

SA 240 – Auditor's Responsibilities Relating to Fraud in Audit of FS

Primary Responsibility – **Mgt** and TCWG

Misstatements can arise from either **fraud** (intentional) or **error** (unintentional). Auditor is only concerned with 2 types of fraud that causes MM in FS –

<u>Fraudulent Financial Reporting (FFR) – Mgt Level</u>	<u>Misappropriation of Assets – Employee Level</u>
<ul style="list-style-type: none"> • Misrepresentation or intentional omission of events or transactions • Manipulation or alteration of A/c records • Intentional misapplication of A/c principles 	<ul style="list-style-type: none"> • Embezzling (steal) receipts • Causing entity to pay for goods not received • Stealing assets or intellectual property • Using entity's assets for personal use
<ul style="list-style-type: none"> • Risk of not detecting MM from fraud is higher than error because fraud may involve sophisticated (complicated) and organized schemes designed to conceal it • Risk of auditor not detecting MM from Mgt fraud is greater than employee fraud, because Mgt can manipulate A/c records or override control 	
<p>Responsibilities of Auditor</p> <ul style="list-style-type: none"> • Auditor is responsible for maintaining professional skepticism • Auditor may accept docs as genuine, unless auditor has reason to believe contrary • If auditor believes that docs may not be authentic auditor shall investigate further 	<p>Risk assessment procedures (RAP)</p> <ul style="list-style-type: none"> • Inquiries of Mgt & others within entity • Obtaining understanding as to how TCWG exercise oversight of Mgt's processes for – <ul style="list-style-type: none"> ○ Identifying & responding to risks of fraud ○ IC to mitigate risks ○ Evaluation of unexpected relationships when performing Analytical Procedure (AP)
<p>FFR can be committed by Mgt overriding controls using such techniques as</p> <ul style="list-style-type: none"> • Engaging in complex transactions • Omitting, advancing or delaying recognition of events & transactions • Concealing, or not disclosing, facts • Inappropriately adjusting assumptions & changing judgments • Altering terms of significant transactions • Recording fictitious journal entries 	<p>Written Representations</p> <ul style="list-style-type: none"> • Acknowledge their responsibility for implementation of IC to prevent fraud • They have disclosed to auditor – <ul style="list-style-type: none"> ○ Knowledge of suspected fraud which could have material effect on FS ○ Knowledge of allegations of suspected fraud communicated by others ○ Results of Mgt's assessment of ROMM due to fraud
<p>Responses to assessed ROMM due to fraud at FS Level</p> <ul style="list-style-type: none"> • Assign & supervise personnel as per knowledge, skill & ability • Evaluate whether selection of A/c policies are indicative of FFR • Incorporate element of unpredictability in NTE of procedures 	<p>Responses to risks of Mgt override of controls Irrespective of auditor's assessment of this risk, auditor shall –</p> <ul style="list-style-type: none"> • Review A/c estimates for biases • For significant transactions outside normal course of business, evaluate business rationale • Test appropriateness of journal entries & adjustments made in FS

<p>Communications to Mgt & TCWG</p> <ul style="list-style-type: none"> • Mgt - communicate about fraud on timely basis • TCWG - Unless all of TCWG are involved in Mgt, if auditor suspects fraud involving Mgt, or where fraud results in MM in FS, communicate to TCWG on timely basis & discuss NTE of procedures 	<p>Communications to Regulatory Authorities</p> <ul style="list-style-type: none"> • Auditor may have duty to report misstatements to authorities when Mgt & TCWG fail to take corrective action • Although auditor has duty to maintain confidentiality, legal responsibilities may override duty of confidentiality in some cases. For eg, Bank 	
<p>Circumstances in which auditor is unable to continue engagement If due to fraud, auditor encounters exceptional circumstances that questions auditor's ability to continue audit, auditor shall -</p>		
<p>Determine PRL responsibilities to report to persons who made appointment or, to regulatory authorities</p>	<p>Consider if it is appropriate to withdraw, where legally permitted</p>	<p>If auditor withdraws -</p> <ul style="list-style-type: none"> • Discuss with Mgt & TCWG, withdrawal and reasons • Same as 1st point
<p>Fraud Risk Factors</p>		
<ul style="list-style-type: none"> • They are events or conditions that indicate incentive or pressure or provide opportunity or rationalization/attitude to commit fraud 	<ul style="list-style-type: none"> • While Fraud risk factors does not mean existence of fraud, they are present in frauds & therefore may indicate ROMM due to fraud 	
<p>Fraud Risk Factors relating to misstatements from FFR</p>		
<p>Incentives/Pressures - Economic, Industry or Operating conditions</p> <ul style="list-style-type: none"> • High vulnerability to rapid changes • New A/c or regulatory requirements • High degree of competition or market saturation • Significant declines in customer demand & increasing business failures • Rapid growth compared to other companies • Operating losses causing threat of bankruptcy • Recurring negative/no operating cash flows 	<p>Attitudes/Rationalizations</p> <ul style="list-style-type: none"> • Communication of inappropriate values / ethics • Non-financial Mgt's excessive participation in selection of A/c policies • Known history of violation of law & regulations • Excessive interest by Mgt in increasing stock price or earnings • Practice by Mgt of committing to investors, creditors to achieve unrealistic forecasts • Mgt failing to remedy known significant deficiencies in IC • Interest by Mgt to minimize reported earnings for tax- reasons • Low morale among senior Mgt • Owner-manager makes no distinction between personal & business transactions • Dispute b/w shareholder in closely held entity • Recurring attempts by Mgt to justify inappropriate A/c on basis of materiality 	
<p>Opportunities</p> <ul style="list-style-type: none"> • Significant RP transactions outside ordinary course of business • Strong financial presence to dictate terms to suppliers or customers • Assets, liabilities, revenues, or expenses based on significant estimates • Significant or highly complex transactions close to period end 		

<ul style="list-style-type: none"> • Use of business intermediaries with no clear business justification • Significant operations in tax-haven jurisdictions with no clear business justification 	<p>Relationship b/w Mgt & auditor is strained</p> <ul style="list-style-type: none"> • Frequent disputes with auditor on A/c or auditing matters • Unreasonable demands on auditor, like unrealistic time for completion of audit • Restrictions on auditor to limit access to people or Info or to TCWG • Domineering Mgt behaviour, attempts to influence scope of auditor's work
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Fraud Risk Factors relating to Misappropriation of Assets

Incentives/Pressures	Opportunities	Attitudes/Rationalizations
<ul style="list-style-type: none"> • Personal financial obligations • Adverse relationships b/w entity & employees due to - <ul style="list-style-type: none"> ○ Known or anticipated future employee layoffs ○ Recent or anticipated changes to employee compensation ○ Promotions, compensation, inconsistent with expectations 	<ul style="list-style-type: none"> • Large amounts of cash on hand • Inventory items that are small in size, of high value, or in high demand • Easily convertible assets • Fixed assets which are small in size, marketable, or lacking observable identification of ownership 	<ul style="list-style-type: none"> • Disregard for need to monitor risks of misappropriations of assets • Disregard for IC over misappropriation of assets by overriding or by failing to take appropriate remedial action on deficiencies • Behaviour indicating dissatisfaction with entity • Changes in behaviour that indicates assets have been misappropriated • Tolerance of petty theft