- (b) In 2017-18, there were significant events which required reconsideration of the valuation. Owing to uncertainty in arriving at the valuation, the valuation of the shares was taken as Nil and accordingly full provision was made for the diminution in the valuation of TTSL shares of Rs.252.15 crores during 2017-18.
- (c) The **Audit Firm** is not required to keep all agreements that were verified by them during the process of audit in the **Audit File**. However, the fact that the agreements and valuation sheet of the management were considered by their valuation team, is evidenced through e-mail dated 23.05.2018, and its Annexures that have now been provided.
- (d) The Guidance Note on Derivatives issued by the ICAI fully applies to the put option agreement.
- (e) The Black Scholes Option Model is permitted to be used even by the Reserve Bank of India for valuation of such derivatives.
- (f) There is no contradiction of assertions between the ET and the valuation team.

- (g) There is no conflict of interest involved in DTTI LLP providing valuation services in this case.
- (h) The recoverability of balances due from the counter party were primarily assessed based on the overall commercial agreement which existed in between the parties. Financial Statements may not be the only way to assess the creditworthiness of the company.
- (i) The disclosure requirements (Paras 55 to 67 of the Guidance Note) were duly complied with.

**2.6.3 The NFRA had duly considered all the above points made by the Audit Firm in detail and had arrived at the following conclusions in the DAQRR:**

- (a) The shares of TTSL (7.85 crore shares of the face value of Rs. 10/- each) appear to have been pledged by the Siva Group as security for loans of Rs.323.15 crores taken from IFIN by three companies of the Siva group. The loans appear to have been granted on 01.12.2011 for a period of 36 months. No other details are available in the **Audit File**. The borrowers appear to have defaulted and IFIN appears to have invoked the pledge and taken over the TTSL shares by way of settlement of the loans outstanding. In such a case, it is clear that the said shares could not have been treated as Long Term Investments and, as such, valued as per AS-13. The definition of “Investments” as per AS-13 is “assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise”. Not only do the TTSL shares held by IFIN not fall within the purview of this definition, the process of acquisition of the these shares was not a process through which Investments (coming within the purview of AS-13) would have been acquired. On the contrary, these were shares that were initially pledged as collateral for loans and were taken over by IFIN upon default by the borrowers.
- (b) **Section 4 of Annex V of the Master Directions 2016 provides that the amount of principal converted into debt/equity instruments on restructuring should be held under “current investments” and valued**

as per usual valuation norms [Para 4.4.2 (ii)]. There is no mandate in the said RBI Directions for treating equity instruments obtained on restructuring as long term investments. The RBI Directions quoted above also provide that the method of valuation of such shares held in current investments should be the lower of “breakup value” and “earning value”. This is the reason why the RBI had insisted upon providing for the entire value of the TTSL shares even as of 31.03.2015. The **Audit Firm** had evidently ignored the specific RBI directions and had accepted the management’s view and supported the treatment of the TTSL shares as long term investments. For the reasons explained above, this treatment, especially in the light of specific RBI directions to the contrary, appeared to be calculated to support the management in the misstatement of its accounts.

- (c) **As far as the applicability of the Guidance Note on Derivatives to the put option in this case is concerned, the statement of the Audit Firm that the valuation of the put option changes in response to the underlying change in the price of TTSL shares, was found to be factually completely incorrect.** With the TTSL share being unquoted and unlisted at any Stock Exchange, the valuation or price of those shares was not objectively discoverable. The **Audit Firm** had also drawn attention to the statement on Para 11 of the Guidance Note to the effect that “this list is meant to be illustrative only and not exhaustive”. All the items listed in the said Para 11 are examples of instruments traded on stock exchanges. Therefore, the statement that the list is illustrative only and not exhaustive, cannot be interpreted to mean that instruments which do not share the tradability characteristic of the instruments in the list, could be included. The statement that the list is only illustrative and not exhaustive had to be read ejusdem generis with the items in the list above. The Guidance Note in question, therefore, did not apply to the put option.
- (d) The **Audit Firm** had quoted a Reserve Bank of India report to support their view that the Black Scholes Option Pricing Model is permitted to be used in the circumstances of this particular case. The RBI report refers to the permitted use of the Black Scholes Model to value an option that is not

traded. **However, this does not mean that the Black Scholes Option Model can be used in a situation where the underlying itself is not traded as in this particular case.**

- (e) Even assuming for the sake of argument, but not admitting, that the Guidance Note on Derivatives is applicable to present put option, the **Audit Firm** had ignored the stipulation of Para 17 of the said Guidance Note. This paragraph defines the fair value in the context of derivative contracts as the “exit price” i.e. the price that would be received when transferring an asset to a knowledgeable and willing counter party. The fair value should also incorporate the effect of credit risk associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract. For the reasons explained in NFRA’s prima facie conclusions (the past credit record of the borrower group, the opacity and complexity of the credit support agreements, and the **Audit Firm** not having scrutinized and evaluated all the relevant documents and valuation reports), NFRA’s conclusion was that the **Audit Firm** had not obtained sufficient, appropriate audit evidence for this “exit” price.
- (f) The **Audit Firm** had explained that they were not required to keep all agreements that were verified by them during the course of audit in the **Audit File**. This statement was found to be completely violative of the basic principles underlying audit documentation. What was produced by the **Audit Firm** in response to the prima facie conclusions was a copy of a mail dated 23.05.2018 along with some annexures (Annexure 3 D.a. to Annexure 3 D.d. of the **Audit Firm**’s response). This e-mail and annexures were not part of the **Audit File** and NFRA stated that it would be fully within its rights to ignore the said documents thus produced. However, the documents thus produced had also been examined by NFRA, without prejudice, and the following conclusions were arrived at:
  - (i) The principal debtor (put option writer) in this case was Shanmugha Real Estate and Properties Private Limited (SREPPL). Their financials had not been examined by the Auditors. In fact, the **Audit**

**Firm** did not even claim that they had done it. While the financial statements of the principal debtor may not reveal the full story about its creditworthiness, the requirement of having to obtain sufficient appropriate evidence to assess the credit risks involved in this case required that the financial statements of SREPPL should have been seen. The **Audit Firm** had, therefore, completely failed in its primary duty of obtaining and evaluating sufficient and appropriate audit evidence.

- (ii) Reference had been made to a Guarantee Agreement in which CPIL (a Siva Group Company) had provided a guarantee to IFIN that 2 companies of the Siva Group namely, Siva Green Power and SREPPL, will comply with their obligations to IFIN. The said guarantee agreement was not available in the **Audit File**; neither had it been produced along with the email. Nor did the ET or the valuation team say that they had seen or verified the said guarantee agreement. Besides, the total liability of CPIL in the guarantee had been capped at Rs. 300 crores. This was in a situation where the liability of SREPPL under the put option is Rs. 253 crores and the liability of Siva Green Power for OCDs was Rs. 190 crores, totaling Rs. 443 crores in all. Clearly, the **Audit Firm** had utterly failed in obtaining sufficient and appropriate audit evidence.
- (iii) The ET says that they had got the land parcels held by Hill County Properties Limited (HCPL) evaluated by their internal valuation team. No such evidence was seen in the **Audit File**. It was seen that the **Audit Firm** had also not gone through the basic requirement of checking the charges that had been registered against the properties of HCPL and the extent to which any balance, if any, of the asset values on realisation would be available to meet HCPL's obligations to CPIL. ET also said that they had verified the hypothecation agreement by which CPIL had committed itself to transferring money received from CPIL to IFIN. No such agreement was found in the file.

- 2.6.4 For all the above reasons, the **DAQRR** concluded that it is very clear that the ET had completely failed to obtain sufficient appropriate audit evidence to satisfy itself about the credit risk associated with the fulfilment of the put option by SREPPL.
- 2.6.5 It is seen that the option Agreement was executed sometime in December 2015. If the argument of the **Audit Firm** that the option had a value of around Rs.180 crores was to be accepted, there was no reason why this was not reflected in the Balance Sheets as of 31<sup>st</sup> March, 2016, or 2017. **The fact that this option contract was brought into the books as of 31<sup>st</sup> March, 2018, only served to confirm the prima facie conclusion of the NFRA that this action was only a method used by the management to inflate the profit, and that the Audit Firm did not display the required professional skepticism and challenge the evidence produced by the management.**

**2.6.6 After considering all the above matters, NFRA concluded as follows in the DAQRR:**

- (a) The **Audit Firm** did not obtain sufficient, appropriate audit evidence to support the value of the derivative asset included in the Balance Sheet as at 31<sup>st</sup> March, 2018;
- (b) The **Audit Firm** did not do the due diligence necessary to obtain and critically evaluate such evidence as was provided to it by the management;
- (c) Accounting guidelines that are clearly inapplicable had been used to justify the treatment given;
- (d) In order to offset the impact of provisioning that could not be deferred any more, on account of RBI insistence, the **Audit Firm** went along with the management in including a derivative asset of zero value in the Balance Sheet at over Rs 180 crores, and taking credit in the Profit and Loss Account. This resulted in a very material misstatement of the financial statements.

**2.6.7 In their reply to the DAQRR, the Audit Firm has disagreed with the conclusions of NFRA and have stated as under:**

- (a) The loans to the Siva Group had been granted in the preceding years and the conversion from loans to investments was also made in the earlier years.
- (b) There was no requirement therefore for us to keep in the audit file for 31 March 2018 the past years' work papers containing the details of the loans given and invoking of the pledged shares.
- (c) In our professional judgement, a security purchased or obtained through other settlement mechanism (like invocation or merger) would be considered as an investment, if the company holds the risk and rewards of that security.

With regard to the Company treating the shares as Long term investments, *Paras 9 and 10* of Chapter V of Prudential Regulations of the Master Direction 2016 are relevant. These provide that:

- (i) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the Company in the Company's Investment Policy; and
- (ii) The decision to classify an investment as current or long term is to be decided by the Company on the date of investment, which has been done in the present case.

**Company's policy:** Extract from Company's Investment Policy adopted by the Board of Directors as required by the RBI Prudential Norms:

*"2) Related to the Lending Business Activities*

*Such Investments mainly includes Debentures, Bonds and Convertible Debentures and are approved under the Credit Approval process as applicable in case of Loans and Advances. As a recovery measure, the Company may acquire investments through enforcement of underlying securities or through settlement with clients. These include Equity Shares, Preference Shares, and Investment Properties. Such Investments are approved by Committee of Directors."*

- (d) **In relation to the TTSL transaction:**
  - (i) On 23 March 2015, the Committee of Directors (COD) of the Company approved invocation of shares of TTSL given as security by Siva Group to protect/ enhance its economic interest.
  - (ii) Further, the COD approval memorandum clearly stated that the intention of the Company was to hold these investments as Long Term. The COD memorandum was also noted by the Board of Directors of the Company and the shares were accounted as Long Term Investments in the books of accounts for the year ended March 31, 2015 and thereafter.

- (iii) Initially TTSL shares were pledged as collateral for loans and were taken over by the Company on account of defaults by the borrowers, but on invocation of the same, the management had clearly articulated that the purpose for the same was in the nature of a long-term investment.
- (iv) It is also of purport that there is nothing in Prudential Norms and AS 13 that precludes acquisition of equity shares carried out in the manner that the Company acquired TTSL shares from being categorized as Investments.
- (v) The RBI in its Inspection Reports has not questioned the company's treatment of acquisition of shares on invocation as investments.
- (vi) Acquisition of TTSL shares was not part of restructuring as per RBI Prudential Norms and the aforesaid RBI norms are definitely not applicable to the facts of the case.
- (vii) The Company had loan exposure to Siva group, which had committed a default in payment on due date. Accordingly, the Company in order to protect its interest, invoked the collaterals placed with the Company as security, thereby extinguishing the loan amount and consequently took on its books the TTSL shares as a new asset.
- (viii) As per the **norms for restructuring of advances** applicable to NBFC's given in **Annexure V** of the **Master Directions 2016**, restructuring is defined as below:

“A restructured account is one where the NBFC, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the NBFC would not otherwise consider. Restructuring shall normally involve modification of terms of the advances / securities, which shall generally include, among others, alteration of repayment period / repayable amount / the amount of instalments / rate of interest (due to reasons other than competitive reasons).” In view of the above definition it is evident

that the acquisition of TTSL shares cannot be termed as restructuring as it does not satisfy the specific conditions.

(e) **In relation to application of the Guidance Note on Derivatives and the Black Scholes Option Pricing Model:**

- (i) Para 8 of the said Guidance Note on Accounting for Derivative Contracts (GN), states this Guidance Note covers all derivatives contracts except those specifically notified as excluded from the same.
- (ii) In present case, the derivative was on a different counterparty i.e. Shanmugha Real Estate and Properties Private Limited (SREPPL) and not on TTSL.
- (iii) The put option satisfied the three cumulative conditions in the definition of Derivatives as per Para 13 of the GN, as follows:

<b>Condition</b>	<b>Basis</b>
Underlying*	Value of the Put Option changes in response to the value of the specified financial instrument i.e. equity shares of TTSL
No Net Initial Investment	While entering into the option agreement, there was no net initial investment paid by the Company
Settlement at a Future Date	Agreement is to be settled at future date

\*Indicative definition of “underlying” as given by GN, nowhere specify that the underlying has to be quoted / listed on a stock exchange.

- (iv) Paragraph 11 of the GN clearly demonstrates that the derivatives covered under the GN are not necessarily only those quoted/traded on a stock exchange. In item (iii) of Para 11, there is a specific mention of traded contracts, and in all the other items, there is no such specific mention of the traded contracts clearly implying that unquoted derivative quotes are also covered under the GN. Nowhere in the GN is it explicitly stated that unquoted derivatives are not covered under the scope of the GN as has been alleged.
  - (v) Black Scholes Option Pricing Model can be used to value options where the underlying is not traded (includes securities of unlisted company).
  - (vi) With reference to the stipulation of Para 17 of the said Guidance Note, we submit that in order to incorporate the credit risk factor, an appropriate Credit Value Adjustment (CVA) was applied on the Derivative Asset Valuation based on Probability of Default (PD) and Loss Given Default (LGD) approach. Refer WP 23150.01.01A “Memo on TTSL and Derivative Assets”.
- (f) Assessment of agreements with and between Shanmuga Real Estate and Properties Private Limited (SREPPPL), Siva Green Power Projects India Private Limited (Siva Green), Chennai Properties and Investment Limited (CPIL), and Hill County Properties Limited (HCPL).
- (i) Assessment of the financial statements of SREPPPL was not considered necessary considering that the credit risk of SREPPPL was guaranteed by CPIL.
  - (ii) The land parcels held by HCPL were evaluated by their internal valuation team, refer work paper 23300.04A.04 “IFVS Memo on Siva Group Properties”.
  - (iii) The charges created on HCPL Properties were verified on a sample basis during our audit of the financial statements for the year ended 31 March 2018, (WP 23300.04B.23 of audit file). The following audit procedures were done with respect to the HCPL properties:

- Physical verification of original title deeds of land mortgaged (equitable mortgage)
- Verification of the charge creation document.

**(g) Recognition of the Value of Put Option**

- (i) The rights under the put option agreement did not arise in FY 2016 and FY 2017 due to the underlying equity valuation of TTSL shares as can be evidenced from the independent third party valuation reports available at both year ends. Thereafter, pursuant to the diminution in the value of the TTSL shares, the put option was triggered during the year ended 31 March 2018 and was duly recognized in the financial statements in accordance with the said GN.
- (ii) Had the Put Option (if the Option had a value) been accounted in the years ended 31 March 2016 and 31 March 2017 as suggested, such accounting would have been fraudulent as without the put option being triggered it would have led to accounting for the value of the Put Option and the value of the TTSL shares, thereby fraudulently inflating the profit by the value of the Put Option for the respective years since the investment in shares of TTSL also continued to be valued.

