



SA 240 – The Auditor’s Responsibility Relating to Fraud in an Audit of Financial Statements

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WIRC ICAI
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How many of you have come across some or other frauds?



The fraudster's greatest liability is the certainty that the fraud is too clever to be detected.

— *Louis J. Freeh* —

AZ QUOTES

What is fraud?

As per SA 240:- 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.



Characteristics of Fraud

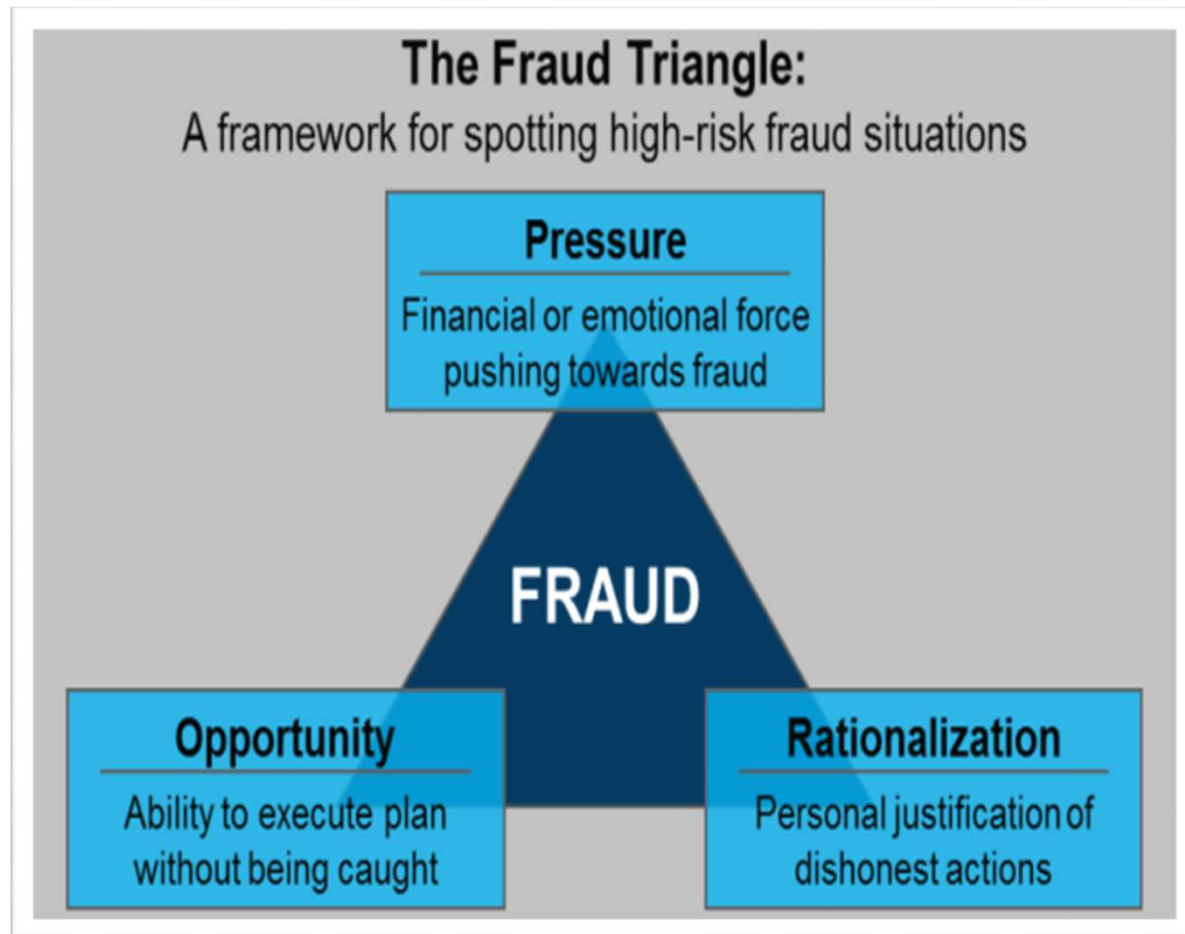
- Although **fraud** is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Financial statement misstatements arise from either **fraud** or **error**.
- Distinguishing factor between fraud & error is whether the underlying action that results in the misstatement of financial statements is **intentional** or **unintentional**.

