Seminar on : SA 240 (Revised) – The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements

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29 November 2014

Overview of SA 240

- Overview
  - Introduction
  - Definitions
- Requirements of the standard
  - Responsibility Relating to Fraud in an Audit of Financial Statements
  - Risk assessment procedures and related activities
  - Identification and assessment of the risks of material misstatement due to fraud and responses to such risks
  - Communication with management, Those charged with goverance (TCCG), regulators and others
  - Management Representation and Documentation

Overview - Scope

- SA 240 is to deal with Auditor's responsibilities relating to fraud in an audit of financial statements.

- It expands on how SA 315 " Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, " The Auditor's Response to Assessed Risks," are to be applied in relation to risks of material misstatement due to fraud.

Overview – Objective (SA 240)

Identify and assess risk of material misstatements whether due to fraud

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Obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud through designing and implementing appropriate response

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Respond appropriately to the identified and suspected fraud

Definitions

- ***Fraud*** is an intentional act by one or more individuals among management, TCWG, employees, or third parties, involving use of deception to obtain an unjust or illegal advantage

- ***Fraud risk factors*** Events or conditions that indicate and incentive or pressure to commit fraud or is an intentional act by one or more individuals among management, TCWG, employees, or third parties, involving use of deception to obtain an unjust or illegal advantage

Characteristics of Fraud

- 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's :

  -Misstatements resulting from fraudulent financial reporting

  -Misstatements resulting from misappropriation of assets

- Although the auditor may suspect or, in rare cases identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

Examples

Fraudulent Financial Reporting

- **Misrepresentation in, or intentional omission** from, the financial statements of events, transactions, or other significant information
- **Manipulation, falsification or alteration of records or documents** from which financial statements are prepared
- **Intentional misapplication** of accounting principles relating to amounts, **classification**, **manner of presentation**, **or disclosures**.

Examples include:

Recording fictitious journal entries, particularly close to the end of accounting period, to manipulate operating results

Misappropriation

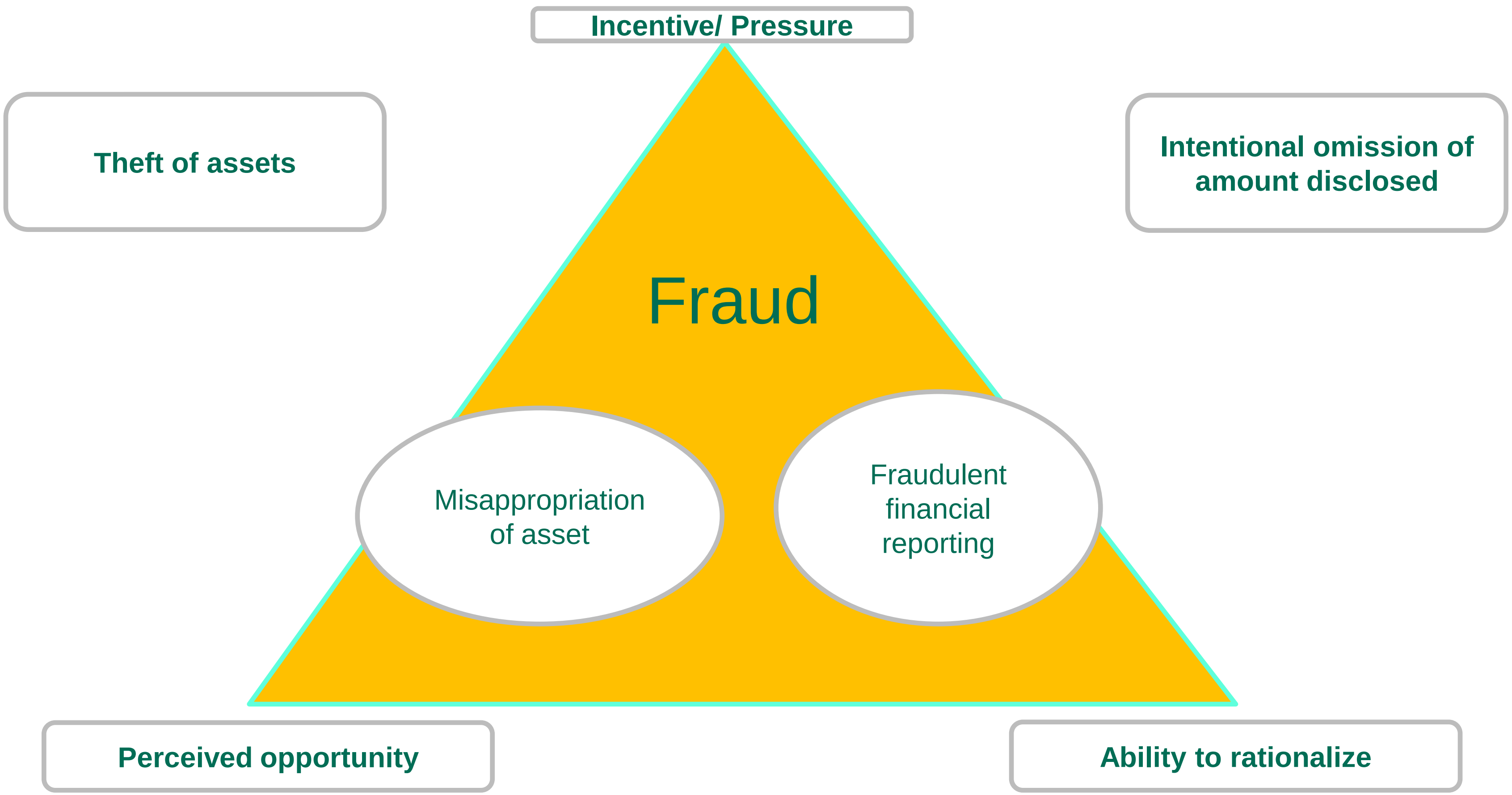
- Misappropriation of assets – often accompanied by false or misleading records in order to conceal that the assets are missing

