SA 240 : Auditor's Responsibilities relating to Fraud in an Audit of FS. [Simple + Storing]

① How mgt does fraud? ⟶ ② Auditor's Responsibilities ↓ ③ Response to fraud.

Q who's primary responsibility for prevention/detection of fraud? mgt & TCWG

Fraud (2 types)
- Fraudulent financial Reporting [mgt → Earnings/Expenses/Assets/Liabilities ↑↓]
- Misappropriation of Assets. [employees ⇒ small thefts]

Techniques of Fraudulent financial Reporting (FFR)

i) Manipulation (malaki) / falsification (jhoothi) / alteration (Baat badalna) of A/c records/supporting documents.

Eg. Expense Invoice 100 → 1,00,000

ii) Misrepresentation / Intentional omission of Events/Trans° from F.S.

Eg. High value sales Return on 29.3.25 [Revenue -ve impact] → Record FY 25-26
[FY 24-25]

iii) Misapplication of a/c principles relating to A.C.P.D [Amt, classif., Rese., Disc.)

Eg Repair Expense on machinery
- Exp ✓ [Instt. depr]
- Capitalised ⇒ ↓ PBT ↑ ⇒ Better profitability FY.
  X

How does mis happen?

Mgt. override of controls (follows)

Techniques: Mgt override of controls

i) Altering records & terms of significant & unusual transactions.

Eg. Sales contract date 4.4.25 [FY 25-26] (Back date) FY 24-25 28.3.25 ⇒ "Sales Better"

ii) Fictitious JEs close to end of A/c period to manipulate profits.

Eg fake sales shown to Related Party to inflate Revenue.

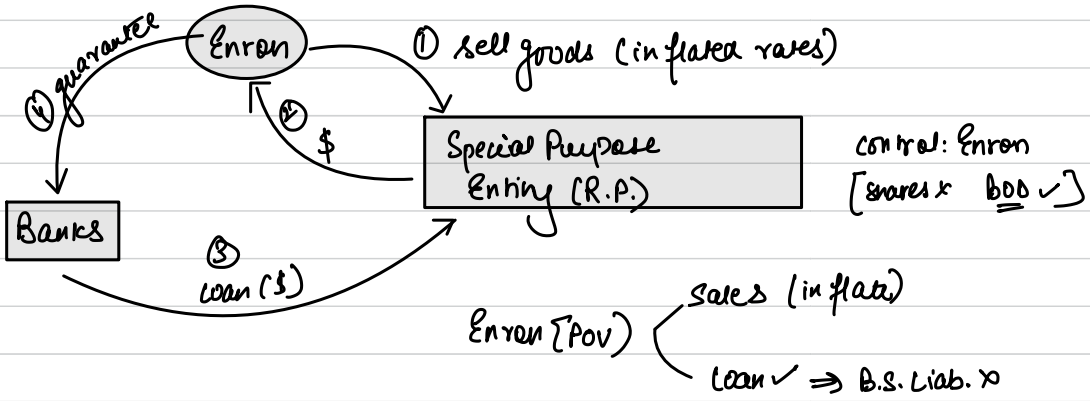
iii) Inappropriately Adjusting Assumptions / judgments for Alc Estimates.

Eg. Co. takes useful life of spl. machine as 10yrs instead of 5years ⇒ Depn exp. p.a. ↓ ⇒ Profitability ↑

iv) Concealing / not disclosing facts that could affect FS. amounts.

Eg legal case → huge loss → Disclose ✗

v) Complex transn to misrepresent financial { position (B.S.) or performance (P&L) }



vi) Omitting / Advancing / Delaying recognition of Events / Transn in FS.

Eg marketing Bill exp. 28.3.24 shown in FY 25-26 to delay expense recognition.

Techniques: Altering Significant: Alter → Records → Sig. transn
Fictitious JE → end of Alc period.
Adjusting Assumptions → Alc Estimates.
Concealing facts
Complex transn
Transn / Events { Omit, Advance, Delay.

Techniques: Misappropriation of Assets.

- Goods
  - ① Stealing physical assets / intellectual property.
    Eg "coke" formula (patented) → sell to competitor
    (or) inventory steal.
  - ② using entity's assets for personal use.
    Eg loan to R.P. [wife of CEO]
- Cash
  - (Receipts)
    ③ Embezzling receipts.
    Eg misappropriation of collections of Drs.
  - (Payments)
    ④ Making entity pay for goods / services not recd.
    Eg Payment to fictitious vendors / employees.