Single audit observations can lead to change in Audit Planning & Strategy



Fraud Triangle

Fraud Risk Factors – Events or conditions that indicate (a) an incentive or pressure to commit fraud or (b) provide an opportunity to commit fraud





**Excerpts from
Regulators**

Audit Quality Review 2021 - QRB

- As per the latest report of Quality Review Board dated 26th-October-21:

The following Auditor's Responsibilities have not been followed properly in relation to SA 240 by 9% of the audit firms. (sample size 33)

- Documenting performance of audit procedures including making inquiries of management or those charged with governance (TCWG). [para 44, A19 and A20]
- Making inquiries of internal auditor and TCWG to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. [para 19]
- Obtaining written representations from the management or TCWG
 1. The matters as stated in Para 39 of SA 240.
 2. That they have disclosed to the auditor the results of its management's assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Audit Quality Review Report by NFRA

- As per the AQRR dated 23rd September-21 issued for **IL&FS Transportation Networks Limited**,
- The Audit Firm did not discuss susceptibility of the financial statements to material misstatement due to fraud, and did not identify and assess revenue recognition and management override of controls as presumed fraud risks. (Para A4, SA 315).
- There is no discussion on understanding the entity to perform risk assessment procedures to identify and assess fraud risks, significant risks and other risks at financial statement level and assertion level. (Para 27, SA 240).
- The auditor has not only failed to identify revenue and management override of control as a fraud risk as required by SA 315 and SA 240, but also to document responses to the assessed risks as required by SA 330, and reasons for rebuttal of fraud risk as required by SA 240

Modus Operandi adopted by SEC to uncover financial statement fraud

- The U.S. Securities and Exchange Commission (SEC) has an Audit Quality Model referred to as “RoboCop” that analyzes financial statements within 24 hours of being submitted—to identify potential fraud.
- Not only are they analyzing the actual numbers, they’re analyzing the text to look for particular phrases, keywords, or linguistic elements used by bad actors to confuse readers on complex issues.
- The SEC has built this analysis based on prior fraudulent filers. So, with each new fraudulent filing, the analysis will become more accurate.

RBI Annual Report 2020-21

- The number of frauds reported during 2020-21 drop by 15% in terms of number and 25 % in terms of value, vis-à-vis 2019-20
- Frauds have been occurring predominantly in the loan portfolio (advances category)
- The average time lag between the date of occurrence of frauds and the date of detection was 23 months for the frauds reported in 2020-21 for frauds below Rs 100 crore and 57 months for +100 crore fraud.
- Introduction of dedicated market intelligence (MI) unit for frauds and implementation of automated unique system generated number for each fraud.

IFAC Audit Consideration due to Covid

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the auditor to make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. If the auditor is unable to conduct fraud interviews in person due to Covid-19, these inquiries could be done utilizing technology such as video conferencing. This may be preferred to only telephone conversations because auditors can still see management's body language.



**Illustrations from
published accounts**

Mahindra & Mahindra Ltd March-20

- **Reporting in CARO**

- During the course of our examination of the books and records of the Company, carried out in accordance with the generally accepted auditing practices in India, and according to the information and explanations given to us, we have neither come across any instance of fraud by the Company or any **material instances of fraud** on the Company by its officers or employees, noticed or reported during the year, nor have we been informed of any such case by the management.

Supreme Industries Ltd March-21

– **Disclosure in notes to accounts**

- There was an instance of fraud by way of embezzlement by an employee during the year under review involving an amount of Rs 40 lakhs at its manufacturing unit at Noida. The Company has taken all requisite steps and an amount of Rs 31 lakhs has since been recovered, Rs 5 lakh is under process of recovery and Rs 4 lakh has been provided for

– **Reporting in CARO**

- Above point was reported stating that it Noida unit was audited by branch auditor.

Muthoot Finance Limited Mar-20

– Disclosure in Notes to Accounts

- During the year frauds committed by employees and customers of the company amounted to Rs 25.94 millions (March 31,2019 : Rs 38.31 Millions) which has been recovered/written off / provided for. Of the above, fraud by employees of the company amounted to Rs 23.20 Millions (March 31,2019 : Rs 33.52 Millions)

– Reporting in CARO

- During the course of our examination of the books and records of the company carried out in accordance with generally accepted auditing practices in India and according to the information and explanations given to us, there have been instances of fraud on the company by its employees amounting to Rs. 23.20 millions as included in Note 50 (extract given above for reference) to the standalone financial statements. No fraud by the company has been noticed or reported during the year, nor have we been informed of any such case by the management.