**2.6.8 NFRA has examined the above contentions of the Audit Firm and has concluded as follows, as far as these arguments are concerned:**

- (a) The investment policy referred to by the **Audit Firm** is not found in the audit file which means that the ET had not even examined the investment policy of the company to confirm whether such a policy spells out criteria for classifying investments into current and long-term.
- (b) The extract of the investment policy quoted by the **Audit Firm** is irrelevant to the present context since it makes reference to enforcement of securities as a recovery measure of the Company. A recovery mechanism would require acquisition of either cash or cash equivalent

assets in settlement of a debt. A case like the present one, of invoking the pledge of illiquid shares of doubtful value, would not amount to a recovery measure, because nothing was recovered immediately; nor there was any hope of recovery in the short run.

**In relation to TTSL Transactions:**

- (a) Admittedly, the Siva Group of companies defaulted on the loans of Rs 323.15 crores taken from IFIN, and IFIN had invoked the pledge and taken over the TTSL shares offered as collateral to the loans. It is important to note that there was no closure of the loan by repayment thereof in cash. The loan was substituted by the elaborately designed “put option” mechanism, implicit in which were several concessions. Thus, the liability of the borrower was not extinguished, even partially. Hence this was not a recovery measure, through enforcement of underlying securities.
- (b) The Committee of Directors (COD) approval memorandum quoted by the **Audit Firm** in support of treating TTSL shares as long- term investment is not found in the Audit File.
- (c) As far as the applicability of AS 13 is concerned, the definition of “Investments” is “assets held by an enterprise for earning income by way of dividends, interest and rewards, for capital appreciation or for other benefits to the investing enterprise”. Given the facts of the TTSL shares, none of these benefits could have realistically been contemplated when the pledge of shares was invoked.
- (d) The RBI had, as early as in 2015, when the transaction first took place, directed the Company to make provision for the entire value of TTSL shares as of 31.3.2015, treating it as current investment.
- (e) The **Audit Firm**’s contention is that the acquisition of TTSL shares cannot be termed as restructuring under the RBI Prudential Norms. RBI’s definition of restructuring provides that restructuring generally includes the following elements:

- (i) Modification of terms of advances/securities;
- (ii) Alteration of repayment period;
- (iii) Alteration of repayable amount;
- (iv) Changes in instalments;
- (v) Changes in interest rates, etc.

Substance over form is defined in Paragraph 35 of the ICAI Framework of Financial Statements. This states that *if information is to represent faithfully the transactions it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.* It is seen that every element in the RBI definition of restructuring, as listed above, applies to the present case. An extended repayment period (effectively repayment will occur if at all, by 2020 instead of 2014), foregoing of interest, reduction in principal value etc. have been carried through. Clearly this was restructuring in effect. Considering substance over form, the transaction should have been treated and disclosed as restructuring.

- (f) In fact, the **Audit Firm** should have questioned the Company for their obvious non-compliance with the RBI Prudential Norms on loan restructuring, which state that restructuring:
  - (i) has to be based on financial viability and reasonable assurance of repayment from the borrower;
  - (ii) would be treated as attempt at evergreening a weak credit facility if done without assessment of viability and shall invite supervisory concern;
  - (iii) shall be based on acceptable viability benchmarks;
  - (iv) Promoters' personal guarantee shall be taken; and
  - (v) Information on restructured advances shall be disclosed in the "Notes on Accounts."

- (g) The **Audit Firm** have themselves confirmed that assessment of the financial statements of SREPPL was not considered necessary considering that the credit risk of SREPPL was guaranteed by CPIL. CPIL guarantee in turn was based on the MoU signed with HPCL, which was a wholly owned subsidiary of IL&FS. The **Audit Firm's** statement implies that the credit risk evaluation of the receivable by IFIN from Siva Group was solely on the basis of a guarantee backed by revenue generated from an IL&FS Group Company itself. There is no explanation forthcoming from the Audit File as to why an IL&FS Group company bound itself to sell its land using only the services of a Siva Group company, and also to part with as much as 20 % of the sale proceeds in return for such services as might be rendered by the Siva Group company. The **Audit Firm** has outright denied the need of credit risk evaluation of the borrower to assess its independent ability to meet the borrowings out of its own resources. Thus, while the financial statements of the principal debtor may not reveal the full story about its creditworthiness, the requirement of having to obtain sufficient appropriate evidence to assess the credit risks involved in this case requires that the financial statements of SREPPL, at a minimum, should have been seen and analysed.
- (h) As regards audit procedures said to be done with regard to HCPL properties, the working papers submitted by the **Audit Firm** do not support the **Audit Firm's** submission of verifying "original" title deeds of land mortgaged and charge creation document. Details of how the original title deeds were obtained and/or copies thereof are not available in the Audit File. Besides, it is not clear how "original" title deeds of properties that were under equitable mortgage were available for checking by the **Audit Firm**.
- (i) Not only did the **Audit Firm** fail to recognise this set of transactions as restructuring, but it also failed to insist upon its categorisation as NPA when there was no proof forthcoming of the account meeting the required viability benchmarks.

No disclosure of this restructured account was made in the Financial Statements, though required by the RBI Directions.

**In relation to application of the Guidance Note on Derivatives and the Black Scholes Option Pricing Model**

- (j) With reference to the ICAI Guidance Note on Accounting for Derivative Contracts (GN), it is pertinent to note that the “Scope” of the GN covered under paragraphs 8-11, is summarised in Paragraph 11, which states that “*The Guidance Note, **thus**, applies...*”, describing the final scope of the GN after taking into account everything which precedes it. NFRA therefore confirms the conclusion that this GN does not apply to the financial instrument under discussion which does not share the tradability characteristics of the instruments listed in Para 11 of the GN.
- (k) The valuation of the Put Option on TTSL shares is one of the most important elements of the Financial Statements for the year 2017-18. The value finally taken, viz, Rs 184.30 crores has inflated the profit, and the asset value in the balance sheet. It is 1043.6% of the profit before tax excluding the said option value. If the option value had not been taken at Rs.184.30 crores and the resulting credit taken into the profit and loss account, the profit before tax would have been only Rs 17.66 crores. Given the trend of declining profits, this was clearly a situation where significant pressures existed on management as far as the results of the company were concerned, and one that was susceptible to fraud risk.
- (l) It is in this context that the **Audit Firm** needed to exercise extra skepticism and challenge the management on:
  - (i) The theoretical model used for option valuation;
  - (ii) The data sources for the inputs required by the model;
  - (iii) The computation method;

- (iv) The fundamental principles behind the computation, so as to not result in a mechanical arithmetic exercise in a clearly inapplicable context;
  - (v) The adjustments, if any, that needed to be made to the output of the model.
- (m) The **Audit Firm** stated that the Black Scholes model was used for valuation of the derivative asset. Black Scholes model determines the value of the option as a function of current stock price, the strike price, time to expiration, interest rate that may be earned from safe investments, and the expected volatility of the log returns of the underlying security. NFRA has even earlier pointed out that the Black Scholes model cannot be used in a case where the underlying is not traded. Such a case is one which is not contemplated at all by the model.
- (n) NFRA notes that there is no evidence in the WP of the sources of assumption made for the key variables of (i) risk free interest (taken as 7.086% from Bloomberg as of 31 March 2018 for 3 –year G-Sec and (ii) Standard Deviation (taken as 11.01 %) for which the WP shows the statement “Weekly one-year range has been taken” without specifying the source of these figures. NFRA observes that the basis for the assumed rate used for computing expected volatility is not stated. Since the underlying asset is not traded in this case, the commonly used methods of “historical” or “implied” values for computing expected volatility cannot be readily applied in this case. The basis for such an assumption therefore is suspect. However, the WP 23150.01.01.A (Excel sheet) provided by the **Audit Firm** is silent on this aspect. Further, the put option contract does not bind the company to exercise the put option at the end of the term. Given that put option was a means of extracting some value from the zero-value TTSL shares acquired by means of invoking collateral from the defaulting Siva Group, the **Audit Firm** should have enquired into the real reasons behind management’s decision that the option would not be exercised before the end of its term in spite of there being no such restrictive condition imposed in the Put Option Agreement itself. The minor reason that can be inferred is that this was required to satisfy one of the conditions for the applicability of the Black Scholes model, which is applicable to European style

options only. The more important reason, that the **Audit Firm** should have inferred, and subjected to challenge, is that such an early exercise would have totally exposed the utter valuelessness of the option. Considering all the above reasons, the value of the put option thus arrived at, of Rs 209.40 crores, is the result of a mere arithmetical exercise based on assumptions that are not justified, and applied to a situation where such formula is clearly not applicable.

(o) As regards computation of the Credit Value Adjustment (CVA), NFRA is confirmed in its observation that the Loss Given Default (LGD) and Probability of Default (PD) rates were assumed without any bases. WP 23150.01.01.A (Excel sheet) shows that the LGD and PD rates were arrived at by the Internal Valuation team (WP 23150.01.01.B) based on a three stage exercise:

- (i) Assigning a credit rating to the counter party;
- (ii) Assigning a Probability of Default (PD) range linked to such credit rating; and
- (iii) Estimating a Loss Given Default (LGD) for the case.

(p) The PD range was estimated by DTTI LLP (WP 23150.01.01.B) at 20.52 % to 32% supposedly based on the credit rating of the counterparty (viz. SREPPL), while the LGD was taken as 60%. The CVA was calculated by the **Audit Firm** using both the highest and lowest value of PD which was Rs. 169.19 crore and Rs 183.62 crore respectively. It is evident that the **Audit Firm** intentionally chose to adopt the value given by the company which was closer to the value determined using the lower of the two PD values, though no justification for the same was anywhere recorded.

Further, NFRA noticed that there was inconsistency in the internal working papers given by the **Audit Firm**. The CVA amounts for the 2 given PD figures as computed by DTTI LLP (WP 23150.01.01.B) is Rs. 42.93 crore and Rs. 24.59 crore, whereas the CVA used by the **Audit Firm** in its working (WP 23150.01.01.A Excel Sheet) is Rs. 40.20 crore and Rs. 25.78 crore respectively. (The **Audit Firm** has been found silent on this matter.)

It is seen that there is absolutely no objective evidence for the numbers used in any of above-mentioned three stages. The entire exercise is fictitious arithmetic. The lack of challenge to the numbers is self-evident from the admission of the **Audit Firm** that they have not even examined the financial statements of SREPPL, the put option writer.

- (q) Thus, NFRA concludes that not only is the **Audit Firm's** contention about appropriateness of Black Scholes model for the valuation of the derivative asset incorrect, the **Audit Firm** has also even failed to challenge the assumptions or verify the bases of various assumed values provided by the Company, or by the so-called independent expert. Thus, the entire value of Rs 184.31 crores of the derivative asset included in the profit for the year and the balance sheet is bereft of any supporting evidence.

#### **Recognition of the value of the Put Option**

- (r) The **Audit Firm** has said that “the rights under the put option agreement did not arise in FY 2016 and FY 2017 due to the underlying value of TTSL shares as can be evidenced from the independent third party valuation reports available at both year ends. Thereafter, pursuant to the diminution in the value of TTSL shares, the put option was triggered during the year ended 31st March, 2018.” Further, they have said that “had the put option (if the option had a value) been accounted in the years ended 31st March, 2016 and 31st March, 2017 as suggested, such accounting would have been fraudulent as without the put option being triggered it would have been led to accounting for the value of the put option and the value of the TTSL shares, thereby fraudulently inflating the profit by the value of the put option for the respective years since investment in the shares of TTSL also continued to be valued.”

The above statements reflect a complete lack of understanding of the transactions and how they should have been treated in the financial statements for the following reasons:

- (i) There are two separate assets involved in this case namely, the TTSL shares, and the put option on TTSL shares;

- (ii) The valuation of these financial instruments and the recognition of such value in the financial statements is independent of each other;
- (iii) As far as the TTSL shares are concerned, they had to be treated as current investments in terms of the RBI Master Directions and valued accordingly at the lower of “break-up value” or “earning value”. As has been pointed out by the RBI in its Inspection Report, this valuation was to be made as of 31.03.2015 itself. The obtaining of “independent third party valuation reports” and basing the valuation of TTSL shares on these reports was completely unwarranted and incorrect;
- (iv) Factually, there was no link between the value of the TTSL shares (howsoever determined) and the so called “trigger” for the put option. According to the option agreement dated 23rd December, 2015, a copy of which has been made available by the **Audit Firm**, the “put option exercise period” started on the expiry of one year from the date of agreement and extended upto the end of the “put option exercise period”. This meant that the put option could have been exercised at any period of time after 25th December, 2016. Assuming that the put option was valued according to any acceptable method, the value of the put option should have been included in the balance sheet as of 31.03.2017;
- (v) While the intention behind the put option may have been to provide a hedge against diminution in the value of the TTSL shares, valuation of these two financial instruments had to be done separately. Of course, the value of the put option would have been dependent upon the expected price of the underlying, namely the TTSL shares, at the option exercise date, and the strike price;
- (vi) To argue, as the **Audit Firm** has done, that valuation of both the TTSL shares as well as the put option simultaneously would have led to fraudulent accounting, is clearly reflective of inadequate understanding of the nature of these instruments and their valuation.

(vii) In fact, and to the contrary, what has happened is fraudulent accounting because a high valuation has been given to the put option at a time when both the value of the underlying and the creditworthiness of the put option writer had been completely discredited. Clearly the value of the underlying was zero, as has been brought out by the RBI's Inspection Reports. At the same time, the creditworthiness of the put option writer was not properly assessed. On any reasonable assessment, the creditworthiness of the put option writer should have been taken only at default level, given the past track record. The elaborate scheme of credit enhancement for the put option that had been worked out was effectively based upon the monetization of ILFS Group assets themselves. Overall, while the full provision for the TTSL shares was correct and, in fact, overdue by three years, the full valuation of the put option at over Rs.180 crores was completely unsupported by any evidence whatsoever. Clearly, this has been taken purely to offset the loss arising out of providing for the TTSL shares. What has been practiced is, therefore, clearly fraudulent accounting.

**2.6.9 NFRA has come to the conclusion that:**

- (a) The **Audit Firm** had failed in not insisting on fully providing for the value of TTSL shares even in the earlier years;
- (b) The **Audit Firm** did not obtain sufficient appropriate audit evidence to support the value of the derivative assets (put option) included in the balance sheet as of 31.03.2018;
- (c) The **Audit Firm** did not show the due diligence necessary to obtain and critically evaluate such evidence as was provided to it by the management;
- (d) Accounting treatment that is clearly inapplicable, had been used to justify the treatment given;
- (e) The RBI Directions relating to restructuring were flouted; the **Audit Firm** did not raise this issue, nor did it take up the matter of non-disclosure of such restructured account in the financial statements;

- (f) In order to offset the impact of provisioning that was long overdue, the **Audit Firm** went along with the management in including a derivative asset of zero value in the balance sheet at Rs.184.31 crores and taking credit for the same in the profit and loss account. This resulted in a very material misstatement in the financial statements.

**2.7 RBI Inspection Matters : NOF – CRAR**

**2.7.1 With regard to the above matter, the NFRA had communicated the following prima facie observations/comments/conclusions in its letter dated 28<sup>th</sup> June, 2019:**

- (a) The minutes/decisions of the Board of Directors taken in 2007 was not available in the **Audit File**.
- (b) The ET (ET) had not evaluated the management’s stand based on the applicable law, or the Regulator’s directions. The ET has not displayed the professional skepticism required by the SAs.
- (c) The ET had accepted the management’s internal documentation of matters discussed in RBI office without asking for or obtaining any confirmation from the RBI about the same.
- (d) The ET had failed to take note of the definition of “companies in the same group” as mentioned by the Regulator in its inspection report. This definition is what is given according to Para II of the explanation to Section 45 IA of the RBI Act, 1934. The ET had unquestioningly accepted the management’s position on this matter that there was no clarity in the definition of “companies in the same group” in the Act and that there were multiple interpretations possible.

**2.7.2 The response of the Audit Firm to these points was as follows:**

- (a) The RBI had not raised any concern about the calculations up to 2016 though the company had been following the same definitions since 2007.