Auditor's Responsibility

- Other matters
- Fraud (Mgt/collusion)
- R.P. (R.trans^n)
- NOCLAR
- a.c.

(1) Obtaining R.A. that F.S. are free from M.M. (due to (Fraud or Error))

(2) Due to SLA, there's unavoidable Risk that some M.M. may not be detected even though audit done as per SAs.

Risk of not detecting MM. from

(3) Fraud > Error

∵ fraud may involve sophisticated & carefully organised schemes to conceal it.

(4) Mgt fraud > Employee fraud.

∵ mgt can manipulate ak records / override controls.

Eg. Approve fictitious payments. [mgt / Rakshak (Bhakshak)]

(5) (Kya karein?) Maintain professional skepticism. [Shak]

(Sabpe Shak?)

(nahi) May Accept Records / Docs as genuine.

(Sirf jaha need hai) • Investigate

Document is unauthentic / modified

Responses to inquiries of mgt are inconsistent.

Fraud Risk factors [(Auditor) Indications | (Mgt) Reasons → Fraud)

- Attitude / Rationalisation
- Incentive / Pressure
- Opportunity

→ Fraudwear financial Reporting

→ Misappropriation of Assets

Incentive / Pressure

Economic, Industry, operating cond^{n}

Economic
- Rapid changes (tech / Int rates)
- New Alc / statutory requirements.

Industry
- High competition
- customer demand ↓ ⇒ Business failures
- Rapid growth / unusual profitability.

operating
- operating losses.
- -ve cash flows.

3rd party Operations / Requirements

Operations
- Profit expectations (Analysts, Institutional investors etc) ↓
- Adverse effects of poor financial results on Bus. combination / contracts.

Requirements
- obtain Debt / Equity for R&D / cap. Exp. ↓
- Meet Debt / listing exchange requirements.

Personal finance of mgt & TCWG

① Sig. financial int^{t} in Entity ↓ → ② Personal guarantee of entity's debts.

③ Compensation contingent on stock price / earnings targets. ↓

④ Pressure to meet financial targets.

Opportunities

Nature of Industry / operations

- Strong financial presence ↓ × ALP trans^{n} ← Supplier, customer
- R.P.Ts / Intermediaries / complex Trans^{n} [o/s N.C.O.B.] (No Business justification) (year end)

Eg. Enron case

- International
  - operations in o/s jurisdictions
  - Subsy / Branches in tax havens.

Alc Estimates

- Mgt domination ↓
  - TCWG oversight ×

Complex / unstable org. structure

- Difficult → Control? ↓
  - complex org. structure ↓
    - High turnover of Sr. Mgt / legal counsel / TCWG.

Deficient Internal Control.

- Alc system ineffective [P2P Invoice pay ✓] ↓
  - Monitoring × ↓
    - High turnover rates (internal auditor, IT staff etc.)

Foreign Entity

51% ↙ 51% ↓ 51% ↘

FC_1 FC_2 FC_3

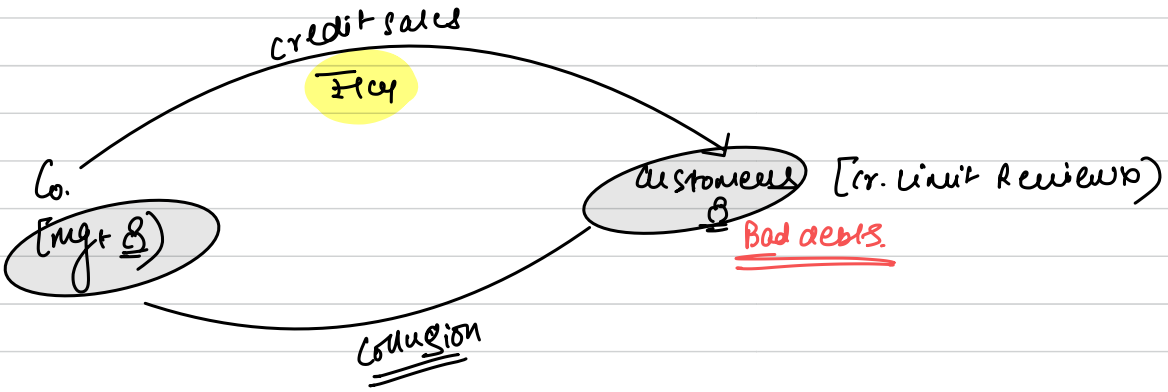
20% ↓ 20% ↓ 20%

Indian Co.