Manapuram March-21

- **Reporting in CARO**

- To the best of our knowledge and according to the information and explanations given to us, no fraud by the Company and no material fraud on the company by its officers or employees has been noticed or reported during the year other than those disclosed in Note 63 to the financial statements.

- **Note 63**

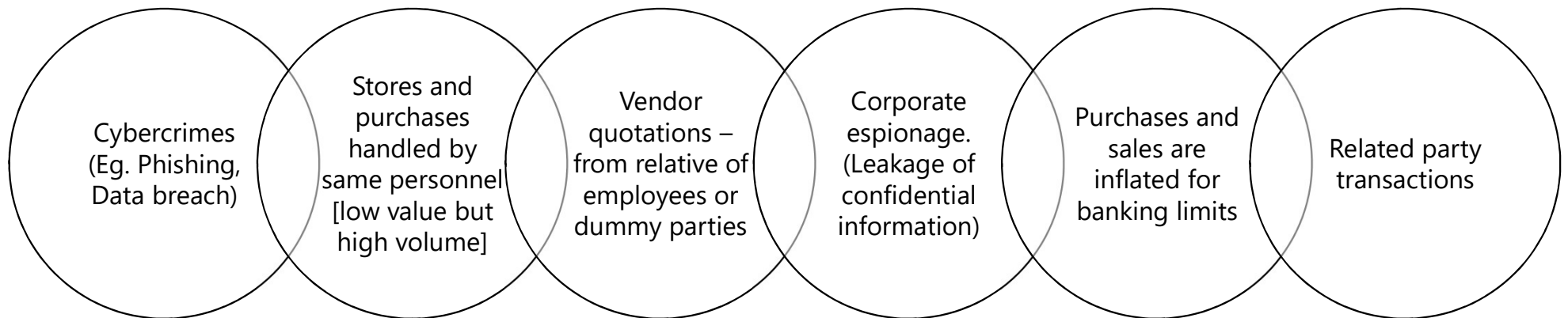
- During the year there have been certain instances of fraud on the Company by officers and employees where gold loan related misappropriations / cash embezzlements / burglaries have occurred for amounts aggregating an amount of Rs 142.24 Million (31st March, 2020 Rs 78.33 Million) of which the Company has recovered Rs.17.23 million (31st March, 2020 Rs 0.06 million). The Company has taken insurance cover for such losses and has filed insurance claims in this regard. Further, the Company is in the process of recovering these amounts from the employees and taking legal actions, where applicable. In addition the Company has created provision aggregating to Rs. 125 million towards these losses based on its estimate.