- (b) There was no “accounting” aspect involved in the matter. The criteria for “companies in the same group” was a matter of interpretation of law covered under SA 250.
- (c) In accordance with the requirements of SA 250, we have obtained an understanding of the matter, discussed the same with the management and obtained a signed letter of representation (WP 30201A) and communicated the same to the Audit Committee as part of their year-end presentation on the audit of financial statements.
- (d) In the absence of specific information from the RBI officials for the minutes of the discussions that the management of the company had with those officials, the minutes partake the character of written representations. Para 2 of SA 580 says that written representations are audit evidence, similar to responses to enquiries.
- (e) The Companies Act, 1956 does not define “companies in the same group”.
- (f) RBI had introduced new definitions for “companies in the group” in November, 2014. The company had approached RBI vide its letter dated 31<sup>st</sup> March, 2015 for clarification on the applicability on this definition (Annexure 4.9A). The RBI had clarified the same vide its letter dated May 5, 2015 (Annexure 4.9B) saying that the definition was only for the purpose of applicability of Prudential Norms on multiple NBFCs in a group and will not apply to concentration of credit/investment norms.

**2.7.3 The NFRA had closely gone through all the points made by the Audit Firm and its conclusions in the DAQRR were as follows:**

- (a) As to the value of the minutes of discussions with the officers of the RBI relating to the disclosure to be made under the accounts, and the extent to which credibility can be given to such a “written representation”, the detailed conclusions of the Authority had been provided separately elsewhere in the **DAQRR**.
- (b) As far as Annexures 4.9A and 4.9B submitted in response to the prima facie conclusions were concerned, these documents could not be accepted

as evidence of due performance of audit procedures by the **Audit Firm** since they do not form part of the **Audit File**. There is nothing in the **Audit File**, or in the submissions made by the **Audit Firm**, to corroborate the claim made that these documents had been taken into consideration in the audit process. Even if these two documents were taken into consideration, without in anyway conceding any status to them as admissible audit evidence, it is clear that were of absolutely no value whatsoever for the following reasons:

- (i) The notification bearing reference DNBR.009/CGM(CDS)2015 dated March 27, 2015, that has been referred to in the company's letter dated March 31, 2015, was superseded by Master Directions DNBR.PD.008/03.10.119/2016-17 dated 1<sup>st</sup> September, 2016.
  - (ii) The reply from the RBI dated 5<sup>th</sup> May, 2015, has no bearing on the definition of calculation of Net Owned Funds (NOF).
  - (iii) As has been pointed out by NFRA even initially, NOF has been defined by RBI Act, 1934. There was no warrant, therefore, for trying to look for definitions of NOF in other documents.
- (c) The contention of the **Audit Firm** that “companies in the same group” has not been defined by the Companies Act, 1956, is clearly incorrect. The **Audit Firm** has referred to Section 370(1B) of the Companies Act, 1956 which defines “companies under the same management”. However, the **Audit Firm** has ignored the definition of “companies under the same group” as provided in Section 372(11) of the Companies Act, 1956.
- (d) For reasons explained at length under the NFRA prima facie conclusions dated 28<sup>th</sup> June, 2019, the stand taken by the company about the continuing applicability of the relevant provisions of the Companies Act, 1956, was clearly wrong under law.
- (e) Given the above situation it was clear that the **Audit Firm** had failed to comply with the SA 250 relating to Consideration of Laws and Regulations.

- (f) As already explained in the prima facie conclusions, this was also not a situation that came within the scope of SA 705 relating to Emphasis of Matter since the matter was NOT appropriately presented or disclosed in the financial statements.

**2.7.4 The Audit Firm has made following points on the various observations made by NFRA in the DAQRR:**

- (a) The **Audit Firm** had submitted Annexure 4.9A & 4.9B, i.e. letter to RBI and the RBI's reply thereto, only to highlight the fact that there were interpretive issues in the definition of the term "companies in the same group", which the ET, based on their past experience with the Company was fully aware of. Further, the RBI response dated 5 May 2015, was in respect of the definition of the 'companies in the group' for purpose of determining credit concentration norms and applicability of prudential norms for such parties.
- (b) The contents of the DNBR.009/ CGM (CDS) 2015 dated 27 March 2015 have been embedded into the Master Directions DNBR.PD.008/03.10.119/2016-17 dated 1 September 2016.
- (c) The interpretive issue with regard to the definition of 'companies in the same group' is one of the important considerations in the determination of NOF. The RBI Act, 1934, does not define this terminology but takes recourse to the Companies Act, 1956, with respect to this terminology. Section 45-IA (7) of the RBI Act, 1934, provides that the term "Companies in the same group" shall have the same meaning assigned to them in the Companies Act, 1956. The Companies Act, 1956 does not define "companies in the same group".

The following sections of the 1956 Act refers to similar terms:

- (i) Section 370(1B) defined "companies in the same management" which was made inoperative vide Companies Amendment Act, 1999;
- (ii) Section 211 refers to Accounting Standard 21, which defines–

“Group” as a parent and its subsidiaries;

- (iii) Section 108H refers to the definition assigned under Monopolies and Restrictive Trade Practices Act, 1969, (which was replaced by Competition Act, 2002) for “group”.

So, the aforesaid makes it apparent and further supports the contention that the term ‘companies in the same group’ has not been defined.

- (d) Along with applicable sections of the law, even the regulator’s view was also considered during the audit period. The framework applicable for the entity had not undergone any change in this regard. Hence, “the **Audit Firm** has ignored the definition of ‘companies under the same group’ in Section 372(11) of the Companies Act, 1956”, is without any merit and is denied by the **Audit Firm**.
- (e) The RBI wanted to change the interpretation of the definition ‘companies in the same group’ from the extant interpretation followed by the Company to the definition under section 370(1B) of the Companies Act, 1956.
- (f) The **Audit Firm** has provided SA 250 checklist issued by the ICAI duly referenced to the audit work papers to demonstrate compliance with the requirements of SA 250.
- (g) The matter of NOF / CRAR did not impact the amounts recognised in the Balance Sheet, Statement of Profit and Loss and the Cash Flow Statement or result in any misstatements thereto. Further, the issue of NOF / CRAR was described in the notes to financial statements and was also referred to as an “Emphasis of Matter” in the joint audit report for the year ended 31 March 2018 in accordance with SA 706.

**2.7.5 NFRA has examined the above contentions of Audit Firm and has concluded as follows:**

- (a) In the initial observations sent by NFRA, it was pointed out that the **Audit Firm** had failed to take note of the definition of “companies in the same

group” as mentioned by the regulator i.e. RBI, in its inspection report. In response, the **Audit Firm** brought in Annexure 4.9 A and 4.9 B as evidence. Now, the **Audit Firm** accepts that these Annexures were neither audit evidence nor relevant (as these definitions were for the purpose of determining credit concentration norms and prudential norms). This shows that the sole purpose of the explanation provided by the **Audit Firm** earlier was to mislead NFRA and divert attention from the issue at hand.

- (b) The **Audit Firm** has further argued that the contents of Notification DNBR.009/ CGM (CDS) dated 27 March 2015 have been embedded into the Master Directions DNBR.PD.008/03.10.119/2016-17 dated September 1, 2016. This is despite the fact that the Master Directions dated 1 September 2016 clearly states that it has been issued in supersession of the Notification DNBR.009/ CGM (CDS) dated March 27, 2015. The RBI Master Direction 2016, in direction 3(vi) gives a clear definition of “companies in the same group” which is consistent with the legal position as well as the consistent stand taken by RBI. This clearly shows that the **Audit Firm** wanted to hide the fact that they had not performed sufficient enquiries in respect of matters highlighted in the RBI inspection report.
- (c) The contention of the **Audit Firm** that “companies in the same group” have not been defined by the Companies Act, 1956, is clearly incorrect. Explanation to Section 45-IA (7) of the RBI Act, 1934, provides that the term shall have the same meaning **as assigned** to them in the Companies Act, 1956. Sections 370 and 372 of Companies Act, 1956, clearly define the said term. These sections were made in-operative by the Companies (Amendment) Act, 1999. But, they were neither repealed from the Act nor were the references to those sections in other parts of Companies Act, 1956, or RBI Act, 1934, deleted. Further, section 465 (2) (c) of the Companies Act, 2013, lays down that any rule of law, inter alia, shall not be affected by the repeal of the Companies Act, 1956, notwithstanding that such rule of law had been derived from the repealed enactment.

- (d) The argument that the definition of “companies in the same group” is an interpretive issue is completely misleading. The auditor has failed in exercising due diligence and professional skepticism while examining the management argument. The legal position as brought out by the RBI Act and the Companies Act has been examined clearly by the NFRA in its prima facie conclusions and in the **DAQRR**. As far as the regulator is concerned, RBI has time and again clarified the matter of “companies in the same group” which has significant implications for NOF and CRAR and, consequently, for the presentation of Audited Financial Statements. The RBI in its Inspection Report of 2015 dated May 6, 2016, has clearly stipulated how the “companies under the same management” should be considered and assessed NOF as negative. The RBI report has stated that due to this the CRAR was also negative and the company has not maintained adequate capital. Despite the presentation given by the company, RBI in its report dated September 14, 2016, has again reiterated its stand and has assessed NOF and CRAR as negative. Further, RBI in its email dated March 27, 2017 has clearly stated that the compliance submitted by the company “**pertaining to major issues like group exposure, ... etc. are not accepted**”. This clearly shows that RBI had taken a final view even in March 2017 and not only in November 2017 as argued by the **Audit Firm**. In fact, the inspection report issued by RBI in November 2017 was pertaining to Financial Year 2016 and had used the same definition as used earlier for the 2015 report.

The contention of the **Audit Firm** that there is nothing new in the RBI email dated March 27, 2017, is also wrong because RBI has clearly stated that they had not accepted the various arguments given by the company in its letter dated November 30, 2016. In fact, in its letter of May 16, 2017 addressed to RBI Deputy Governor, the company had stated that the increase in exposure to group companies was due to factors beyond the company’s control. Thus, the management had already accepted the definition given by RBI. It may be noted that the entire communication as mentioned above has been taken from Working Paper No.29205.02 of the Audit File. Even though all this evidence is available in the Audit File, the **Audit Firm** had not challenged the final view taken by Management that

the definition of “companies in the same group” is an interpretive issue. This clearly shows that the **Audit Firm** had unquestioningly accepted the management’s position on this matter without considering the clear stand taken by the Regulator.

- (e) As far as the RBI was concerned, it was never a change in the interpretation of the definition of ‘companies in the same group’.
- (f) The **Audit Firm** has stated that they have performed procedures in accordance with applicable Auditing Standards SA 250. The **Audit Firm** has also provided SA250 check list issued by the ICAI duly referenced to the audit work papers. The **Audit Firm** has given a 11-page Annexure [Annexure 2.8.3.(e)] and reference of 14 Working Papers to show that they have complied with SA 250. NFRA has examined all the working papers. However, none of the papers challenge the Management stand regarding NOF/CRAR or the alleged interpretive issue of “companies in the same group”. There is no independent analysis carried out by the **Audit Firm** regarding the issues raised by RBI or the legal position in this regard. The **Audit Firm** has thus misled NFRA by providing a list of voluminous Working Papers to cover up its failure to comply with the SA 250.
- (g) The issue regarding impact of NOF / CRAR on the amounts recognised in the Balance Sheet, Statement of Profit and Loss and the Cash Flow Statement and “Emphasis of Matter” Para has already been covered above in NFRA’s observation regarding ROMM.
- (h) The **Audit Firm** should have understood that a letter written by the auditee company to the regulator on a final Inspection Report does not convert matters that have reached finality into ones still under discussion. Furthermore, supervisory concerns that are repeated in the Inspection Report for every succeeding year do not make it an ongoing correspondence or matter under discussion either. RBI/DNBR/2016-17/45 Master Direction DNBR.PD.008/03.10.119/2016-17 dated 01 September 2016; Chapter – XV; Interpretations, provides as follows: “122. *For the purpose of giving effect to the provisions of these Directions, the Bank may, if it considers necessary, issue necessary clarifications in respect of*

*any matter covered herein and the interpretation of any provision of these Directions given by the Bank shall be final and binding on all the parties concerned*” (emphasis added). The cavalier attitude of the auditee company was such that the RBI had to specifically point out in its letter dated 04 December 2017 that “We would like to emphasise that regulatory/supervisory directions are required to be acted upon promptly by the regulated entities and not to be subjected to review by them. You may also note that the instructions contained in our above letter were issued after a process of due approval by the Bank and the timelines stipulated in our letter needed to be strictly adhered to.” This stand of the RBI should have informed the decisions of the **Audit Firm**.

- (i) Thus, the **Audit Firm** ignored the overwhelmingly clear legal position as brought out by Companies Act 1956, Companies Act 2013, RBI Act 1934, RBI Master Directions 2016 and RBI Inspection Reports and chose to accept the stand taken by the management without questioning it even once. The **Audit Firm** did not evaluate the management response or the applicable law or the regulatory directions. The **Audit Firm** failed to exercise due diligence and professional skepticism, as required by the SAs.

## 2.8 Management’s Written Representations relating to RBI Inspections

### 2.8.1 In its prima facie conclusions dated 28<sup>th</sup> June, 2019, the NFRA has stated that:

There is no sufficient evidence available in the **Audit File** to show that the **Audit Firm** has complied with the requirements of Para 9 of SA 500 in the case of the matter of RBI’s approval for the disclosure to be made in the accounts.

### 2.8.2 The Audit Firm had stated as follows in response:

- (a) The absence of specific confirmation from the RBI officials for the minutes of the discussions with them that have been prepared by the company do not negate the validity of such minutes since the minutes partake the character of a written representation.

- (b) During the course of the audit, we did not come across any information that should have caused us to have any concerns about the competence, integrity, ethical values or diligence of the management, or about its commitment to enforce all these.
- (c) The Audit Committee had considered the management's update on their meeting with RBI officials. As such we were entitled to rely upon the representations provided to us.

**2.8.3 NFRA had considered the above responses in detail and its conclusions were as follows in the DAQRR:**

- (a) Admittedly, the issue relating to calculation of NOF and CRAR was a very serious issue about which there had been protracted correspondence between the management and the RBI. Admittedly also, the RBI had not changed its stand on the matter, or in any way accepted the company's position notwithstanding the company's efforts over a long period of time. This background and context should have informed the **Audit Firm's** evaluation of any evidence, including management representations, that had been provided to it.
- (b) The **Audit Firm** has quoted Para 15 of SA 580 and has said that ET did not come across any information that should have caused it to have any concern about management competence, integrity etc. However, at the same time, they have failed to take note of other requirements of SA 580 as follows:
  - (i) Although written representations provide necessary audit evidence, **they do not provide sufficient appropriate audit evidence on their own about any of the matters** with which they deal. Furthermore, the fact that the management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions (Para 3).

- (ii) In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter (Para 16).
  - (iii) The Auditor shall disclaim an opinion on the financial statements in accordance with SA 705, if there is sufficient doubt that the written representations are not reliable (Para 19).
- (c) Clearly, the requirements of SA 580 needed the Auditor to obtain corroborating evidence for the matters covered by the written representation before accepting the same. Clearly, the claims of the management about the outcomes of the meetings that they had with RBI were completely inconsistent with the stand of the RBI that had been in evidence throughout the period when this matter was under discussion. In other words, the written representation forwarding the unacknowledged minutes of the meetings with the RBI officers was inconsistent with this overwhelming past evidence, and the Auditor was duty bound in terms of Para 3 and Para 16 of SA 580 to perform other audit procedures to attempt to resolve the matter. And in the event of being unable to resolve the matter, a disclaimer of opinion needed to have been made in line with Para 19 of SA 580.

2.8.4 The **Audit Firm** has said that the Audit Committee had considered the management update on their meetings with RBI officials and as such, the **Audit Firm** was entitled to rely on the information provided to them. It was seen that the said Audit Committee meeting was held on 28.05.2018, the date on which the financial statements were approved by the Audit Committee and the Board and also communicated to the Stock Exchange (after having duly notified the Stock Exchange in advance about the date and agenda of such meetings). Clearly, no significance could be attached to the supposed “ratification” by the Audit Committee of the management update as at that stage.