Examples include:

- Embezzling receipts
- Stealing physical assets or intellectual property

Fraud Triangle

- There are three conditions generally present when fraud occurs



Error

Unintentional mistakes in financial information such as

- mathematical or clerical mistakes in the underlying records and accounting data;
- Incorrect accounting estimate arising from oversight or misinterpretation of facts; or
- misapplication of accounting policies.

Distinguishing Factor

- The distinguishing factor between fraud and error is whether the **underlying action** that **results in the misstatement** in the financial statements is **intentional or unintentional**.
- Fraud is intentional and usually involves deliberate concealment of the facts.
- While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

Responsibility Relating to Fraud in an Audit of Financial Statements – TCWG & Management

✓ Management:

- Establish proper policies.
- Emphasis on ethics and honesty.

✓ Those charged with governance:

- ▪ Oversight of management policies.
- ▪ Consider potential for management override of controls.
- ▪ Consider potential for management's inappropriate influence on financial reporting.

Auditor's Responsibility for Prevention and Detection of Fraud

- ✓ The primary responsibility for the prevention and detection of fraud rests with both TCWG of the entity and management.
- ✓ Obtain reasonable assurance that financial statements are free of material misstatements, whether caused by fraud or error.
- ✓ Owing to the inherent limitation of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be deducted even though the audit is properly planned and performed in accordance with the SAs.(SA 200 " Objective and General Principal Governing and Audit of Financial Statements")

Requirements

a) Professional Skepticism

- The auditor shall maintain attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatements due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's managements and TCWG

b) Discussion among the Engagement Team

-SA 315 requires a discussion among the team particularly emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

Risk Assessment procedure and Related Activities

Auditor shall performed shall perform the following procedure to identify the risks of material misstatement due to fraud

- *Management and Other's within the Entity* - The auditor shall make inquiries of regarding (a) Management's assessment of risk (b) Management's' process for identifying responding to the risk (c) Management's communication to those charged with governess (d) Management's communication to employee.

  The auditor can also make inquiries with the internal audit function in this regard.

- *Those Changed with Governance* - Obtain understanding of how those TCWG exercise oversight of management's process for identifying and responding to the risk of material misstatement due to fraud

Risk Assessment procedure and Related Activities (continued)

Unusual or Unexpected Relationship - The auditors should identify Unusual or unexpected relationship while performing analytical procedure and evaluate them to assess the risk of material misstatement due to fraud.

Evaluation of Fraud Risk Factors - *The auditor may identify events or conditions that indicate the existence of fraud risk factors, e.g. ineffective control environment, the need to meet expectations of third parties to obtain additional financing etc.*

Responses to the assessed risk of material misstatement due to fraud

- The Auditor Shall :
  a) Assign proper audit personnel
  b) Evaluate selection & application of accounting policies
  c) Incorporate unpredictability in audit procedures
  d) Presume fraud risk in revenue recognition and management override of controls.