Potential Fraud & Misappropriation risks reported under KAM

Revenue overstated to achieve performance targets

Risk of material misstatement arising from technology

Other areas susceptible to fraud



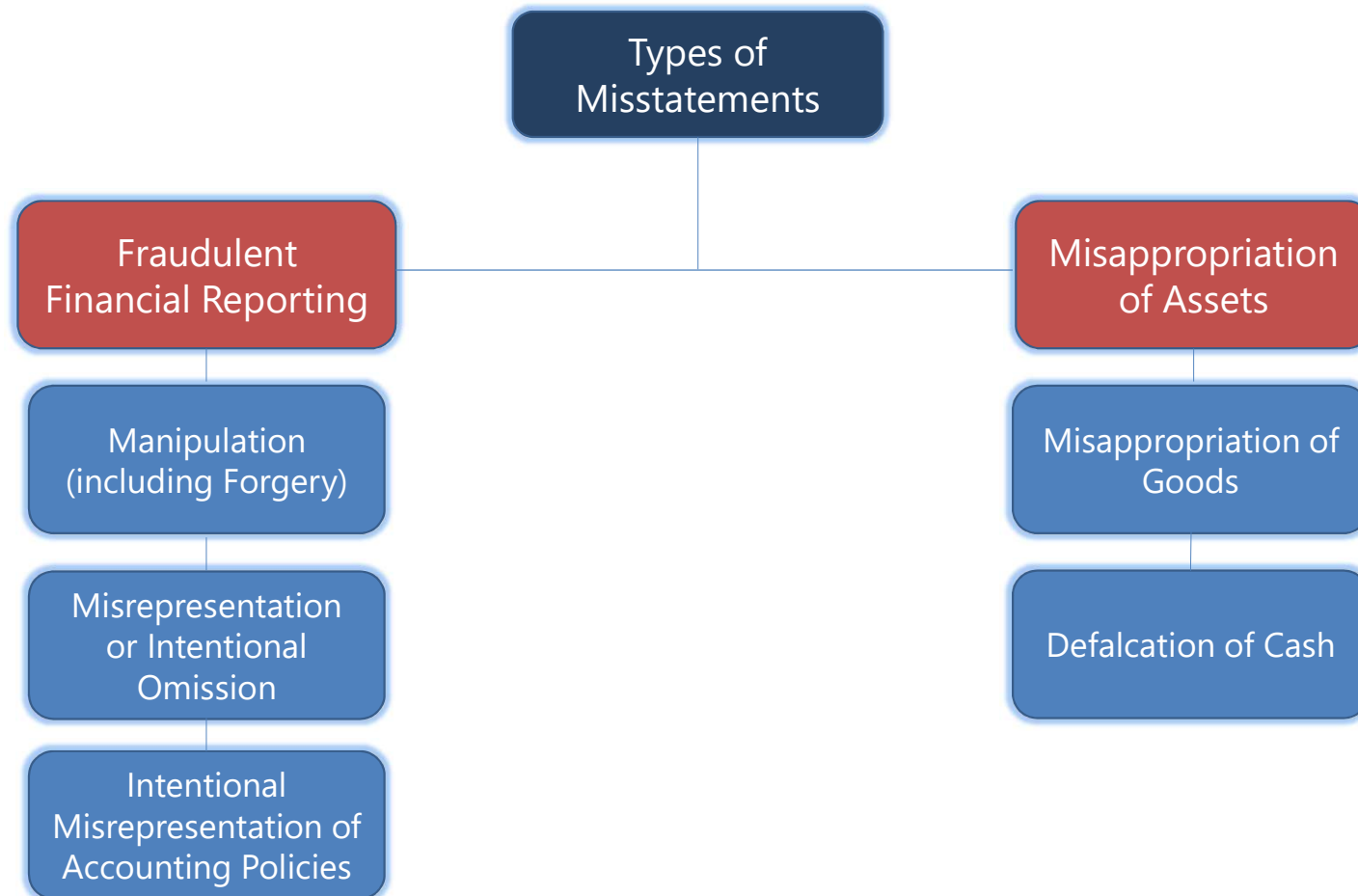


Overview of SA 240 and
Auditors responsibility
under Companies Act, 2013

Coverage of Topics from SA 240

- Types of Misstatements
- Objectives of Auditor with respect to misstatement of financial information
- Professional scepticism
- Auditor's Responsibilities
- Internal Controls
- Considerations specific to smaller and new age entities
- Audit of Charitable Organisations
- Overview of requirement u/s 143(12)
- Reporting under CARO
- Risk assessment procedures
- Auditors Responses
- Evaluation of Audit Evidence
- Auditor unable to continue the engagement
- Documentation

Misstatements in the financial statements



Objectives of Auditor

- Auditor's objectives with respect to the financial statements misstatements are as follows:

Identify and assess the risk of material misstatement due to fraud

Obtain sufficient and appropriate audit evidence

Respond appropriately to the identified or suspected fraud

Professional skepticism

What is professional Skepticism???????

- Attitude that includes a questioning mind
- Critical assessment of Audit Evidence
- Being alert of conditions which may indicate possible misstatement due to fraud or error
- Investigate the inconsistent responses from the management related to the inquiries.
- SA 315 which covers the Auditor's response to assessed risks, requires discussion among the engagement team members and the engagement partner on those matters which are to be communicated to other team members not involved in the discussion.



What are Auditor's Responsibilities?

Obtain reasonable assurance that the FS are free from material misstatements

Risk of non-detection of management fraud is greater than of employee fraud

Maintain professional scepticism throughout the audit

Risk of non-detection of fraudulent material misstatement is higher than the misstatement due to error.

Is Auditor responsible for the Prevention and Detection of Fraud?

- No, Management has the Primary responsibility for the prevention and detection of fraud and not the auditor. Management should take all necessary steps for fraud prevention and deterrence through implementing policies and controls.