2.8.5 **The Audit Firm has made the following points on the various observations made by NFRA in the DAQRR:**

- (a) The RBI had issued its inspection reports and had advised the Company to adopt a new definition of 'companies in the same group' and the Company's subsequent correspondences with the RBI were all provided to us in the normal course of our audits. During the audits, the **Audit Firm** had not come across any instance where information or clarification was not forthcoming.
- (b) Given the profile of the Independent Directors in the Audit Committee and Board of the Company (including shareholder nominated directors who represented reputable shareholders' interests), the **Audit Firm** had no reasons to doubt their integrity, ethical values, competence, or diligence and commitment of management.
- (c) The corroborating evidence that was considered by the ET was the timeline of 31 March 2019 provided by RBI. It needs to be noted that the timeline was provided by the RBI in the context of complying with the minimum regulatory requirements of NOF / CRAR by 31 March 2019.
- (d) If the audit committee had any reservations, it would not have recommended the financial statements for approval of the Board of Directors. There was adequate time available as per the statutory deadline for the accounts to be approved on that date.

**2.8.6 NFRA has examined the above contentions of Audit Firm and has concluded as follows:**

- (a) With regard to the **Audit Firm**'s contention that RBI had advised the Company to adopt a new definition of 'companies in the same group', RBI had never stated that they wanted to change the interpretation of the definition 'companies in the same group' to the definition based on 370(1B) of the Companies Act, 1956 from the interpretation that had been followed by the Company upto that time. In all its correspondence, RBI had noted the divergence in computation of NOF and CRAR and had provided a corrected computation with negative NOF and CRAR.
- (b) Audit Committees of listed companies are directly responsible for the appointment, compensation, and oversight of the auditors. In order to

protect and preserve the shareholders interests, the Audit Committee oversees the nature and scope of work of the external auditors, evaluates their effectiveness, and recommends the proper audit fees. Thus, it is the duty of the external auditor to provide appropriate support to the Audit Committee in the discharge of its functions. The argument given by the **Audit Firm** regarding the profile of the independent directors in the Audit Committee, and hence its reliance on the Audit Committee, goes against the basic duty of the external auditor vis-a-vis the Audit Committee. The **Audit Firm** was supposed to raise the issues highlighted by RBI with the Audit Committee instead of misleading the Audit Committee. However, as seen in the presentation made to the Audit Committee on 28<sup>th</sup> May 2018, the **Audit Firm** had completely supported the stand taken by the management without conducting any independent enquiry. This is despite the fact that the evidence provided by the statutory position, as well as the regulator's observations, were completely inconsistent with the management representations. This is also a clear violation of Para 16 and Para A 23 of SA580.

- (c) As brought out in the Para related to NOF/CRAR above, the legal position as brought out by the Companies Act, 1956, RBI Act, 1934, RBI Master Directions, 2016, and RBI inspection reports, was that the Auditee was in clear violation of requirement with respect to NOF/CRAR. The requirements of SA 580 needed the **Audit Firm** to obtain corroborating evidence for the matters covered by the written representations of management. The claim of the management was that there is no violation of any RBI directions or Regulations. On the other hand, RBI had originally given time up to March 31<sup>st</sup>, 2017 (vide letter dated September 14<sup>th</sup>, 2016) which was further extended up to March 31<sup>st</sup>, 2019 to achieve the minimum regulatory requirement for CRAR and NOF. Thus, the claim of the management was completely contrary to the directions and the timeline given by RBI. However, surprisingly, the **Audit Firm** has considered the timeline given by RBI (to comply with the legal position) as the corroborating evidence for the diametrically opposite view of the management that the Auditee was in compliance with RBI directions.

- (d) The question here is not about availability of time for the approval of accounts by the Audit Committee as claimed by the **Audit Firm**. The question is that whether the **Audit Firm** has done enough independent verification with regard to management's submission on the serious issue of calculation of NOF and CRAR. In fact, the **Audit Firm** instead of exercising due diligence and professional skepticism, misled the Audit Committee by completely supporting the management stand without conducting any independent enquiry. The **Audit Firm** was in such hurry that in one single day it ensured communication with TCWG, review by EQCR, presentation of Audited Financial Statements to Audit Committee and Board of Directors, and the final signatures on the audit report, with complete disregard to SA 260 (Revised) and SQC 1.

**2.9 Evaluation of the Going Concern Assumption:**

**2.9.1 In its prima facie conclusions dated 28<sup>th</sup> June, 2019, NFRA had stated as follows:**

- (a) The **Audit Firm** had not made the relevant enquiries of the management as required by Para 10 of SA 570 (Revised).
- (b) The **Audit Firm** had failed to capture the significance of the RBI Inspection Report and the non-compliance with the minimum NOF and CRAR requirements to continue the NBFC business and, in doing so, Paras 16 onwards of SA 570 (Revised) had not been complied with.
- (c) The **Audit Firm** had admitted that the company had not made any assessment of the going concern assumptions. Also that the company had not forecast any future cash flows nor was any future action plan drafted. However, the **Audit Firm** had concluded that considering the Indian bullish market and past trend of the performance of the company, it was of the view that the going concern assumption was appropriate. This audit procedure and conclusion was in gross violation of SA 570 (Revised).
- (d) The assertion by the **Audit Firm** that they had discussed with the management and understood the plans they had proposed to comply with

the RBI requirements by 31<sup>st</sup> March, 2019, was false since no such plans were available in the Audit File.

2.9.2 In its response dated 3<sup>rd</sup> August, 2019, the Audit Firm had stated as follows:

- (a) We obtained sufficient appropriate evidence to conclude:
  - (i) on the appropriateness of management's use of the going concern basis of accounting in the preparation of financial statements; and
  - (ii) that no material uncertainty existed about the entity's ability to continue as a going concern.
- (b) As per Para A9 of SA 570 (Revised) it is not the auditor's responsibility to rectify the lack of analysis by management. When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis.
- (c) The auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude about the going concern assumption.
- (d) **“The independent directors of the Company, by all accounts, were knowledgeable of finance and accounting, whom we had the right to rely on, and did so, and if they had any doubt about the ability of the Company to continue as a going concern, they would have alerted us of the matter as they in any case had the responsibility under the Companies Act to make the assertion about the going concern assumption”** (emphasis added) (repeated verbatim thrice at pages 21, 23, and 26 of the Para 11 response).
- (e) During our discussions with the directors, management and review of relevant board minutes, etc., we were not made aware of any doubt which would call into question the financial viability of the parent or any of its subsidiaries through the date of the audit opinion.

- (f) The RBI had not issued any letter for cancelling the company's Certificate of Registration. The RBI had also not issued any communication that the Company's Registration would be cancelled if the March 31, 2019 deadline was not met. Besides, our enquiries with the management indicated, inter alia, that several methodologies for remediation of the exposure due to loans to "companies in the same group" were being considered. Also that the plans for compliance proposed by the management were also approved by the Audit Committee of the company. Some details about such plans have been given in the response pertaining to Para 11 at pages 51 and 52.
- (g) The plan, referred to above, was placed before the Audit Committee and the Board of Directors on May 28, 2018. The Company had sought time until June 30, 2018, to submit the same to RBI since the company wanted to submit a more detailed plan to the RBI. This cannot be construed to imply that the plan did not exist on May 28, 2018, when the Minutes of the Audit Committee and the Board on May 28, 2018, clearly state the consideration and approval of the plan by these parties. We strongly deny the unfounded allegation that this is a false statement made by us.

**2.9.3 NFRA had considered the response of the Audit Firm and had concluded as follows in the DAQRR:**

- (a) The **Audit Firm** had not provided any evidence whatsoever to contradict their own admission that company had not made any assessment of the company's ability to continue as a going concern and that the company had not forecast any future cash flows nor was any future action plan drafted. However, attempting to draw support from Para A9 of SA 570 (Revised), the **Audit Firm** asserted that it is not the auditor's responsibility to rectify the lack of analysis by management. They also quoted the same paragraph to say that the auditor's evaluation of the appropriateness of the management's assessment may be made without performing detailed evaluation procedures if the auditor's other procedures are sufficient to enable the auditor to conclude about the management's use of the going concern assumption.

- (b) The above stated argument of the **Audit Firm** is not only violative of the spirit but also the very letter of SA 570 (Revised). As clearly provided by Para 10 (b) of SA 570 (Revised), the auditor was duty bound to discuss with the management the basis for the intended use of the going concern assumption in a situation where the management had itself not performed such an assessment, as was the admitted situation in this case.
- (c) Para 10 (b) of SA 570 (Revised) is under the Requirement portion of the SA. As is the convention relating to the Requirements portion, all such Requirements are made **Unconditional and Mandatory** by the use of the word “shall”. Given the situation described in the paragraph, the **Audit Firm** did not have any discretion in the matter. The discussion with the management and enquiry with them that the SA required, had to be complied with and the same had to be documented as per the requirements of the SA relating to documentation. By their own admission, the **Audit Firm** had not conducted any such discussions and enquiry, neither is any proof of such discussion and enquiry available in the Audit File.
- (d) The attempt to draw support for what the **Audit Firm** has done from Para A8 of SA 570 (Revised) (the Para stands renumbered as A9 in the Revised SA 570 (Revised) only) is itself a gross distortion of what is contemplated and permitted by that paragraph. The context referred to is only a situation where management has not made any **detailed analysis**. It does not cover a situation as this where, admittedly, no analysis at all was available.
- (e) The contention of the **Audit Firm** that the Independent Directors of the company were, by all accounts, knowledgeable in financial and accounting matters, and that the **Audit Firm** had the right to rely on them and that it was, in any case, their (Independent Directors) responsibility to alert the auditors in case they had any doubt about the going concern assumptions is clearly evidence of the **Audit Firm**'s gross dereliction of duty. Taken to its logical conclusion, this argument can be used to support a complete abdication of its prescribed duties by the **Audit Firm**.

2.9.4 As far as action plan for compliance with the RBI guidelines on NOF is concerned, the **Audit Firm** had initially informed the NFRA that they had

discussed with the management and understood the plans they (the Management) had proposed to comply with the RBI Requirements by March 31<sup>st</sup>, 2019. Since no such plan is available in the Audit File, this claim of the **Audit Firm** was dismissed by NFRA as being false. The **Audit Firm** has replied saying that the said plan was placed before the Audit Committee and approved by them and thereafter placed before the Board on 28<sup>th</sup> May, 2018. However, since the Board wanted to submit a more detailed plan to the RBI, they had sought time till 30<sup>th</sup> June, 2018. The **Audit Firm** contends that this cannot be construed to imply that the plan did not exist on 28<sup>th</sup> May, 2018.

In this connection, it was being clarified (though a plain reading of NFRA's earlier contention should not have required any clarification at all) that it was never contended by NFRA that a plan did not exist on 28<sup>th</sup> May, 2018. This issue had not come up for NFRA's consideration at all. What was instead asserted by NFRA was that no such plan was found in the Audit File and therefore could not have been discussed with the management on the grounds that any discussion about such a plan between the **Audit Firm** and the management would also have had to be documented appropriately in the Audit File and the **Audit Firm's** conclusion thereon also duly recorded. Since no such evidence was available in the Audit File, NFRA had concluded that the **Audit Firm's** claim that they had discussed the plans with the management and understood the same, was patently false. Some details of the alleged plan have been placed at pages 51 and 52 in response to Para 11 and repeated again at pages 68 to 69 of the same response. Both these references and details have to be considered only as an afterthought and a subsequent creation of audit evidence since there is no substance of these matters in the Audit File. The NFRA, therefore, concluded that it was reinforced in its conclusion that the statement about discussions with the management on the compliance plan was false.

2.9.5 On a consideration of all the above, NFRA concluded that the **Audit Firm** had completely failed to obtain sufficient, appropriate audit evidence to assess the management's use of the going concern assumption.

2.9.6 **The Audit Firm has made following points on the various observations made by NFRA in the DAQRR:**

- (a) There seems to be confusion between “Management making an assessment” and “discussing with Management”. The **Audit Firm** has not stated that they did not carry out discussions/inquiries with the Management.
- (b) The Working paper 11102 was compiled based on discussions with the CFO and comprised an understanding of factors like Insufficient working capital, Requirement for new capital, Substantial debt from unusual sources or on unusual terms, Violations, or apparent violations, of debt restrictions, Violations, or apparent violations, of capital structure regulations, Inability to make debt payments as scheduled or to pay other creditors, Projections of significant cash-flow difficulties, Loss or possible loss of a major customer or group of customers, Existence of off-balance-sheet financing or contingent liabilities, etc.
- (c) The earlier response was provided only in the context of a formal analysis not being carried out by the Management for assessing the going concern assumption and which was considered not required in view of the *prima facie* positive evidences available within the financial statements to support the going concern assumption. Various factors like cash profits after taxes for the years ended 31<sup>st</sup> March 2018 and 31<sup>st</sup> March 2017, positive cash flows from operations, provisions for NPAs and standard assets as per RBI norms, positive net worth, undrawn facilities with banks aggregating Rs. 8,279.95 million as at 31 March 2018, no default in payments, excess of long-term funds over long-term assets, etc. were considered to determine that no events or conditions existed as on that date that could cause significant doubt about the Company’s ability to continue as a going concern.
- (d) The **Audit Firm** has not violated the letter or the spirit of SA 570. The Firm has complied with the requirements of the applicable Standards on Auditing including Para 10 (b) of SA 570 and Para A8 of SA 570 (the Para stands renumbered as A9 in the SA 570 (Revised) only). (Page 295 of *ibid*)

- (e) It will be incorrect to state that the Management did not perform any analysis of cash flows and going concern, when considering the regulatory disclosure requirements in the form of “Asset Liability Management Maturity pattern of certain items of Assets and Liabilities”, which was disclosed in the financial statements by the Management.
- (f) The Directors Responsibility Statement also clearly makes the assertions that the directors had prepared the annual accounts on a going concern basis.
- (g) The **Audit Firm** has reiterated that they had discussed with the Management on the going concern assumption and based on the evidences available on the date of audit report, no events or conditions existed that to their knowledge cast a significant doubt on the ability of the Company to continue as a going concern. Further, the fact that the Independent Directors of the Company were, by all accounts knowledgeable in financial and accounting matters, was an additional ground and the **Audit Firm** had the right to rely on them and that it was, in any case, their (Independent Directors) responsibility to alert the Auditors in case they had any doubt about the going concern assumptions.

2.9.7 Based on the factors mentioned in paragraph A3 of SA 570 (Revised) and the sufficient appropriate evidence obtained, the **Audit Firm** concluded that Management’s use of the going concern basis of accounting in the preparation of the financial statements was appropriate and that no material uncertainty existed about the entity’s ability to continue as a going concern. However, further evidence of discharging professional responsibilities in this regard was the inclusion of the “Emphasis of Matter” paragraph in the audit opinion referring to the matter relating to companies in the same group as per RBI directions.

**2.9.8 NFRA has examined the above contentions of Audit Firm and has concluded as follows:**

- (a) The **Audit Firm** has not attempted to rebut, and has, therefore, admitted the correctness of, the conclusion of the NFRA that there was no Management assessment of the entity’s ability to continue as a going

concern as required by SA 570 (Revised). Para 12 requires that the auditor shall evaluate Management's assessment of the entity's ability to continue as a going concern. Para A8 further adds that Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of Management's use of the going concern basis of accounting. As clearly provided by Para 10 (b) of SA 570 (Revised), the auditor was duty bound to discuss with the Management **the basis for the intended use of the going concern assumption** in a situation where the Management had itself not performed such an assessment. Even though the **Audit Firm** claims to have had a checklist based discussion with the Management on the entity's ability to continue as a going concern, the assessment is found to be completely insufficient.

