

SA240(R)

THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL

What is a Fraud?

Intentional mistakes to get unjust advantage are commonly known as fraud. Fraud as defined by SA 240 is

- An intentional act
- by one or more individuals among
 - management,
 - those charged with governance,
 - employees,
 - or third parties,
- involving the use of deception
- to obtain an unjust or illegal advantage."

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

e.g. To reflect a good financial position deliberately purchase is suppressed. Here suppression of purchase is used for deception, which is done intentionally by management and employees with the directions of those charged with governance. As a result of this by showing inflated profit the entity will enjoy unjust or illegal advantage of fictitious financial health.

Hence we can conclude that Frauds are planned. A person responsible for fraud has a knowledge of what he is doing. Frauds are committed with due care. Fraud will always result in loss to aggrieved party. Frauds are deliberately concealed. Usually errors are rectified and ratified but frauds should be reflected in financial statements.

*** Those charged with governance means : persons charged supervising, controlling, and directing responsibility (include management only when they perform managerial persons) viz. Audit committee under a company can be termed as committee of persons those charged with governance

Illustrate by way of some example how Fraudulent Financial Reporting and Misappropriation of Asset can be done?

Examples of FFR

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

Following are the examples of MOA

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

- Using an entity's assets for personal use, (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Who is responsible to prevent and detect Fraud?

According to SA-240 "The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. Management through internal control places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place,

How much Auditor is responsibilities for detection of Fraud?

According to SA-240 " An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

What are Inherent Limitations of Audit?

Inherent limitations means limitations obtained by the subject in inheritance i.e. since its evolution, which cannot be overcome. As per SA-240 An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. Followings can be listed as inherent limitation of audit.

- The use of judgment (about materiality, sufficiency and appropriateness of audit evidence)
- The use of testing (not extending deep audit procedures to a group of immaterial items),
- The inherent limitations of internal control (defined in SA-330) and
- The fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. (Debtors confirmation is not conclusive evidence that he is good and will not result in bad in future, it can only persuade the auditor to believe the existence of debtor))
- The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error
- The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures.

As far as auditor 's responsibility is concerned as per SA240 "When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit.

What is Professional Skepticism?

Professional skepticism means vigilant attitude. Auditor should not accept all the representations, explanations as it is without a vigilant look over the same. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

At the planning stage it required to communicate to the engagement team members that how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

What is objective of auditor as far as concerned with fraud in financial statement?

According to SA-240 the objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

PART-A

Identifying and assessing the risk of material misstatement due to fraud

Following steps are required to be considered when auditor is assessing the risk of material misstatement due to fraud:-

1. **Understanding the entities business :-** According to SA315 auditor before planning the audit procedure should understand the entities business which helps him to identify fraud risk prone areas.

2. **Enquiries through management :-** According to SA240 The auditor shall make inquiries of management regarding
a) **Managements assessment of Fraud risk Factor :-** Auditor shall enquire that what is management's assessment of the fraud risk and how frequently management assesses the same. Further auditor shall evaluate the management's process for identifying and responding to the risks of fraud in the entity. Auditor shall also enquire how management communicated such assessment to those charged with governance and employees so that the ethical behaviour can be established.

b) **Knowledge about actual or suspected or alleged fraud:-** The auditor shall make inquiries of management, those charged with governance and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

3. **Enquiries with Internal Auditor :-** According to SA240 the auditor shall make inquiries of internal audit (if engaged by entity) to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

4. **Result of Auditor's Analytical Procedures :-** At planning stage auditor applies certain analytical procedures (i.e. ratio analysis, trend analysis) over the financial statement. When auditor applies such procedures he should evaluate the result of such procedures that whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

PART-B

Obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud.

As in Part A we have seen how auditor assesses the Fraud Risk in financial statement now we will understand how auditor will respond through his audit procedure to address the Fraud Risk Factors. Auditor will have two kind of responses to such risks

1. **Overall Response :-** Overall response means collective impact of all fraud risk factors over the financial statement as a whole. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall depute adequately skilled and experienced engagement team which has knowledge of significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement. Further Auditor shall evaluate whether the selection and application of accounting policies by related to subjective measurements and complex transactions. Auditor shall incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

2. **Auditor's Response to Assertion Level :-**

In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. As we know management is in a position to override the internal controls according to SA240 auditor shall apply following procedure to satisfy himself that management had not misused its position to give a room for fraud to take place.

(a) Test the appropriateness of journal entries recorded:

- Enquire employees involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
- Select journal entries and other adjustments made at the end of a reporting period; and
- Consider the need to test journal entries and other adjustments throughout the period.

(b) Review accounting estimates involved: - As we know risk of fraud is greater where the estimates are involved auditor shall evaluate whether accounting estimates are appropriate and not biased. In performing this review, the auditor shall Evaluate whether the judgments and decisions made by management indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year⁸.

After above response to audit risk by applying audit procedures audit will obtain sufficient and appropriate audit evidences. Now it is required for auditor to evaluate the audit evidence obtained through above procedure.

PART-C

Response to identified or suspected fraud

1. Audit Evidences showing that there is a misstatement :- As auditor found a misstatement in Financial Statement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. When the auditor confirms that, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications. The implications may be that either he issue a qualified opinion and if the magnitude of the fraud is extremely significant auditor may issue an adverse opinion.

2. Auditor unable to conclude whether or not misstatement exist or not – In such cases auditor may issue a reservation of opinion or if magnitude of suspected fraud is extremely significant auditor shall issue a reservation of opinion or disclaimer of opinion.

Can auditor may decide to withdraw from his engagement.

According to SA 240 If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

What kind of Representation by Management required under SA-240?

According to SA240 " The auditor shall obtain written representations from management that:

- (a) It acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- (b) It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- (c) It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
- (i) Management;
 - (ii) Employees who have significant roles in internal control; or
 - (iii) Others where the fraud could have a material effect on the financial statements; and
- (d) It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

What are the Auditors responsibilities of communication of fraud or Suspected fraud?

According to SA240 - If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management. The auditor shall communicate these matters to those charged with governance also on a timely basis.

Is it required for the auditor to communicate to Regulatory and Enforcement Authorities?

In India presently it is not required by any law to communicate the instance of fraud to regulatory or enforcement authorities but SA240 has a provision that if law requires such reporting auditor should report accordingly. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal duty may have an overriding effect over the same.

Give some Examples of circumstances that Indicate the Possibility of Fraud?

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.
- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.