Internal Controls

- A commitment to quality and good internal controls at the highest levels of an organization may avoid many financial problems
- Here are three good reasons why you should focus on internal controls:
 - (1) to protect yourself against the unscrupulous conduct of employees
 - (2) to prevent and detect problems before they can hurt
 - (3) because poor internal controls can lead to misleading financial statements

Considerations Specific to smaller entities

Manual controls

No segregation of duties

Promoter driven

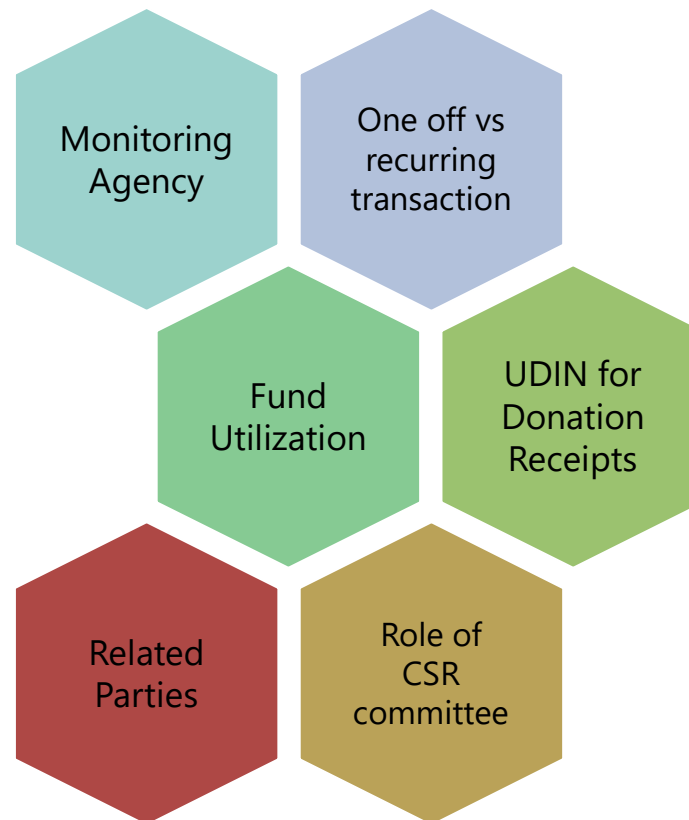
No SOP's

ERP Controls are weak

New age entrepreneurs & Business models

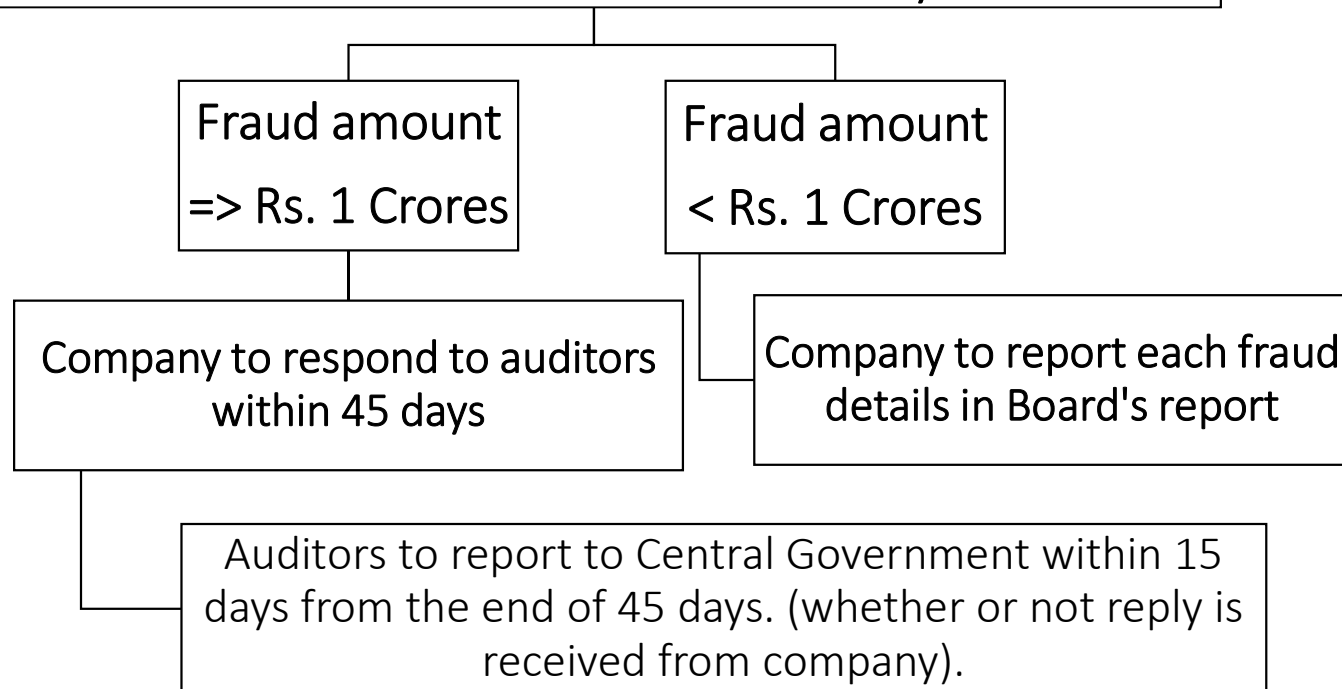
- The internet revolution has given birth to a series of innovative digital industries which are snowballing in size, and getting tough to ignore.
- As Nirmala Sitharaman said “New age industries will be the catalyst and will make a big change to global economy as a whole”.
- Auditors of such entities needs to customized their audit strategy, audit procedures & risk analytical procedures for such kind of industries/business.
- Crypto Exchanges
- EdTech (E.g. – BYJU’S, Unacademy)
- Fintech (E.g. – Paytm, Phone pay)
- E-commerce (E.g.- Flipkart, Amazon)
- FoodTech (E.g.- Zomato, & Swiggy)
- Others (Ola, OYO, Dream11)