- (b) Further, Para 16 (a) of SA 570 (Revised) also provides that when Management has not yet performed an assessment of the entity's ability to continue as a going concern, the **Audit Firm** shall request the Management to make the assessment. No such request has been included in the Audit File.
- (c) As far as Working paper 11102 is concerned, it has twelve items as mentioned in the reply given by the **Audit Firm**. Eleven items out of these have a standard comment that "no such cases have been identified from our review and discussion with Deepak Parekh (CFO)". There is absolutely no further analysis on any of the items and any further comments by the ET or the EQCR. It may further be noted that Para A3 of SA 570 (Revised) gives **examples of 21 events**, in a listing that is described as "non-inclusive", of conditions that, individually or collectively, may cast significant doubt about the going concern as option. The **Audit Firm** has listed only 12 events and given a standard comment of one line for each of them.
- (d) The **Audit Firm** has further mentioned that they have considered various factors like cash profits, positive cash flows, provisions for NPAs, positive net worth, et cetera to determine that no events or conditions existed as on that date that could cause significant doubt about the company's ability to

continue as a going concern. However, none of these points have been analysed in Working paper 11102. There are no other references quoted by the **Audit Firm** where analyses of these factors are available in the audit file. Hence all this justification appears to be an afterthought by the **Audit Firm** with no backing whatsoever in the audit file.

- (e) The evaluation of the going concern assumption as claimed to be done by the **Audit Firm** is found to be completely insufficient as a guide to future liquidity. It is not supported by any future cash flow statement or an analysis of adverse key ratios as required by Para A3 of SA 570 (Revised). The decrease in the Net worth of the company as on 31st March 2018 and the major reduction in the Profit earned during the year, were not given due importance. The **Audit Firm** failed to test the source of the cash generated and the company's ability to meet the immediately arising future liabilities.
- (f) The "Asset Liability Management Maturity pattern of certain items of Assets and Liabilities", which has been disclosed in the financial statements by the Management is not a substitute for future cash flow analysis and is restricted to only certain items of Assets and Liabilities. This disclosure is also in compliance of RBI directions only, and is not a substitute for what the **Audit Firm** needs to do as per SAs. The **Audit Firm** has not provided any evidence to show that they scrutinized or otherwise performed any procedures at all to review the cash flow forecasts for at least a 12-month period from the Balance Sheet date. No working papers or references in the audit file have been provided in this connection. The maturity pattern of certain assets and liabilities as disclosed in the notes to accounts of the Financial Statements has been prepared by the Management only. NFRA could not find any document at all in the Audit File to substantiate any kind of audit procedures performed by the auditor to evaluate the authenticity of any such information.
- (g) The assertion by the **Audit Firm** "that the Independent Directors of the Company were, by all accounts knowledgeable in financial and accounting matters, was an additional ground and the **Audit Firm** had the

right to rely on them” (Page 296 of **Audit Firm**’s response) is also unacceptable and shows a complete abdication of its duty by the **Audit Firm**. The **Audit Firm** has expressed surprise that this one factor has been picked up in isolation and that NFRA has assumed that this is the only justification based on which the assessment was done. NFRA notes that the statement about the duty of independent directors and the **Audit Firm**’s being justified in relying on the due discharge by them of such duty, has been reiterated thrice in their responses. Besides, such a justification is clearly a complete negation of the attitude of professional skepticism that the auditor is expected to maintain. This is a requirement that is all pervasive in the SAs. As explained in SA 200, “A belief that Management and Those Charged With Governance (TCWG) are honest and have integrity, does not relieve the auditors of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance” (Para A22).

- (h) The **Audit Firm** had failed to capture the significance of the RBI’s inspection and report regarding non-compliance of minimum NOF and CRAR requirements to the continuation of IFIN in the NBFC business. The company had repeatedly delayed in submitting a compliance plan as per the RBI directions. The checklist provided under Para A3 of SA 570 (Revised) itself provides that “Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions” is an indicator of the events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern. The **Audit Firm** has completely ignored the fact that the RBI, on several occasions had rejected the requests and submissions made by the company. Thus, the **Audit Firm** has failed significantly to fulfil the requirements under Paras 16 and 23 of the SA 570 (Revised) including obtaining the Management assessment of the going concern assumption and communicating with TCWG.
- (i) The **Audit Firm** had claimed that the Management’s plan for compliance with the NOF/CRAR requirements had been discussed with the

Management. This claim had been found to be unsubstantiated. In response, the **Audit Firm** has been able to only point out to the minutes of the Audit Committee meeting held on 28<sup>th</sup> May 2018. This response only confirms the Draft Report's conclusion that the claim that such a compliance plan had been discussed with the Management is false for not being supported by any documentation. The significance of the compliance plan was enormous because this was the key to the continuation of the NBFC licence. NFRA is, therefore, reinforced in its conclusion that the **Audit Firm** was found totally wanting in complying with the requirements of SA 570 (Revised).

- (j) The **Audit Firm** has stated that as further evidence of discharge of their professional responsibility with regard to the going concern issue, an "Emphasis of Matter" paragraph was included in the audit opinion referring to the matter relating to companies in the same group as per RBI directions. Use of "Emphasis of Matter" paragraph to discharge responsibilities with regard to going concern basis is not supported by SAs. As per Para 6 of SA 706, EOM should be used to draw attention to matters that are fundamental to users' understanding of the financial statements, provided the Auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. This was a case where CRAR and NOF as disclosed were clearly wrongly presented and disclosed. Hence, EOM was not justified in this case. Besides, the EOM Para did not include any reference to the "going concern" issue. NFRA is unable to understand in what manner the **Audit Firm** claim that the EOM Para was used to comment on the validity of the going concern assumption. The **Audit Firm** was required to evaluate management's assessment of the going concern assumption and agree with it or disagree with it. The EOM Para does not do any such thing. No such argument was put forth by the **Audit Firm** at any stage in the protracted process of the **AQR** prior to this claim. There is no evidence adduced from the Audit File to show that the doubts, if any, about the going concern assumption were considered while deciding on the EOM Para. It is, therefore, dishonest and entirely misleading for the **Audit Firm** now to claim that the EOM Para is "further evidence of our discharging

our professional responsibilities” (page 300) with respect to the going concern matter. Such a claim, if anything, only betrays the **Audit Firm**’s own doubts about the validity of the going concern assumption.

- (k) The assertions in the Directors Responsibility Statement do not amount to an assessment by the Management of the going concern assumption, much less an evaluation of such an assessment by the **Audit Firm**.

**2.9.9 Having examined the responses of the Audit Firm, NFRA is reinforced in its conclusion that:**

- (a) The **Audit Firm** has not obtained the Management’s assessment of the applicability of the going concern assumption; consequently, no evaluation of such assessment has been made.
- (b) The **Audit Firm** did not obtain sufficient appropriate audit evidence as required by the SAs, especially SA 570 (Revised), to evaluate the Management’s assessment of this assumption, such as it may have been.
- (c) The evidence discussed above indicates that there were serious doubts about the justification of the case of the Going Concern assumption in the present case. The **Audit Firm** has completely failed in displaying the required professional skepticism and obtaining sufficient appropriate evidence on this matter.
- (d) The **Audit Firm**, therefore, has clearly not complied with SA 570 (Revised).
- (e) The **Audit Firm**’s assertions and response are thus found not sufficient, not appropriate and not conclusive in support of having discharged their obligations to test and evaluate and report on the Going Concern assumption as regards the Company.

**2.10 Documentation of EQCR Processes**

**2.10.1 The prima facie conclusions of the NFRA on the above matter vide its communication dated 28<sup>th</sup> June, 2019, inter alia, were that :**

- (a) The work papers do not identify or document any discussion about significant matters between EQCR team and the EP.
- (b) The EQCR was not carried out in a timely manner at appropriate stages during the engagement.
- (c) The EQCR required an in-depth examination to be made of the issues arising out of the RBI inspection and directions. Documenting the EQCR process in this connection, and the conclusions arrived at, could not be reduced to mere check box “Yes” or “No” responses.
- (d) Modification carried out in the RoMM mentioning the same as both “adverse” and “EOM” is internally inconsistent and self-contradictory.
- (e) The EQCR has not noted the absence of any communication at all between the ET and TCWG.
- (f) A major inconsistency between the time said to have been spent on the EQCR by the partner and the Director compared with the dates of the EQCR indent and the documents said to have been reviewed by them.

**2.10.2 The response of the Audit Firm was as follows:**

- (a) SQC 1 does not specify any documentation requirement related to the performance of EQCR procedures. No mandatory documentation of discussions between the EQCR Team and the ET is prescribed in the SAs. The EQCR Team signing off on the work papers provides compelling evidence of the completion of their objective reviews of the relevant work papers, and proof that this was not done merely relying on oral explanations.
- (b) The reference to “adverse” in WP 30515 is an inadvertent oversight of a clerical and typographic error on one place in the said WP, as against multiple references to the contrary in the same document.
- (c) Para 24 of SA 220 refers to the documentation requirement imposed on the ET. It is only Para 25 of SA 220 that refers to documentation requirements for the EQCR.

**2.10.3 NFRA had examined the above contentions of the Audit Firm and had concluded as follows in the DAQRR:**

- (a) The mandatory requirements of the SAs have to be considered holistically and harmoniously. It is not acceptable to look at any single extract from the SAs that ignores the overall context. It is, therefore, necessary to consider the “Nature and Purpose of Audit Documentation” (Paras 2 and 3 of SA 230) as providing the overall context for audit documentation.
- (b) Furthermore, Paras 8 to 11 of SA 230 dealing with the Form, Content and Extent of Audit Documentation will also have to be considered.
- (c) Going by the above, it can hardly be contended, as **Audit Firm** has sought to do, that mere check box “Yes” or “No” responses are sufficient to “enable an experienced auditor having no previous connection with the audit to understand” the work that has been performed by the EQCR Team.
- (d) Both Paras 24 and 25 of SA 220 lay down what information needs to be documented. The word “document” cannot be interpreted to mean mere ‘yes’ or ‘no’ responses to a set of standard questions prepared as a general all purpose template. The documentation needs to have specific reference to the facts of the case in question and must provide the evidence as required by the SAs, all taken together.
- (e) Therefore, the documentation of the EQCR processes does not provide any evidence of the proper and complete performance of the EQCR work by the EQCR Team.

2.10.4. NFRA, therefore, concluded that the Engagement Quality Control Review was not carried out in the manner stipulated by SQC 1 and other applicable SAs.

**2.10.5 The Audit Firm made following points on the various observations made by NFRA in the DAQRR:**

- (a) The Paras/text given in SA 230 are in the context of “Auditor” and not in the context of “EQCR”. A distinction between Auditor and EQCR is more particularly set out in Para 24 and 25 of SA 220.
- (b) The EQCR has reviewed multiple audit work papers and signed the same as an evidence of review. The same has been documented with the help of a checklist, as required by SA 220.
- (c) As per Para 25 of SA 220, what is required is only an affirmation from the EQCR on the compliance with the statements (Para 25 does not envisage a narrative description as required under the clauses of paragraph 24 for the Auditors).
- (d) The evidence of EQCR involvement throughout the engagement can be noted from the signed work papers (which has been submitted to NFRA in file /under letter dated 3<sup>rd</sup> August, 2019) from the planning stage to the conclusion of the engagement, and the discussions with the ET, ensuring that the firm’s consultation process has been duly followed.
- (e) The EQCR process is a defined process and the policy has been laid down and is governed by the firm’s SQC 1 guidelines. And the same procedures were carried out according to SQC 1 and other SAs (like SA 220).
- (f) The **Audit Firm** has initiated certain refinements to the EQCR process such as requiring the maintenance of minutes of discussions between the EQCR team and the ET. This is likely to apply for the audits from year ending 31<sup>st</sup> March, 2020.

**2.10.6 NFRA has examined the above contentions of the Audit Firm and has concluded as follows:**

- (a) The line of argument taken by the **Audit Firm** is that SA 230 is applicable only to the auditor and not to the EQCR. However, Para 3 of SA 230 clearly states that Audit documentation serves a number of additional purposes including “enabling the conduct of quality control reviews and inspections in accordance with SQC 1”. The footnote to Para 3 gives references to Paragraphs 60, 63 and 65

of SQC 1. Paragraph 60 of SQC 1 relates to policies and procedures regarding EQCR. Para 63 is about the criteria for eligibility of EQCR. Para 65 brings out matter to be included in the EQCR including evaluation of firm's independence, significant risk identified during the engagement, judgements made particularly with respect to materiality and significant risk etc. Hence the argument of the **Audit Firm** that SA 230 is not applicable to EQCR is completely misleading.

Further, the definition of "**Auditor**" as given in SA 200 states that the term is used to refer to the person or persons conducting the audit, usually the EP or other members of the ET or, as applicable, of the firm. Thus, the term 'auditor' includes other persons which are conducting the audit and are members of the firm. EQCR team members also carry out the audit of the client and are members of the firm. The definition gives EP as an example but does not restrict the scope to only to the ET. Further, the definition specifically intends that if a requirement or responsibility is to be fulfilled by the EP, the word "EP" is used. Hence, the SAs use the term "EP" or "EQCR" if it intends that as a requirement. Otherwise, the term "Auditor" is used. Even the **Audit Firm** in its presentation to management on 19<sup>th</sup> January, 2018 (WP 13902) has shown EQCR as Audit Support Team and part of ET.

Further, even if the convoluted logic of the **Audit Firm** that SA 230 is not applicable to EQCR is accepted, the documentation of discussions between the EQCR team and EP is also required from the perspective of the ET.

- (b) Even though the EQCR team has claimed to have reviewed multiple audit work papers, there is not a single paper in the Audit File where the EQCR has carried out independent analysis or review. Para 6 of SQC 1 defines "engagement quality control review" as *a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the ET made and the*

*conclusions they reached in formulating the report.* Thus, the process required objective evaluation and separate working needs to be done for the purpose of evaluation of significant judgments and to verify the results. The same was not done by the reviewer. It has been shown clearly above that SA 230 is applicable to the EQCR. Therefore, EQCR should have documented its working properly and separately from the working of the Audit team. Further, in the last submission given by the **Audit Firm**, they have admitted that EQCR has reviewed multiple audit work papers and signed the same as an evidence of review, which means that the EQCR did not perform any separate working to check the results of the ET.

(c) Para 25 of SA 220, states that EQCR shall:

DOCUMENTATION

25. *The engagement quality control reviewer shall document, for the audit engagement reviewed, that:*

*(a) The procedures required by the firm's policies on engagement quality control review have been performed;*

*(b) The engagement quality control review has been completed on or before the date of the auditor's report; and*

*(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the ET made and the conclusions they reached were not appropriate.*

Thus, Para 25 of the SA requires documentation of the EQCR process and other various requirements. Mere confirmation relating the issues covered by Para 25 is not sufficient.

Further, in this regard, we highlight Para 30 and Para 36 of SQC Policy of the **Audit Firm** given in DAAM-30400, which lays down that:

Para 30

*“The Engagement Quality Control Reviewer shall evaluate the conclusions reached in formulating the audit report and consider whether the proposed report is appropriate”.*

Para 36

#### DOCUMENTATION

*“Documentation of an engagement quality control review shall contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this section”.*

This Para 36 quoted above clearly shows that the **Audit Firm**'s contention that SA 230 does not apply to the EQCR is violative of their own DAAM. Accordingly, the EQCR partner was required to document reasons and the bases for its conclusions and not merely provide check box “Yes or “No” responses. Therefore, the contention of the **Audit Firm** that “Para 25” of SA 220 requires only an affirmation from the EQCR on compliance with the statements is completely invalid.

- (d) The contention of the **Audit Firm** is that the involvement of EQCR can be proved from the signed working papers from the planning stage to the conclusion of the engagement. However, there is absolutely no record of any discussion held by the EQCR with the ET. There is no independent analysis carried out by the EQCR team. In fact, there are many papers which just show the opening and closing balances without any evaluation or analysis by the ET or the EQCR. For example, Working Paper 24340, Provision for General Contingencies, just shows an opening balance of Rs.450 crores and closing balance of Rs.275 crores. The reversal of Rs.175 crores from provision for general contingencies has not been explained in the Working Paper. The EQCR team has neither done any independent Analysis nor questioned the ET on the same. The conclusion is, therefore, inescapable that the profits for the year were inflated by Rs. 175 crores, without any basis or justification.