Attitude / Rationalisation (justify) (Fraud → purpose)

- Intt. to maintain / increase stock price / earnings
- [Egoistic / Rationalisation] committing analysts / creditors to achieve unrealistic targets.
- (Tax Saver) Minimize Earnings reported to save tax.
- (Make personal profits) violation of security laws eg Insider Trading
- (Motivation) ∞ low morale of Sr. Mgt. eg. lack of motivation in Sr. Mgt to point out frauds.

Ans 3



Fraud Risk factors : Misappropriation of Assets

1. Incentive / Pressure : Personal financial obligation on employees / Mgt having access to cash / other assets.

Adverse relation b/w entity & employees having access to cash / other assets.

Created by :

① changes to employee compensation ② Promotion not as per expectations ③ Expected lay offs.

2. opportunities : eg
   - large amts of cash on hand
   - Inventory Items : ↓ size, ↑ value + Demand eg medicines
   - Fixed Assets : ↓ size, ↑ value, lack identification of ownership eg laptop / mobile
   - Convertible Assets : Bearer Bonds, diamonds, computer chips → cash eg i9, i7 processor.

Inadequate I.Cs over assets → Increase chances of Misappropriation. (chori)

Examples

BOD

Chori kyu hui?

DOPRe nein SOD nahi thal

[Imp]

Inadequate
- Documentation of transn. Eg credits for goods returned.
- oversight of Sr. mgt expense. Eg travel reimbursements.
- physical safeguards over cash, inventory etc.
- Record keeping w.r.t. assets. Eg PPE/Inventory registers
- Segregation of duties / checks.

3. Attitude / Rationalisation

Disregard for:
- Monitoring of risks } over misapp. of Assets.
- Internal control

Behaviours
- of dissatisfaction with entity.
- changes, indicate assets misappropriated.

Tolerance for petty thefts.

& Emp — & Supplier [lifestyle changes: Big car / iPhone Pro max]
collusion
Ant farm

Cases:

1) [Fake]

goods Return
Documentation ✗

Customer
Co. employee

Co.

Actual credit (Refund)

2. Segregation of Duties (SODs) Eg Purchases

& Purchase Authorise → & Execute → & custody (warehouse) → & Records / DOCs

Fraud? "Collusion" (chances ↓)

[Attitude]

Examples showing (strained) strained relationships b/w mgt & auditor [4M] DUFRE

- Dominating mgt behaviour with auditor. Influencing scope, selection / continuance of auditor. TOCSP
- Unreasonable demands on auditor. [Time constraints] 2 weeks → complete [Generally 2 months]
- Frequent disputes with auditor
- Restrictions on auditor. [Limit Access / people / Info. / TCWG]

Notes:

- Fraud Risk factors → Relevance for auditor? → Indicate RONUM due to fraud.
- E.T. discussion?

F.S. fraud → How? / where? [F.S.] } what if E.T. believes Mgt TCWG are honest? Yes

- Audit Procedures

1. Risk Assessment Procedures

Inquiry [mgt & others (IA auditor / sales etc)] (CFO)

- Understand → how TCWG oversees ↓ mgt process of identifying & high value [fictitious sales] Responding to fraud risk ↓ & internal controls to mitigate risk.