Audit of Charitable Organization



Overview of requirement u/s 143(12)

As per section 143(12) of Co. Act, all frauds against the company by its officers or employees to be reported by auditors to Board or Audit Committee in **2 days**



Reporting under CARO 2020

- CARO 2020 has also mandated for reporting in case where:
 - Fraud is committed by the Company or
 - Fraud is committed on the Company.

Auditor needs to disclose the nature and amount of fraud in CARO in both the above cases.



- Any report under section 143(12) of the Companies Act has been filed by the auditors in Form ADT-4 with the Central Govt. Further, suspected frauds are not required to be reported under CARO.
- Auditor has considered the complaints received from Whistle Blowers.

Risk Assessment Procedures

- To obtain information which is used for risk identification, auditors shall:

Enquire the management about the **Controls**
and **Oversights**

Assessment of risk to financials due to fraud- nature, extent & frequency of such assessment

Process of Identifying & responding to risk of fraud including fraud already identified

Communication to those charged with governance for identifying & responding to risk of fraud

Communication to employees regarding its view on business practice & ethical behavior

Risk Assessment Procedures (continued..)

To **inquire**

- the management,
- internal audit team and
- those charged with governance

whether any instance of actual or alleged fraud has occurred in the past and obtain their respective views on the risk of fraud.

- Consider whether any other information obtained indicates the risk of fraud.
- Evaluate any **fraud risk factors** are present from the information obtained from the assessment.
- Identify unusual or unexpected relationship while performing analytical procedure and evaluate them to assess the risk of material misstatement due to fraud.

Auditor's Responses

A. To the Risk of Material Misstatement due to fraud-

As Per SA 330, the auditor to determine overall responses to address the assessed risk through:

- Assign and supervise personnel taking significant engagement responsibilities.
- Evaluate accounting policies to be indicative of fraudulent financial reporting.
- Incorporate audit procedures to be executed to include an element of unpredictability.
- Management override of controls.

B. To the Risk related to Management Overrides of Control-

- In order to mitigate the risk of management override of controls, auditor to design and perform the following Audit procedures:
- Test the appropriateness of journal entries
- Review accounting estimates
- Evaluate unusual transactions
- Perform further audit procedures

Evaluation of Audit Evidence

Auditor shall evaluate whether they are:

- indicative of previously unrecognized risk of material misstatement due to fraud
- indicative of fraud
- In case of fraudulent misstatement where auditor believes management is involved, then
 - (a) re-evaluate the response to the assessed risk
 - (b) If unable to conclude if the financials are fraudulently misstated, then the auditor to evaluate the implications for the audit.

NOTE: 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, then the auditor shall withdraw from the audit if appropriate and report to the person who made audit appointment.