- (e) Further, the **Audit Firm** has stated that communication with TCWG on all the RBI related matters were carried out through a Presentation to the Audit Committee (W.P. No. 30301) on 28<sup>th</sup> May, 2018. On the same date, the audit was finalised, the accounts were approved by the Audit Committee, as well as the Board of Directors. The EQCR partner reviewed all the documents pertaining to the RBI matters and also reviewed and finalised all the closing documents including the 'EQCR close indent' and the final Auditors Report. However, the total man hours logged by the EQCR team on 28<sup>th</sup> May 2018 is just one hour. It may further be noted that the EP was in the Audit Committee meeting whereas the EQCR team was not part of the Audit Committee meeting. Hence any interaction between the EQCR team and EP was not possible on that day. This clearly shows that the exaggerated claims of **Audit Firm** of involvement of EQCR team is clearly farcical and an attempt to mislead NFRA.
- (f) Thus, the EQCR has failed in appraising the quality of the work performed. The EQCR has also failed miserably in providing an objective evaluation of the significant judgements the ET made and the conclusions they reached in formulating the report. Thus, the **Audit Firm** has failed in complying with various provisions of SQC 1, SA 220 and SA 230.
- (g) As shown above, the **Audit Firm** has completely failed to maintain documents as per SA 230. The EQCR has also failed to document various requirements as required by Para 25 of SA 220. The review of multiple audit work papers and signatures on the same date without any kind of independent analysis and work papers show that the evidence of EQCR involvement is false and has been created subsequently. Hence, even though the refinement in the EQCR process that the **Audit Firm** intends to apply on the audits for the year ending 31st March, 2020 is appreciated, it would appear only to be an acknowledgement of the merit of the issues raised by NFRA.
- (h) Having examined the responses of the **Audit Firm**, NFRA concludes that:
  - (i) The argument of the **Audit Firm** that SA 230 is not applicable to EQCR is completely erroneous;

- (ii) The EQCR has completely failed in documenting its working properly and separately from the work of the Audit team as required by SQC 1 and SA 230;
- (iii) The contention of the **Audit Firm** that “Para 25” of SA 220 requires only an affirmation from the EQCR on compliance with the statements is completely invalid;
- (iv) The exaggerated claims of the **Audit Firm** about involvement of EQCR team is clearly unsupported by evidence and is an attempt to mislead NFRA;
- (v) The **Audit Firm** has failed in complying with various provisions of SQC 1, SA 220 and SA 230;
- (vi) The conclusion, therefore is inescapable that such EQCR as was, if at all, performed, was so perfunctory as to render it a complete sham;
- (vii) NFRA’s comment in other portions of this **AQRR** are substantive evidence of the inadequacy of the EQCR system;
- (viii) The large scale failure of the EQCR process that comes out of the above analysis is also evidence of the inadequacy and ineffectiveness of the QC policies of, and their implementation by, the **Audit Firm**; and
- (ix) The refinement in the EQCR process that the **Audit Firm** intends to apply is an acknowledgement of the merit of the issues raised by NFRA.

## **2.11 SQC 1 Compliance: Policies & Procedures**

**2.11.1 In its communication dated 28<sup>th</sup> June, 2019, NFRA had conveyed its prima facie conclusions as follows:**

- (a) Annexure II as provided by the **Audit Firm** vide their response dated 13 May, 2019, does not comprehensively and adequately cover all the essential requirements stipulated in SQC 1.

- (b) The policies and procedures relating to independence, which are required to be an integral part of the QC Manual, are not present in the Section titled “Independence” in **Annexure II**.
- (c) Details of the written confirmation required to be obtained from the **Audit Firm** personnel were not available and hence it was presumed that no such confirmations were in fact obtained.
- (d) No details were provided about the actions to be taken by the **Audit Firm** to mitigate and eliminate the familiarity threat.
- (e) **Annexure II** does not include any policies and procedures relating to breaches of independence requirements.

2.11.2 **The Audit Firm in its response dated 03<sup>rd</sup> August, 2019, has stated as follows:**

- (a) The firm’s Policies are documented in DPM 3110 within the DTTL Policies Manual (DPM) and the Audit DPM India Supplement (Level III) (DPM India Level 3 policies). The DPM India Level 3 policies, which are India specific, will prevail over the DPM Level 1 and DPM Level 2 policies in case of any conflict.
- (b) The SQC Policies within the DPM Level I and DPM Level 2 policies are compliant with ISQC 1, and the DPM India Level 3 Policies, which are India specific will prevail over the DPM Level 1 and DPM Level 2 policies in case of any conflict. Hence, the DPM Level 1, Level 2 and the DPM India Level 3 read together address the requirements of SQC 1 as issued by the ICAI.
- (c) Further the DPM Level 1, DPM Level 2 and the DPM India Level 3 Policies along with Deloitte Audit Approach Manual (DAAM) also establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of DHS LLP’s SQC.
- (d) The DPM Level 1 and DPM Level 2 Policies and the DAAM are available to all practitioners on the network’s intranet. The DPM India Level 3

Policies are available on the Audit Knowledge Management (AKM) website.

- (e) Changes/updates are communicated to the practitioners through various “alerts”. These are also uploaded on the AKM website.
- (f) Policies and Procedures for independence, including threats to independence, are covered by DPM 1420-Independence. These Policies are communicated to all concerned and are hosted on the Risk and Reputation Office (RRO) web page.
- (g) Learning courses are devised so that all practitioners are provided with sufficient learning to enable them to understand and comply with the independence policies.

2.11.3 As part of **DAQRR**, NFRA closely examined all the documents and information submitted by the **Audit Firm**. The information submitted was provided over 396 pages covering the basic information. Many documents have further references to many other documents. As explained by the **Audit Firm** itself, the basic structure seems to have been obtained from their Global Network Office. This is itself in the form of numerous documents with a large number of inter-references. All this is to be supplemented by the Level 3 India Specific Policies. Besides, a perusal of the documents clearly showed that it was only a portion of the total QC documentation that had been provided and that there are numerous other documents which are all said to be a part of policy documentation. Overall, it was clear that the total QC policy documentation would be considerably in excess of the approximately 500 pages that had been referred to in part 2.5 of the **Audit Firm**'s letter dated 03<sup>rd</sup> August, 2019.

2.11.4 NFRA concludes that the documentation of the Quality Control Policies and Procedures of an **Audit Firm** should be in the form of a **single document that is both comprehensive and concise**, and contains, in a systematic, structured and coherent manner, all the dos and don'ts that need to be adhered to by employees of the **Audit Firm**.

2.11.5 On the contrary, the policy documentation provided by the **Audit Firm**, which is admittedly **only partial since the numerous other documents that have**

**been referred to at various places therein have not been provided**, was clearly unstructured and unsystematic, and put together by the assembling of a wide range of documents. Most of the documents seemed to be from the Global Network Entity and had not been developed with reference to Indian laws, rules and regulations.

2.11.6 Clearly there was a surfeit of information relating to laws and regulations in foreign countries which the majority of the workforce of the **Audit Firm** in India will have no occasion whatsoever to deal with in the course of their employment.

2.11.7 In response to the prima facie conclusions of the NFRA that **the policies and procedures relating to independence, which are required to be an integral part of the QC Manual, are not present in the section titled “Independence” in Annexure II**, the **Audit Firm** has stated that the policies and procedures for independence, including threats to independence, are covered by DPM 1420-Independence. The said document (DPM 1420-Independence), which runs to 150 pages, was carefully gone through. It is seen that this document is based **completely on US laws; it has no reference whatsoever to Indian laws.**

2.11.8 **NFRA therefore concluded that the Audit Firm does not have a policy document as required by SQC 1.** Such documents as were produced to the Authority did not conform, for the reasons already made clear, to the requirements of SQC 1. These documents also have a very substantial part completely unrelated to any operations in India. The sheer volume of the documents, and their substantial irrelevance to Indian conditions, laws and operations, would make it a certainty that the employees of the **Audit Firm** will be left completely without any guidance about what exactly is to be understood as the approved policy in any situation. **The absence of a policy document as required by SQC 1 was identified as a serious non-compliance with the SAs.**

2.11.9 NFRA concluded that the **Audit Firm** should, without any further delay, prepare a comprehensive, concise and systematically structured policy document to conform to SQC 1 and provide the same to the Authority for its perusal at the earliest.

**2.11.10 On this subject, the Audit Firm in their response to the DAQRR has stated as under:**

- (a) SQC 1 does not require the quality control procedures to be in a single document. While Para 3 of SQC 1 states that the “firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements,” Para 107 states that “**how such matters are documented is the firm’s decision.**”
- (b) Not only is it not mandatory for the entire set of SQC 1 policies to be in a single document, it is also not possible to do so.
- (c) Deloitte Policies Manual (“DPM”) Level 1, DPM Level 2 and DPM Level 3 Policies, read in a holistic and harmonious manner, incorporate all the policies as required by SQC 1.
- (d) The SQC policies are comprehensive, detailed and systematic and are easily accessible to the practitioners. The policies articulate the requirements of SQC 1 in a structured manner.
- (e) DPM Level 3 policies are India specific and clearly state that such policies will prevail over DPM Level 1 and DPL Level 2 policies in case of any conflict. They further state that their “approach of applying both Indian and international standards and complying with the requirements of those which are, as between them, more stringent, ensures adequate and full compliance with all Indian requirements and laws on ‘Independence.’”
- (f) Hence they have denied that there is any ‘absence of a policy document as required under SQC 1’ or that there is a need to prepare any new policy document to comply with SQC 1 as has been suggested.

**2.11.11 NFRA has considered the above contentions of the Audit Firm and its conclusion are as follows:**

- (a) NFRA is a body constituted under the Companies Act, 2013, to, inter alia, monitor and enforce compliance with auditing and accounting standards

prescribed under the said Act. All auditors of companies that are registered under the Act will be monitored only with reference to standards in force in India. The supposed equivalence of International Standard to, or their even greater rigour in comparison with, Indian Standards is entirely irrelevant for the purposes of NFRA;

- (b) Both the inadequacies of the QC policies and processes on the one hand, and the non-compliance with such policies as exist on the other, have been clearly brought out in this **AQRR**. Specifically, NFRA wishes to draw attention to the large scale and serious violations of Independence requirements, the clear display of the lack of the required professional skepticism, the lack of insistence on obtaining sufficient appropriate audit evidence, the repeated assertions that there could be more than one EP for an engagement, the evident confusion in assessing the ROMM and its impacts on the Audit responses and evidence obtained, and the sham character of the EQCR, as evidence of the need to revamp the QC policies and processes of the **Audit Firm**;
- (c) The complete breakdown of QC system evident in this case is serious enough to support the suspicion that the **Audit Firm** had aligned itself completely with the interests of the management of the Auditee Company;
- (d) NFRA, therefore, is of the opinion that the **Audit Firm** would be well advised to prepare a comprehensive, concise and systematically structured policy document to conform to SQC 1, and to put in place mechanisms to rigorously enforce it and monitor compliance.

Approved by the Executive Body of NFRA for Issue

(Vivek Narayan)

Secretary, NFRA

# ANNEXURE

## ANNEXURE-I

Engagements non compliant with independence requirements

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
(a)	<p>EL Date: 1-APRIL-2018</p> <p>EL Amount: Rs.15,00,000/-</p> <p>Engagement Servicing Firm: DTTILLP</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per the Engagement Letter ("EL") submitted by the Audit Firm:</p> <p>i. Advice on any issues identified by the client in terms of automation of data flow from ERP systems to consolidation systems.</p> <p>ii. Advice on processes for day to day closing and consolidation activities.</p>	<p>(i) Services are in the nature of:</p> <p>a. Design and implementation of a financial information system,</p> <p>b. Management services.</p> <p>(ii) Services are violative of the Code of Ethics.</p> <p>(iii) Services are prohibited under section 144 of the Companies Act, 2013.</p>	<p>(a) Deloitte's scope will be purely advisory in nature. Deloitte to suggest various available resources for different system issues along with pros and cons for each one.</p> <p>The scope exclusions clearly indicate that design and implementation of any financial information system was specifically excluded from the scope of Deloitte Touche Tohmatsu India LLP.</p>	<p>The conclusions of NFRA in para 2.3.5 (a) are reiterated. The response of the Audit Firm ("DHS") is not acceptable in view of the following:</p> <p>(i) The argument that only advisory services are provided, and no decision making, has no force given the scope of "management services". The services are in the nature of design and implementation of a financial information system and management service. Moreover, any service or advice on processes for day to day closing and consolidation activities, are in nature of accounting and book keeping services, and hence violative</p>

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			<p>(b) Reference has been made to ICAI Code of Ethics 2019.</p> <p>(c) Reference has been made to the US SEC Independence Rules.</p> <p>(d) The Engagement Letter (“EL”) includes a clause that explicitly excludes the performance of any management function/responsibilities.</p> <p>(e) The services were rendered by another member firm in India, of</p>	<p>of Section 144 of the Companies Act. .</p> <p>(ii) ICAI’s Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report. In any case, any provision in the Code cannot violate the Act.</p> <p>(iii) Reference to SEC is not applicable and cannot be relied upon, being completely extraneous material.</p> <p>(iv) The reference to the exclusion clause of the Engagement Letter (“EL”) is not relevant given the definition of "management services" and nature of services provided as part of engagement.</p>

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			<p>the Deloitte network, namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different from the audit engagement team of DHS LLP.</p> <p>(f) However, the scope of services were commenced from 01 April 2018.</p>	<p>(v) In view of the explanation given in Section 144 of the Companies Act, 2013 for "directly or indirectly", which, inter alia, prohibits the provision of any services though any entity whose name or trademark or brand is used by the firm or any of its partners, the contention of the Audit Firm is not tenable and therefore not accepted.</p> <p>(vi) The performance of the said non-audit services clearly coincide with the period of performance of the audit service for IL&amp;FS Financial Services Limited (“IFIN”), since the audit report was signed on 28<sup>th</sup> May 2018. The audit was very much in progress and most of the work had still remained to be done</p>

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				<p>as is apparent from the audit file. The prohibition under Section 144 of the Companies Act, 2013 not only applies to the company audited, but also its holding and subsidiary companies.</p> <p>(vii) The services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>
(b)	<p>EL Date: 16-FEB-2018</p> <p>EL Amount: Rs.1,50,00,000/- (Out of pocket expenses @ 10 to 12% extra)</p> <p>Engagement Servicing Firm: DTTI LLP</p> <p>Client Company: ILFS Financial Services Ltd.</p>	<p>(i) Services are agreed upon and rendered during the course of statutory audit engagement.</p> <p>(ii) Services are in the nature of:</p> <p>a. Investment Advisory Services,</p> <p>b. Management Services.</p> <p>(iii) Services are violative of the Code of Ethics.</p>	<p>(a) The service provided is not investment advisory service as per SEBI (Investment Advisers) Regulations, 2013 (IA Regulations).</p>	<p>The conclusions of NFRA in para 2.3.5 (b) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The SEBI Regulations are framed to carry out the implementation of the SEBI Act, which deals only with the securities markets. It does not deal with</p>

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	<p>Services as per EL submitted by the Audit Firm:</p> <ul style="list-style-type: none"> <li>i. Advisory services relating to growth strategy for IFIN with a focus on new business opportunities.</li> <li>ii. Understanding of goals and aspirations; one line statement articulating the vision of IFIN.</li> <li>iii. Analysis and advice on market landscape document for potential opportunities.</li> <li>iv. Assistance in preparing integrated strategy for prioritised opportunities.</li> <li>v. Assistance in preparing business plan for prioritised opportunities.</li> </ul>	<p>(iv) Services are prohibited under section 144 of the Companies Act, 2013.</p>	<ul style="list-style-type: none"> <li>b) SEC Independence Rules under Regulation S-X (Rule 210.02-01)</li> <li>c) The General Terms and Conditions of the engagement letter</li> </ul>	<p>capital investment decisions made by businesses.</p> <p>(ii) "Investment advisory services" is a term that covers any type of investment decision of a company, and is not restricted to only investments in securities coming under SEBI's jurisdiction.</p> <p>(iii) Advice relating to investments in SEBI regulated securities when rendered by an auditor to a company would also come under the scope of "investment advisory services".</p> <p>(iv) Besides the plain reading of the definition, the threat of self-review is certain in the auditor providing "investment advisory services".</p> <p>(v) Reference to SEC is not applicable and cannot be relied upon, being completely extraneous material.</p>