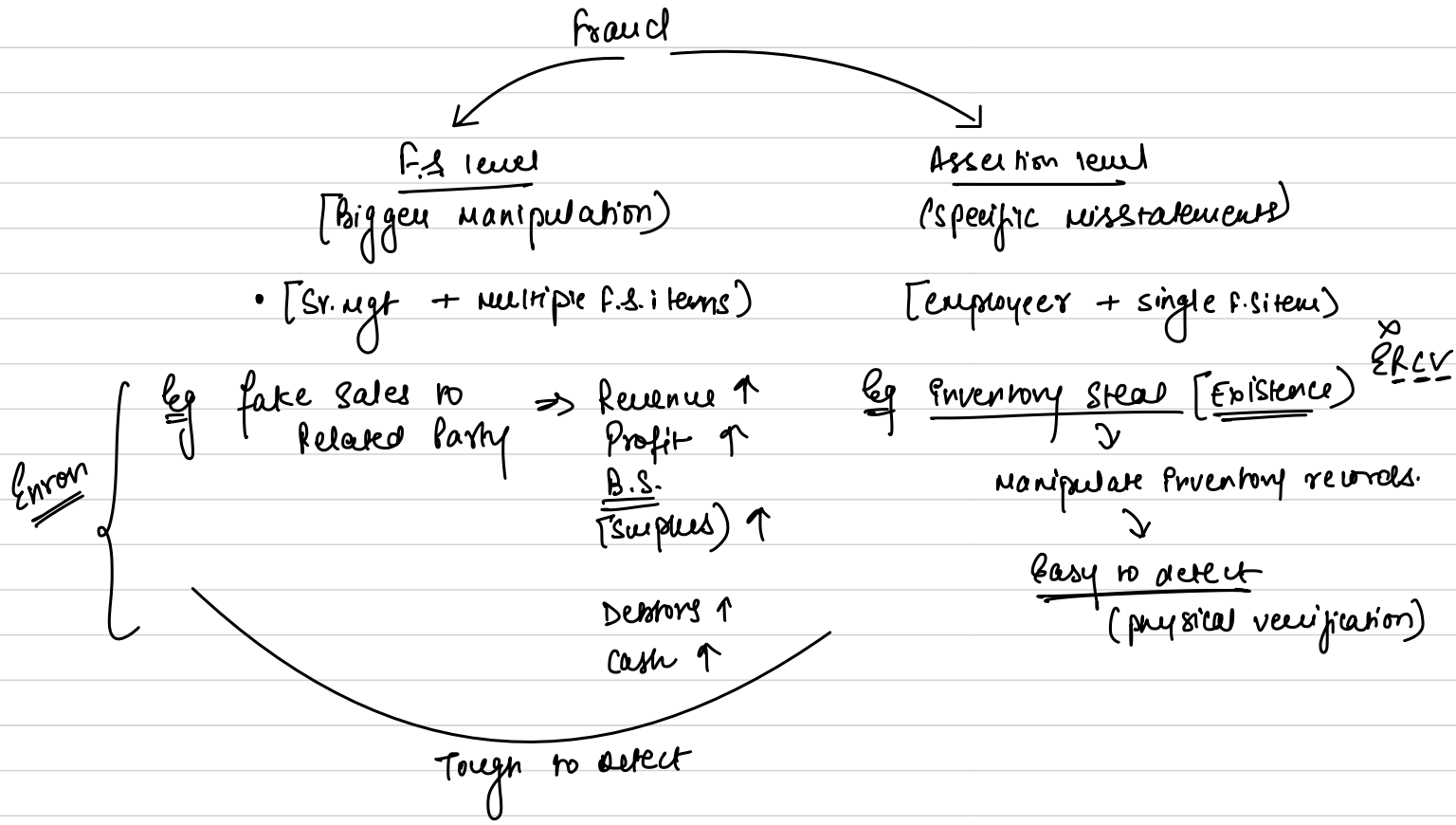
{ sales > ₹10,00,000 ⇒ CFO Approval ⊕ Match — order / invoice / Delivery doc - [e-way bill, courier etc] }

Analytical Procedures

Evaluation of unexpected relationships.

[Sales 20% ↑ shipping expense 10% ↓] ↓? Re-negotiate → Docs? genuine?

{ Ref C.Y. P.Y variance % ⇒ RONMT ↑ }



Responses to fraud at F.S. level

① Evaluate A/c policies
↓
related to subjective measurements (A/c estimates)
&
complex transactions
↓
that whether it's F.F.R to manage earnings.

eg: Co. goods => 2 years warranty
- mgt assume 1% of products need repair [Industry avg 5%]
- ↓ cont. liab ✓ provisions
  cost recognise
  ↓
  claims happen.

② Include unpredictability in NTE of Audit Procedures.

eg 1. Surprise verification - Inventory / Cash

2. Year end trans^n ⊕
Test trans^n end of Q_1 / Q_2 ... (midyear)

③ Assign & supervise personnel considering
- Knowledge
- Skill
- Ability

of individuals.

eg Revenue / Inventory etc.
↓
Risky Areas
- Novice ∞
- Experienced

AP on Personnel (SkA)

2 min

Evaluation of Audit Evidence

↓

Misstatement identified

↓

Fraud?