Auditor Unable to Continue the Engagement

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:

- Determine the professional and legal responsibilities applicable in the circumstances,
- Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is **legally permitted**; and
- If the auditor withdraws:
 1. Discuss with the appropriate level of management , the reasons for the withdrawal; and
 2. Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment.

For Instance-

- PWC in its letter also pointed out it was threatened by the two companies (Reliance Capital & Reliance home finance) with legal action. "... vide its letter dated June 9, 2019, The Companies threatened us with legal proceedings including civil and criminal proceedings, in the event we proceed to discharge our duties as prescribed by law... such actions create an intimidation threat for us and prevent us from performing our duties as statutory auditors of the company..."

Documentation

- The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by **SA 315** shall include:

(a) Decisions reached during the discussion among the engagement team regarding the susceptibility of fraud; and

(b) The identified and assessed risks of material misstatement due to fraud.



- The auditor's documentation of the responses to the assessed risks of material misstatement required by **SA 330** shall include:

(a) The overall responses to the assessed risks at the financial statement level and the linkage of those procedures with material misstatement due to fraud at the assertion level; and

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

Key Takeaways

Vigilant

Assertion

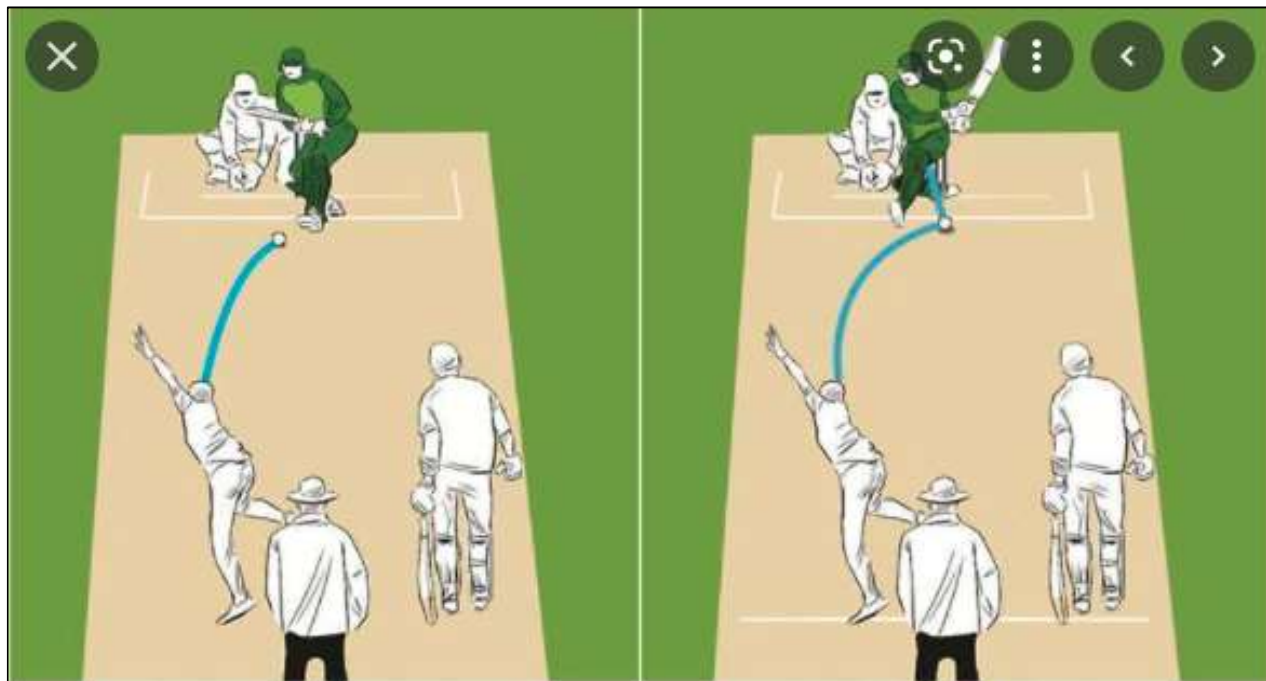
IT control &
system audit

Site visit for audit

Documentation

Unpredictability in Audit procedures

- Low value transactions ,Inquiry for absconded employees and high attrition rate. Vendor/Customer invoices with same addresses, Correlating employee asceticism records with ERP log records





THANK YOU

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