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	vi. Assistance in preparing report on organisation and financial implications and implementation road-map for enabling IFIN to execute on the proposed opportunities.		<p>clearly exclude obligations to perform any management function/responsibility.</p> <p>d) The services were rendered by another member firm in India of the Deloitte network namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different from the audit engagement team of DHS LLP.</p>	<p>(vi) Not relevant because the prohibition applies to "management services" and not to management functions or responsibilities.</p> <p>(vii) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly".</p> <p>(viii) Moreover the services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>
(c)	<p>EL Date: 30-JAN-2018</p> <p>EL Amount: Rs.44,00,000/-</p>	(i) Services are agreed upon and rendered during the course of statutory audit engagement.		The conclusions of NFRA in para 2.3.5 (c) are reiterated. The response of DHS is not acceptable in view of the following:

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	<p>Engagement Servicing Firm: DHS LLP</p> <p>Engagement Lead Partner: CA. Shrenik Baid</p> <p>Client Company: IL&amp;FS Financial Services Ltd.</p> <p>Services as per EL submitted by the Audit Firm:</p> <p>i. Advisory Services for the conversion of the financial statements of the company to converge to IndAS</p> <p>ii. Obtain an understanding and discuss the applicability of IndAS Statutory or Other Reporting requirements with the management.</p> <p>iii. Provide advice, recommendation, and observation on the impact analysis report, accounting</p>	<p>(ii) Services provided by key team member of audit engagement.</p> <p>(iii) Services are in the nature of:</p> <p>a. Accounting and book keeping services,</p> <p>b. Design and implementation of a financial information system,</p> <p>c. Management services.</p> <p>(iv) Services are violative of the Code of Ethics.</p> <p>(v) Services are prohibited under section 144 of the Companies Act, 2013.</p>	<p>a) This assignment was an Advisory Services engagement relating to <b>IndAS</b> which was not applicable for the year under audit, i.e. FY 2017-18.</p> <p>b) Scope Exclusions / Limitations stated in the engagement letter.</p>	<p>(i) The engagement involves Design of financial information system and generating financial statements, which would be subject to review and audit.</p> <p>(ii) NFRA has not said that there was a proved self-review threat. NFRA has said that the prohibition under Sec144 is absolute and that there is no need to prove the existence of any category of threat as a pre-condition for the prohibition to be effective.</p> <p>(iii) Sec 144 does not exempt any non-audit service only on grounds that the recommendations will be considered for implementation only in a future period.</p> <p>(iii) None of these exclusions/limitations take the services outside the purview of accounting and book keeping services, the design and implementation of a financial</p>

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	<p>policies, the draft opening Balance Sheet, specific advances classification and measurement, review of valuations for specific securities.</p> <p>iv. Expected credit loss (maximum two types of model) for retail and corporate.</p> <p>v. Advice in preparation of financial statements</p>		<p>c) Reference has been made to ICAI Code of Ethics, 2009. It has been stated that the services are permissible and not in the nature of accounting and bookkeeping services.</p> <p>d) Reference to ICAI Code of Ethics, 2019</p> <p>e) US SEC Independence Rules have been referred to</p>	<p>information system, and management services.</p> <p>(iv) The services were also in the nature of design and implementation of a financial information system, and management service.</p> <p>(v) Para 200.12 of the Code of Ethics, inter-alia, provides for firm-wide safeguards which includes using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client. In the present case CA Shrenik Baid was involved in both the audit and this non audit engagement.</p> <p>(vi) ICAI's Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report. In any case, the Code of Ethics cannot be pressed into</p>

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			<p>f) The Company has obtained the committee of director's approval, which was noted by the Board.</p>	<p>service where the Act has been violated.</p> <p>(vii) Reference to SEC is not applicable and cannot be relied upon, being completely extraneous material.</p> <p>(viii) The date of Board minutes is not mentioned by DHS. The minutes of the Audit Committee meetings do not record any approval for any of the specific terms of the engagement. Hence, it is clear that the approval of the Audit Committee was not obtained.</p> <p>(ix) As per section 177 of the Companies Act, 2013 the Audit Committee is, inter-alia, required to review and monitor the auditor's independence and performance, and the effectiveness of audit process;</p> <p>(x) In view of above and section 144 of the Companies Act, 2013,</p>

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				approval of the Audit Committee was required, which was not obtained.
(d)	<p>EL Date: 11-JUN-2018</p> <p>EL Amount: Rs.55,00,000/-</p> <p>Engagement Servicing Firm: DHS LLP</p> <p>Client Company: IL&amp;FS Ltd and its affiliates.</p> <p>Services as per EL submitted by the Audit Firm:</p> <p>i. Advising on applicability of withholding tax queries.</p> <p>ii. Assistance in Appeal Proceedings before Income Tax Appellate Tribunal (ITAT).</p>	<p>(i) Analysing computation of MAT and advance tax deals with a source of financial information subject to the review or audit.</p> <p>(ii) Representing an income tax case before Tribunal may impact assessment of contingent liabilities under AS 29.</p> <p>(iii) Assistance in appeal proceedings at various other levels such as DRP and High Court, and in obtaining legal opinion, will result in self-review threat.</p> <p>(iv) Services are violative of the Code of Ethics.</p>	<p>a) The audit report on the standalone financial statements were signed on 28 May 2018 and this EL is dated 11 June 2018, i.e., after we had signed the Accounts.</p> <p>b) Analysing the computation of income including Minimum Alternate Tax (MAT) and Advance Tax calculations prepared by the client and providing recommendations based</p>	<p>The conclusions of NFRA in para 2.3.5 (d) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The audit report of the consolidated financial statements was signed on 28-Jun-2018.</p> <p>(ii) The EL, inter-alia, states that the client includes IL&amp;FS and its affiliates. Annexure – I of EL i.e. List of clients has not been provided by DHS along with the EL. As such, it is concluded that IFIN was also one of the clients.</p>

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	<p>iii. Analysing the computation of income including Minimum Alternate Tax (MAT) and Advance Tax calculations.</p> <p>iv. Assistance in appeal proceedings before the Dispute Resolution Panel (DRP)</p> <p>v. Assistance in briefing the counsel in appeal proceedings before Tribunal/High Court including assisting in preparing and filing of appeal before the tribunal and High Court.</p> <p>vi. Assistance in obtaining the legal opinion from the Counsel.</p>	<p>(v) Services are violative of SQC1/SA 200.</p>	<p>on an understanding of the applicable tax regulations, are permissible services.</p> <p>c) DHS LLP's assistance on legal opinion was limited to assisting the client in preparing a case for opinion and in collating the requisite case laws which is permissible.</p>	<p>(iii) The services create a self-review threat. For example, analysing computation of MAT and advance tax deals with a source of the financial information subject to the review or audit. Further, representing an income tax case before Tribunal may impact assessment of contingent liabilities under AS 29.</p> <p>(iv) Similarly, assistance in appeal proceedings at various other levels such as DRP and High Court, and in obtaining legal opinion, will result in a self-review threat, and compromise of independent audit.</p> <p>(v) Moreover the services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>

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(e)	<p>EL Date: 22-JAN-2018</p> <p>EL Amount: Rs.25,00,000/-</p> <p>Engagement Servicing Firm: DHS LLP</p> <p>Client Company: IL&amp;FS Financial Services Ltd.</p> <p>Services as per EL submitted by the Audit Firm : Transfer Pricing Services</p>	<p>(i) EL includes reference to another EL which is not provided.</p> <p>(ii) Scope of work includes services to IL&amp;FS, IFIN and other subsidiaries.</p> <p>(iii) Transfer pricing study/service is performing managerial function and is a source of financial information subject to review and audit.</p> <p>(iv) Services are violative of the Code of Ethics.</p> <p>(v) Services are prohibited under section 144 of the Companies Act, 2013.</p>	<p>a) We are surprised that you have chosen to consider the non-submission of a referred EL which was not even a request from the Authority as a reluctance to share requested information with the Authority.</p>	<p>The conclusions of NFRA in para 2.3.5 (e) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) EL dated 22.1.18 itself states that it is a sub engagement letter. Thereby meaning that the complete engagement letter would comprise of EL dated 23.8.17 along with that dated 22.1.18. Accordingly, the observation on non-submission of EL is in order.</p> <p>(ii) The Authority had, in exercise of power under Rules 8 (1) and 8 (3) of NFRA Rules 2018, asked the audit firm to submit this information by way of affidavit. The audit firm submitted on oath that the information submitted by them was based on the data and records available with them and believed the same to be true. Hence, the availability and submission of this engagement letter now is questionable.</p>

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			<p>b) No managerial function was performed by DHS LLP</p> <p>c) ICAI Code of Ethics, 2019 have been referred to</p> <p>d) US SEC Independence Rules have been referred to</p>	<p>(iii) The audit firm has signed the EL to assist the auditee company in complying with preparation of Master File and CBC report which includes matters providing for overview of overall transfer pricing policies, and global allocation of income and economic activity.</p> <p>(iv) The submission of the Audit Firm is not relevant because the prohibition is for “management service”, which may or may not include management functions or responsibilities.</p> <p>(v) ICAI’s Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report. In any case, these cannot override the provisions of the Companies Act.</p> <p>(vi) Reference to SEC is not applicable and cannot be relied</p>

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				<p>upon, as being completely extraneous material.</p> <p>(vii) Moreover the services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>
(f)	<p>EL Date: 02-JAN-2018</p> <p>EL Amount: Rs.78,00,000/-</p> <p>Engagement Servicing Firm: DHS LLP</p> <p>Engagement Lead Partner: CA. Shrenik Baid</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per EL submitted by the Audit Firm :</p>	<p>(i) Services are agreed upon and rendered during the course of statutory audit engagement.</p> <p>(ii) Services provided by key team member of audit engagement.</p> <p>(iii) Design of financial information system and generating financial statements subject to review and audit by ET.</p> <p>(iv) Services are in the nature of:</p> <p>a. Accounting and book keeping services,</p>	<p>a) The scope of services consisted of advisory services for the conversion of the financial statements of the company from India GAAP to IndAS.</p> <p>b) IndAS is applicable to IL&amp;FS only from the financial year commencing 1 April</p>	<p>The conclusions of NFRA in para 2.3.5 (f) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The services are for the design and implementation of a financial information system. As such, any service in the nature of design of financial reporting statements is in the nature of accounting and book keeping services. Besides, the services are clearly “management services”.</p> <p>(ii) Para 2(d) of EL, inter-alia, states that scope of work includes Control</p>

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	<p>i. Advisory Services for the conversion of the financial statements of the company to converge to Ind AS.</p> <p>ii. Advise in preparation of stand-alone and consolidated IndAS financial statements as at 1.4.17 and for the year ended 31-Mar-2018, along with disclosures.</p> <p>iii. Advise on new transactions.</p> <p>The fee in addition to fixed fee of Rs.78 Lakhs, is subject to additional work @Rs.4500/- per hour.</p>	<p>b. Design and implementation of a financial information system, c. Management services.</p> <p>(v) Services are violative of the Code of Ethics.</p> <p>(vi) Services are prohibited under section 144 of the Companies Act, 2013.</p>	<p>2018 for which financial year we are not the auditors. Hence, the question of “self-review threat” does not arise.</p> <p>c) The last audit of financial statements of IL&amp;FS Limited was for F.Y. 2016-17. For this year, DHS LLP audited the financial statements prepared in accordance with the Indian GAAP and not as per IndAS. Therefore, there is no self-review threat</p>	<p>evaluations for Subsidiaries, Associates and Joint Ventures. Accordingly the same includes IFIN as well.</p> <p>(iii) The scope consisting of conversion of the financial statements from India GAAP to IndAS, is clearly subject to the self-review threat.</p> <p>(iv) The audit report of the standalone financial statements was signed on 28.5.18 and consolidated financial statements was signed on 28-Jun-2018.</p> <p>(v) The Audit Firm and the Partner in Audit Engagement were involved in providing services prohibited by Section 144 of the Companies Act, 2013, to the holding company, while performance of the audit of the subsidiary, i.e. IFIN was still ongoing.</p>

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			<p>d) ICAI Code of Ethics, 2019 have been referred to</p> <p>e) US SEC Independence Rules have been referred to</p>	<p>(iv) ICAI's Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report.</p> <p>(v) Reference to SEC is not applicable and cannot be relied upon, as being completely extraneous material.</p> <p>(vi) Moreover the services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>
(g)	<p>EL Date: 03-APR-2017</p> <p>EL Amount: Rs.61,12,500/-</p> <p>Engagement Servicing Firm: DHS LLP</p>	<p>(i) Analysing computation of MAT and advance tax results in generating financial information that is subject to the review by audit.</p>	<p>a) Services were limited to Transfer</p>	<p>The conclusions of NFRA in para 2.3.5 (g) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) By providing 'transfer pricing services', the auditor is performing</p>

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	<p>Client Company: IL&amp;FS Ltd and its subsidiaries and affiliates.</p> <p>Services as per EL submitted by the Audit Firm :</p> <p>i. Services relating to transfer pricing, direct tax and indirect tax.</p> <p>ii. Assistance in Company's compliance with maintenance of the prescribed information and documents as required u/s 92D of the IT Act 1961 in respect of the international transactions and specified domestic transactions.</p> <p>iii. Representation before Appellate authorities.</p> <p>iv. Briefing and assisting counsel for appearing before ITAT.</p>	<p>(ii) Representing an income tax case before the Tribunal will influence the assessment of contingent liabilities under AS 29.</p> <p>(iii) Assistance in appeal proceedings at various other levels such as ITAT and High Court, and in providing representation and litigation services, and advising on service tax matters, would result in a self-review threat and compromise of independent audit.</p> <p>(iv) By providing 'transfer pricing services', the auditor is performing a managerial function and such a responsibility also influences the generation of the financial information subject to review by audit.</p>	<p>Pricing Compliance, Direct and Indirect tax advice.</p> <p>b) There is no self-review threat.</p> <p>c) Reference to ICAI's Code of Ethics, 2019.</p> <p>d) Engagement partner was Audit engagement</p>	<p>a managerial function and clearly, the services provided are in the nature of management services.</p> <p>(ii) Such a responsibility also influences the generation of the financial information subject to review by audit.</p> <p>(iii) There is clear self-review threat. The same can be noted from the scope in the EL, which, inter-alia, states that, "... assist IL&amp;FS Ltd. and its subsidiaries and affiliates as per annexures attached herewith (collectively referred to as "Client") in tax matters for the benefit of the Client."</p> <p>(iv) ICAI's Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report. In any case, they cannot override the provisions of the Companies Act.</p>

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	<p>v. Review of computation of income and provide comments.</p> <p>vi. Assistance in computation and payment of advance tax.</p> <p>vii. Advising withholding tax rates.</p> <p>viii. Representation and litigation services.</p> <p>ix. Advising on any matters pertaining to Service Tax for the period 01-Apr-2017 to 31-Mar-2018.</p>	<p>(v) Services are all violative of Code of Ethics.</p> <p>(vi) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>partner of IFIN and not of IL&amp;FS and engagement team members were also different.</p>	<p>(v) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly".</p> <p>(vi) Moreover the services provided did not have the approval of the Audit Committee of the auditee Company, as also required vide section 144 read with section 177 of the Companies Act, 2013.</p>
(h)	<p>EL Date: 29-SEP-2016</p> <p>EL Amount: Rs.11,00,000/-</p> <p>Engagement Servicing Firm: DHS – Mumbai LLP</p>	<p>(i) Analysing tax implications and tax impact analysis would influence the financial information that would be the subject of review by audit.</p>	<p>a) DHS scope is to attend meetings organised by the</p>	<p>The conclusions of NFRA in para 2.3.5 (h) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) By attending meetings with advisors and lawyers organised by</p>