↓

(Yes)

↓

Mgt Involved

- → Reassess RoMM due to fraud ↑
- → N.T.E of A.Pro. ↑
- → W.R. Rely ×
- (collusion) → [employees + Mgt + 3rd parties]

↓

Reconsider reliability of other evidence [Eg confirmations]

Audit Implications

Unable to complete Audit Engg (SA 705)

Report

(CARO 2020) (Central Govt)

Determine professional & legal responsibilities

↓

to Report to

Person(s) who appointed auditor [CARO 2020)

or

Regulatory Authorities [Eg 143(12) → CG]

Withdraw

- consider possibility

↓

- If auditor withdraws

↓

"Report" withdrawal + Reasons

↓

Mgt & TCWG

ADT-3 // 30 days / Co. / Reasons / AoC

&

professional & legal responsibilities to Report to Regulatory Authorities.

Eg ROC

Clause (xi) of Para 3 of CARO 2020

(Matter of EM)

Any fraud

↓

By or on Co.

↓

noticed / reported during year

↓

Nature & amt of fraud.

Any report u/s 143(12) of Cos. Act 2013

↓

filed with CG in form ADT-4

Considered whistle blower complaints

↓

recd. by Co. during year.

Fraud → !! not to police after don

Sec 143(12) of Cos. Act 2013

Case I [Fraud 1cr or above]

① Fraud 1cr or above in Co. by KMP officer / employee [Individually] → ② Report to BOD/A.C. in 2 days & seek reply in 45 days.

Reply ✓ ↓ → ③ Report + Reply + Comments → ④ Send to Secretary, MCA within 15 days of reply [ADT-4]

Reply ✗ ↓ → only Report

Case II If fraud < 1cr → report to AC / BOD within 2 days.
[Specify: NAP of fraud (Nature / Amt / Parties)

Q5 15.3.2024 Purchases ⇒ pay ✗ ⇒ Documents ✗ } • fictitious JE • Reporting → prof / legal resp. ⇒ Reg. Auth. ⇒ owners.

- Sec 143(12)
- CARO 2020.

Communication to Mgt / TCWG

• fraud identify → mgt involved → ✗ ⇒ inform mgt
↓
✓ / suspected
↓
inform TCWG

Presumption of fraud risk in Revenue Recognition

fraud risk maybe resulted [present ✗] → Single simple revenue structure
eg. lease revenue from single property.

high probability of fraud risk → complex Revenue Structure or lack of controls.

Q6 Arihant Ltd

- Hotels
- Tourism packages
- Airline booking

→ complex Revenue Structure

+ [controls weak] ⇒ fraud Risk Yes

SAS Refer

Ans
- As per SA 240 & SA 315, identify & assess RoMM due to fraud at FS & assertion level.

Presumption
- Auditor shall presume fraud risk in revenue recognition.

SAS sequel
- As per SA 240 & SA 330, respond to RoMM due to fraud at FS & Assertion level.