Fraud Risk – Revenue Recognitions

As per SA 240, while identifying and assessing the risk of material misstatement, the standard requires auditors to presume **fraud risk in revenue recognition and management override of controls**. It requires the auditor to :

a) Evaluate the types of revenues / transactions / assertions leading to this risk

b) Document if presumption not applicable

c) Treat the assessed risk as significant risk

d) Obtain further understanding of internal controls

Fraud Risk – Management Override of controls

– Audit procedures responsive to risk of management override of controls

a) Test appropriateness of journal entries

b) Review accounting estimates for biases

c) Evaluate business rationale for unusual /significant transactions

d) Any other audit procedure, if required

Communication regarding the material misstatement due to fraud

- On identification of fraud or obtained information indicating fraud, auditor shall communicate these matters to appropriate level of management
- On identification of fraud or suspects fraud involving management, employees having significant roles in internal control or others, where the fraud results in a material misstatement in the financial statements, communicate these matters to TCWG
- report such fraud to regulatory and enforcement authorities, If the auditor has responsibility to do so

Communication regarding the material misstatement due to fraud

Q. Auditor's professional duty to maintain the confidentiality of client information precludes him from reporting any fraud to a party outside the entity such as regulatory and enforcement Authorities

True or False

Debrief : **False**

SA 240 states "auditor's legal responsibilities may override the duty of confidentiality in some circumstances"

Management Representation

The auditor shall obtain written representation from the management that :

- It acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud
- It has disclosed to the auditor the results of its assessment of the risk that the financial statement may be materially misstated as result of fraud
- It has disclosed to the auditor its knowledge of actual, suspected, or alleged fraud affecting the entity

Documentation as per SA 240

In addition to the certain documentation covered in SA 315, SA 240 further requires

a) Responses to the assessed risk
b) The results of the audit procedures designed to address the risk of management override of controls
c) Communication of fraud to management, TCWG, regulators and others
d) Reasons for non-applicability of presumption of risk of material misstatement relating to revenue recognition

Q&A session

Seminar on SA 315 – Identifying and Assessing the Risks of Material Misstatement through Understanding the entity and its environment.

-By CA Amyn Jassani

29 November 2014

Learning objectives

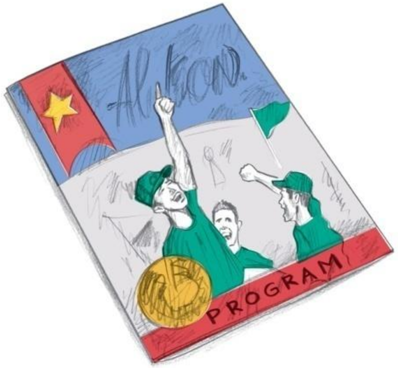
Assessing the "Doosra" effectively

- Understanding the top down, risk based approach
- Understanding risk assessment process
- Identifying and assessing the risk of material misstatement
- How to implement SA 315 for audit of SME
- Preparing an audit plan

Program guide

Risk Assessment procedures

- Overview
- Requirements of the standard
  - Risk Assessment Procedures and Related Activities
  - Understanding of the Entity and its Environment
  - Identifying and Assessing the Risks of Material misstatement
  - Documentation
- Practice Issues



Overview

First, back to game basics

- **What do we mean by Risk Assessment procedures**

  The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, *to identify and assess the risks of material misstatement* whether due to fraud or error, at the financial statement and assertion levels.

- **Why perform Risk Assessment**
  - Provides basis for designing and implementing responses to the assessed risks of material misstatement
  - Assist us to reduce the risk of material misstatement to an acceptably low level

What are the sources of information likely to assist in identifying risks of material misstatement?

a) Inquires of management and of others within the entity
b) Analytical Procedures
c) Observation and inspection
d) Information from client acceptance/ continuance process
e) Other engagements performed for the same entity
f) Auditors previous experience with the entity
g) Discussion of engagement team on susceptibility of the entity's financial statements to material misstatement
h) All of the above
i) A, B, C, and h

Debrief

What are the sources of information likely to assist in identifying risks of material misstatement?

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What should be the depth of Risk Assessment Procedure??