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	<p>Engagement Lead Partner: Vijay Dhingra</p> <p>Client Company: IL&amp;FS Financial Services Ltd.</p> <p>Services as per EL submitted by the Audit Firm :</p> <p>i. Provide tax implications in the hands of IFIN</p> <p>ii. Provide advisory implications under Income Computation and Disclosure Standards (ICDS)</p> <p>iii. Undertake Tax Impact Analysis on adoption of IndAS</p> <p>iv. DHS would attend meetings organised by the client with its advisors, lawyers etc.</p>	<p>(ii) By attending meetings with advisors and lawyers organised by the client, the auditor is performing a managerial function, which is a management service and also creates to a self-review threat.</p> <p>(iii) Services are all violative of Code of Ethics.</p> <p>(iv) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>client with its advisors, lawyers etc.</p> <p>b) We are currently unable to locate the Board/ Audit Committee approval in our files. Rs.11,00,000 paid by the Company for tax work done has been shown under Auditors' remuneration in footnote iv (b) to Note 21(b) of the standalone financial statements of the Company for the year</p>	<p>the client, the auditor is performing a managerial function, which is a management service and also creates to a self-review threat leading to compromise of independent audit.</p> <p>(ii) As per 290.181 of ICAI Code of Ethics, 2009, a self-review threat may be created when the litigation support services provided to a financial statement audit client include estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements.</p> <p>(iii) As per footnote iv (b) to Note 21(b) of the standalone financial statements of the Company for the year ended 31 March 2017, auditor's remuneration as auditor is Rs.212 lakh for taxation matters is Rs.36.9 lakh, and for other matters is Rs.84.6 lakh. It is not clear where the remuneration for this</p>

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	<p>v. Provide comments after reviewing documentation prepared from Income Tax perspective.</p>		<p>ended 31 March 2017. The financial statements were recommended by the Audit Committee to the Board for their approval and the same were approved by the Board.</p> <p>c) The team performing these services were different from the audit engagement team.</p> <p>d) All tax advice was provided to client management for their consideration, decision making and for management to determine if the tax advice would require any amounts to be recorded in the financial statements.</p>	<p>engagement amounting to Rs. 11 lakh is shown, as contended by the audit firm. In any case, even if, for the sake of argument, such remuneration had, in fact, been shown, it would not have in any way been compliance with the approval of the Audit Committee for the service, as required under Sec 144 of Companies Act, 2013.</p> <p>(iv) Clearly, the allowed services should have the prior approval of the Audit Committee, which in this case the audit firm does not have.</p> <p>(vi) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly".</p> <p>(vii) The issue is that it was prohibited to provide the said Services. It is immaterial how the client uses it.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
(i)	<p>EL Date: 14-AUG-2014</p> <p>EL Amount: Rs.37,00,000/-</p> <p>Engagement Servicing Firm: DTT India Pvt. Ltd.</p> <p>Engagement Lead Partner: Nikhil Bedi</p> <p>Client Company: IL&amp;FS Financial Services Ltd.</p> <p>Services as per EL submitted by the Audit Firm : Integrity Due Diligence on the Target Companies and Key Principal.</p>	<p>(i) Services agreed upon are in the nature of management consultancy service or management services.</p> <p>(ii) Services are all violative of Code of Ethics.</p> <p>(iii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>a) The services were rendered by another member firm in India of the DTTL network namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different from the audit engagement team of DHS LLP</p> <p>b) DTTI LLP did not conclude on the results, and management ultimately performed additional actions or decisions based on the information gathered.</p>	<p>The conclusions of NFRA in para 2.3.5 (i) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly", which includes provision of services through any entity whose name or trade mark or brand is used by the firm or any of its partners. Besides, no approval of the Audit Committee was obtained, as is required by Sec 144 of the Companies Act, 2013.</p> <p>(ii)The issue is that it was prohibited to provide the said Services. It is immaterial how the client uses it.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
(j)	<p>EL Date: 23-APR-2015</p> <p>EL Amount: Rs.72,00,000/-</p> <p>Engagement Servicing Firm: DTT India Pvt. Ltd.</p> <p>Engagement Lead Partner: Vijay Kumar Iyer</p> <p>Client Company: IL&amp;FS Ltd.</p>	<p>Engagement Letter G/200/1192 dated 22 August 2014 has not been provided by DHS to NFRA.</p>	<p>(a) We regret that we had inadvertently missed clarifying that the services were provided under an Addendum Letter which was supplemental to the engagement letter referenced as G/200/1192 dated 22 August 2014, please find attached herewith the engagement letter G/200/1192</p> <p>b) The Addendum Letter were an extension to include additional coverage period from 1 July 2014 to 31 March 2015 with the</p>	<p>The conclusions of NFRA in para 2.3.5 (j) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The Authority had, in exercise of powers under Rules 8 (1) and 8 (3) of NFRA Rules 2018, asked the audit firm to submit this information by way of affidavit. The audit firm submitted on oath that the information submitted by them was based on the data and records available with them and believed the same to be true. Hence, the availability and submission of this engagement letter now is questionable.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
			<p>same scope of work (high level financial due diligence).</p> <p>c) Please refer to our comments provided under 'o' below.</p>	<p>(ii) Refer 'o' below for further comments.</p>
(k)	<p>EL Date: 12-DEC-2014</p> <p>EL Amount: Rs.12,50,000/-</p> <p>Engagement Servicing Firm: DHS – Mumbai LLP</p> <p>Engagement Lead Partner: Bahroze Kamdin</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per EL submitted by the Audit Firm :</p> <p>i. Assistance in the analysis and identification of FFIs within the client group for the purpose of applicability</p>	<p>(i) Services are all violative of Code of Ethics.</p> <p>(ii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>a) Please refer to our response on “management services” provided in 2.3.3.d. As you will see, DHS LLP did not undertake any “management services”.</p> <p>b) Deloitte <b>will assist</b> the client in on-line registration of the identified FFIs with the US IRS based on the information provided by</p>	<p>The conclusions of NFRA in para 2.3.5 (k) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The services clearly are in the nature of management services. Hence the engagement violates Sec 144 of the Act. In any case, the approval of the Audit Committee was also not obtained.</p> <p>(ii) Threats to independence may also arise when a firm provides a</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
	<p>of FATCA (Foreign Account Tax Compliance Act).</p> <p>ii. On-line registration of the identified FFIs with the US IRS.</p> <p>iii. Reviewing communication templates for investors, counter-parties and third party service providers.</p> <p>iv. Reviewing on-boarding to identify additional data requirement for new financial accounts.</p>		<p>the client and after client's review and approval.</p> <p>c) There is no self-review threat as the services did not have any implications on the financial statements of the Client.</p>	<p>non-assurance service as in the present case, of a non-financial statement audit assurance engagement.</p> <p>NFRA has not specifically alleged self-review threat in this case. However the same is very much there in view of non-audit and audit services provided to the Auditee and its parent company, simultaneously.</p>
(1)	<p>EL Date: 27-AUG-2014</p> <p>EL Amount: Rs.9,00,000/-</p> <p>Engagement Servicing Firm: DHS – Mumbai LLP</p> <p>Client Company: IL&amp;FS Ltd.</p>	<p>(i) Services agreed upon clearly in the nature of management service.</p> <p>(ii) Services are all violative of Code of Ethics.</p>	<p>a) The scope of services were related to assistance in transfer pricing advisory</p>	<p>The conclusions of NFRA in para 2.3.5 (1) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) As mentioned before, by providing 'transfer pricing services', the auditor is performing</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
	<p>Services as per EL submitted by the Audit Firm: An analysis which would assist in determining the best possible approach/ method to commercialise the IL&amp;FS Brand.</p>	<p>(iii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>services involving the royalty payment for the right to use the IL&amp;FS Brand.</p> <p>b) Please refer to our response on “management services” provided in 2.3.3.d. As you will see, DHS LLP did not undertake any “management services”.</p> <p>c) The team who performed these services was different from the audit engagement team.</p> <p>d) ICAI Code of Ethics, 2019 have been referred to.</p>	<p>a managerial function and such a responsibility also influences the generation of the financial information subject to review by audit.</p> <p>(ii) The services clearly are in the nature of management services in violation of section 144 of Companies Act, 2013.</p> <p>(iii) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly".</p> <p>(iv) ICAI’s Code of Ethics, 2019 are not relevant since these have neither come into force yet, nor these were in force on the date of Audit Report. In any case, any provision in the Code cannot violate the Act.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
			e) US SEC Independence Rules have been referred to.	(v) Reference to SEC is not applicable and cannot be relied upon, as being completely extraneous material.
(m)	<p>EL Date: 29-JUNE-2015</p> <p>EL Amount: Rs.9,00,000/-</p> <p>Engagement Servicing Firm: DTT India Pvt. Ltd.</p> <p>Engagement Lead Partner: Mehul Modi</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per submission made by the Audit Firm:</p> <p>Impact analysis report under SEBI Listing Agreement laws.</p>	<p>(i) Services agreed upon clearly in the nature of management service.</p> <p>(ii) Services are all violative of Code of Ethics.</p> <p>(iii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>a) The services were</p>	<p>The conclusions of NFRA in para 2.3.5 (m) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The Authority had, in exercise of powers under Rules 8 (1) and 8 (3) of NFRA Rules 2018, asked the audit firm to submit this information by way of affidavit. The audit firm did not submit the EL and as such is non-compliant w.r.t. submission of documents to NFRA. Only Invoice was submitted by M/s DHS. Accordingly, all assertions regarding service provided do not have any basis.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
			<p>permissible and there was no violation of Section 144 of the Companies Act.</p> <p>b) The services were rendered by another member firm in India of the Deloitte network namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different from the audit engagement team of DHS LLP</p>	<p>(ii) Moreover, the said services as being claimed are in the nature of due diligence services which are related to accounting and book keeping services. Above all, clearly the services provided included financial management planning and financial policy determination, thus are also in the nature of management services. Besides, the approval of the Audit committee was not obtained.</p> <p>(iii) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly", which includes provision of services through any entity whose name or trade mark or brand is used by the firm or any of its partners.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
(n)	<p>EL Date: 11-AUG-2014</p> <p>EL Amount: Rs.40,00,000/-</p> <p>Engagement Servicing Firm: DTT India Pvt. Ltd.</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per EL submitted by the Audit Firm :</p> <p>i. Assistance with collation of financial analysis databook.</p> <p>ii. Provide recommendations to management</p>	<p>(i) Services agreed upon clearly in the nature of management service.</p> <p>(ii) Services are all violative of Code of Ethics.</p> <p>(iii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>a) The scope of services were related to transaction assist services in collation of financial databook for analysis purposes based on historical financial information provided by the client.</p> <p>b) DTTIPL did not undertake any “management services”.</p> <p>c) The services were rendered by another member firm in India of the Deloitte network namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different</p>	<p>The conclusions of NFRA in para 2.3.5 (n) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The said services are in the nature of due diligence services, financial management planning, financial and business policy determination. Collation of financial databook for analysis purposes was done as per request of the client after taking additional fees for the same. The service provided was not part of Audit work. As such, the said services are clearly in the nature of management services. Besides, the approval of the Audit Committee was not obtained.</p> <p>(ii) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly", which includes provision of services through any entity whose name or trade mark or</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
			from the audit engagement team of DHS LLP.	brand is used by the firm or any of its partners.
(o)	<p>EL Date: 22-AUG-2014</p> <p>EL Amount: Rs.38,00,000/-</p> <p>Engagement Servicing Firm: DTT India Pvt. Ltd.</p> <p>Client Company: IL&amp;FS Ltd.</p> <p>Services as per EL submitted by the Audit Firm :</p> <p>i. Preparation of Due Diligence Report</p> <p>ii. Technical evaluation/ appraisal of intangible assets, IT systems and controls and their commercial exploitation capabilities.</p>	<p>(i) Services agreed upon clearly in the nature of management service.</p> <p>(ii) Services are all violative of Code of Ethics.</p> <p>(iii) Services are violative of Section 144 of the Companies Act, 2013.</p>	<p>a) The scope of services was related to providing high level financial due diligence services.</p> <p>b) We did not perform any work on (i) Technical evaluation/ appraisal of</p>	<p>The conclusions of NFRA in para 2.3.5 (o) are reiterated. The response of DHS is not acceptable in view of the following:</p> <p>(i) The said services are in the nature of due diligence services; system analysis and design, and IT related services; business policy, corporate planning, organisation structure and behaviour, development of human resource including design and conduct of job description, job evaluation and evaluation of work loads.</p> <p>(ii) Clearly, the said services are in the nature of management services.</p> <p>(iii) Not acceptable in view of the scope of work stated in EL.</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
	<p>iii. Reporting on sales and marketing policy, management details and directors' CVs.</p>		<p>intangible assets, IT systems and controls and their commercial exploitation capabilities, (ii) Reporting on marketing policy, management details and directors' CVs as indicated in the <b>Observation.</b></p> <p>c) The services were rendered by another member firm in India of the Deloitte network namely, Deloitte Touche Tohmatsu India LLP (“DTTI LLP”) and not DHS LLP. The team which performed these services was different from the audit engagement team of DHS LLP.</p> <p>d) US SEC Independence Rules have been referred to</p>	<p>(iv) Not acceptable in view of the explanation given in Section 144 of the Companies Act for "directly or indirectly", which includes provision of services through any entity whose name or trade mark or brand is used by the firm or any of its partners. Besides, approval of the Audit Committee was not obtained.</p> <p>(v) Reference to SEC is not applicable and cannot be relied</p>

S.N.	Engagement and Details of Service provided	Conclusions of the DAQRR (Refer para 2.3.5 for details)	Summary of Audit Firm response vide letter dated 04.11.2019	Final Conclusion of NFRA (references to paras are to the DAQRR)
				upon, as being completely extraneous material.

Notes:

1. ELs pertaining to the period prior to FY 17- 18 (period of this review) have been included to show examples of violations of Standards of Audit and Companies Act, 2013 that were committed by DHS prior to FY 17 – 18 as well. This is evidence that the Audit firm entered the audit of FY 17-18 with its independence in mind, and in appearance, completely compromised.
2. In respect of all the ELs, there is no evidence of prior approval from the Audit Committee of the Auditee, as mandatorily required. Besides the services provided were violative of the SAs and Companies Act, 2013.

## ANNEXURE II

## Chronology of events leading to the issue of the AQR

Sl. No	Date	Event / Correspondence
1.	25.02.2019	Formal letter of NFRA letter sent to CA Udayan Sen requesting for the Audit file of IL&FS Financial Services Ltd for the Financial Year 2017-18.
2.	25.04.2019	NFRA's letter dated 25.04.2019 sent to CA Udayan Sen (Engagement Partner) seeking list of related parties and Audit/Non-Audit revenue in stipulated format under Affidavit.
3.	02.05.2019	NFRA's letter dated 02.05.2019 containing Questionnaire, sent via email on 02.05.2019 to CA Udayan Sen seeking replies to the same.
4.	08.05.2019	Reply of CA Udayan Sen to NFRA letter dated 25.04.2019 under affidavit and also sent via email by CA Shrenik Baid.
5.	13.05.2019	Email from CA Shrenik Baid in response to NFRA Letter No. 11013/2/2018 dated 02.05.2019
6.	28.06.2019	NFRA's letter dated 28.06.2019 to CA Udayan Sen conveying its prima facie observations/comments/conclusions on the various issues in the questionnaire.
7.	3.8.2019	Reply of CA Udayan Sen dated 02.08.2019 to NFRA's letter dated 28.06.2019.
8.	25.09.2019	Issuance of Draft AQR Report (DAQRR)
9.	30.10.2019	Presentation to NFRA by CA Udayan Sen, CA Shrenik Baid and other team members from Deloitte Haskins & Sells LLP (Auditor).
10.	04.11.2019	Written replies furnished by CA Udayan Sen to NFRA's observations in the DAQRR.
11.	12.12.2019	Issuance of the final AQR Report by NFRA.

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