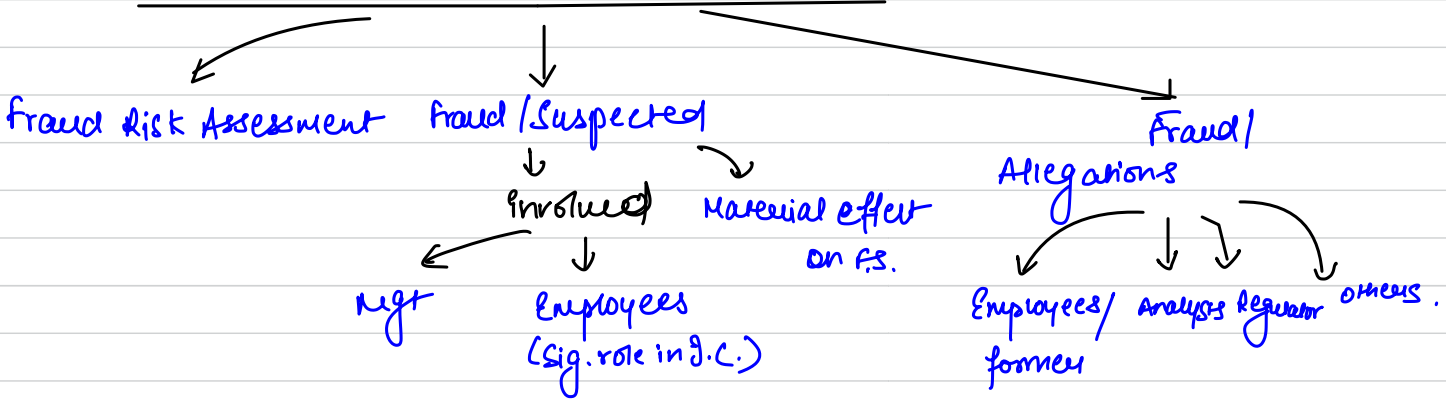
Presumption (Detail)
- Presumption of fraud risk in Revenue recognition maybe rebutted. eg. for single simple revenue structure.
- But, if its a complex revenue structure or lack of controls, then high probability of fraud risk.
- Obtaining understanding of entity is continuous, dynamic process of gathering, updating & analysing info. throughout audit.

Facts: ₹35 cr. revenue fraud occurred in the Co.

Conclusion:
- Auditor should have recognised fraud risk (Sig. Risk) due to complexity of revenue structure & deficient internal controls.
- Also, since fraud ≥ 1 cr, report to C.G. u/s 143(12) of Cos. Act 2013.

Written Representation

- Mgt → DIM of IC → prevent & detect fraud
- Disclosed to auditor



Summary of SA240

① **Fraud techniques**
- **Fraudulent financial Reporting**: Manipulation + Misapplication + Misrepresentation
  [Alc Records/supp.docs] [Alc Prin. → AEPD] [Events/Trans^n]
- **Mgt override of controls**: Altering Significant FACCT
  [items → sig. trans^n] [Fictitious J.E. (end of Alc period) + Assump. Alc Est. + Complex Trans^n + Unusual Trans^n ∈ A ∉ A + {
- **Misapp. of Assets**: Goods [steal/personal use) + Cash [Receipts embezzle + fictitious pay.)

② **Auditor Resp**: RA → ILA (Risk of MM Detect^n) → Fraud > Error → Mgt fraud > E.E. fraud → Prof skep. → R/D genuine ✓ → Investigate [R/D manipulate + inquiry response inconsistent)

③ **Fraud Risk factors** [F.F.R + Misapp. of Assets) → Indicate RoMM due to fraud.
(Attitude / Incentive/Pressure / Opportunity) [covers from charts + Book)

④ **R.A.P.** [Inquiry (Risk & controls) + Analytical Procedures)

⑤ **Responses to fraud** [S/F/A]
- **FS. level** [AA Un Personnel): Alc policy + Unpredictability Appro. + Personnel
- **Assertion level**: Relevant & Reliable evidence or corroborative info. eg sales contract: customer (confirm) | non-fin. person (inquiry)
- **Mgt override of controls**: J.E. Testing + Alc Estimate [Bias?) + Trans^n OIS N.C.O.B. [unusual → Business Rationale?

⑥ **Audit Evidence**: fraud ✓ → Mgt involve ✓ → RoMM (fraud) + N.T.E of A.Pro. + W.R. Rely ✗ + collusion [other A.E. Rely ✗)

⑦ **Unable to complete Engg**: Report [✗ Appointment/Reg.auth.) + withdraw & Report [mgt/TCWG + Reg.auth.)

⑧ **W.R.**: DIM of IC + Disclosed to auditor [fraud risk Assessment + fraud [suspected]
(mgt involved; comm. by EE/Reg./others)

⑨ **Fraud Risk Presumption** (RR):
- Recruitment → Single Simple Revenue Structure → Retail (single Property)
- High fraud Risk → Complex Revenue structure or lack of controls.

⑩ **Communicate to mgt & TCWG**

⑪ **Document**: Decisions of FS. fraud + RoMM due to fraud (FS + Assertion level) → Responses + NTE of Pro. → Results + Communications [mgt, TCWG, others)

⑫ **Add^n Reporting**: clause 6(i) Para 3 CARO 2020 + [ICM or above] Co's officers/EE ⇒ CG [Sec 143(12)]