- Scope and depth of risk assessment procedure is purely based on auditor's judgment

- Scope and depth would be much higher in case of first year engagement with no previous industry experience

- In case of continuing client where information obtained in the first year is well documented, the time required to update the information in the subsequent year should be considerably less then the required in the first year

Understanding the Entity and its Environment including its internal control

External Factors:

- Relevant Industry
- Regulatory environment
- Applicable financial reporting framework

Other Factors:

- Nature of the entity, its operations, ownership and governance structures, types of investment (including Special- purpose entities)
- Selection of accounting policies
- Objectives and strategies and business risks
- Measurement and review of the entity’s financial performance

Evaluating Entity's Internal Control

The starting point

Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It's a matter of the auditor's professional judgment whether a control individually or in combination with others, is relevant to the audit.

Evaluating Entity's Internal Control

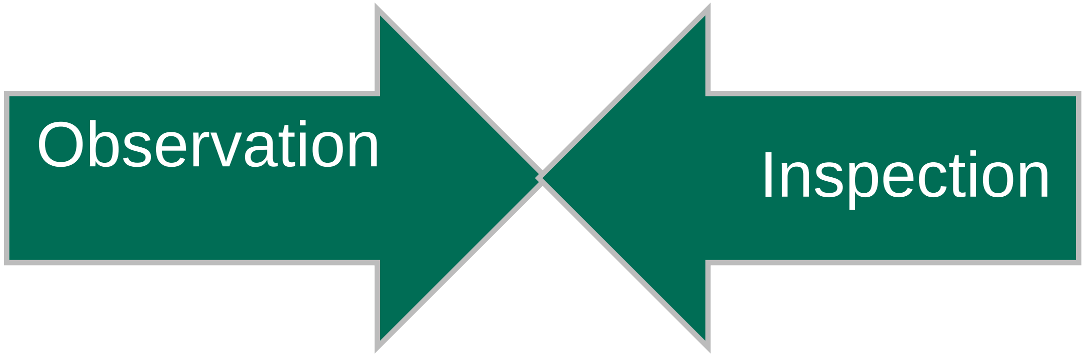
Components of Internal Control

- **C**ontrol Activities
- **R**isk assessment Process
- **I**nformation system, including the related business process relevant of financial reporting, and communication
- **M**onitoring of controls
- Control **E**nvironment

Reading the "Doosra" effectively

GAAS requirements

When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity’s personnel



Identifying and assessing the Risks of Material Misstatement
Considerations for the auditor

The auditor shall identify and assess the risks of material misstatement at

a) The financial statement level or
b) The assertion level for classes of transaction, account balances and disclosures

To provide a basis for designing and performing further audit procedures

True or False

Identifying and assessing the Risks of Material Misstatement

Considerations for the auditor

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To provide a basis for designing and performing further audit procedures

True or **False**

Steps involved in identifying and assessing the risks of material misstatement

a) Identify the risk by **understanding the entity and its environment**, including relevant controls related to the risk

b) Assess the identified risks and evaluate whether they are pervasive and potentially affect many assertions.

c) Relate the identified risk to WCGW at the assertion level

d) Consider the **likelihood of misstatement** and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that require Special Audit Consideration

Identifying **Significant Risk**

Whether the risk is

- A risk of fraud
- Related to recent significant economic, accounting or other developments
- Related to complexity of transactions
- Involves significant transactions with related parties.
- Involves significant transactions that are outside the normal course of business or appear to be unusual
- With degree of subjectivity in the measurement

Risks that require Special Audit Consideration

-Implication of **Significant Risk**

When the auditor has determined that a significant risks exists, the auditor shall obtain an understanding of entity’s control, including control activities, relevant to that risk.

Risks for which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

In respect of some risks, it may not be possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them.

Risks of inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention.

Documentation

The auditor shall document :

a) Engagement Team brainstorming and conclusions.

b) Key elements of the understanding regarding entity and its environment and each of the internal control components; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level

d) The risks identified, and related controls about which the auditor has obtained an understanding

Documenting the Risk Identification Procedure

Documenting the Risk Identification Procedure may involve three steps -

1. Information about the entity

2. Risk assessment procedure; and

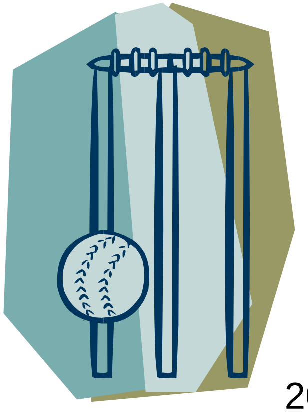
3. Relating identified risk to possible error and fraud in the Financial Statements

Practice Issues

Avoid the run outs

Failure to understand the requirements can lead to:

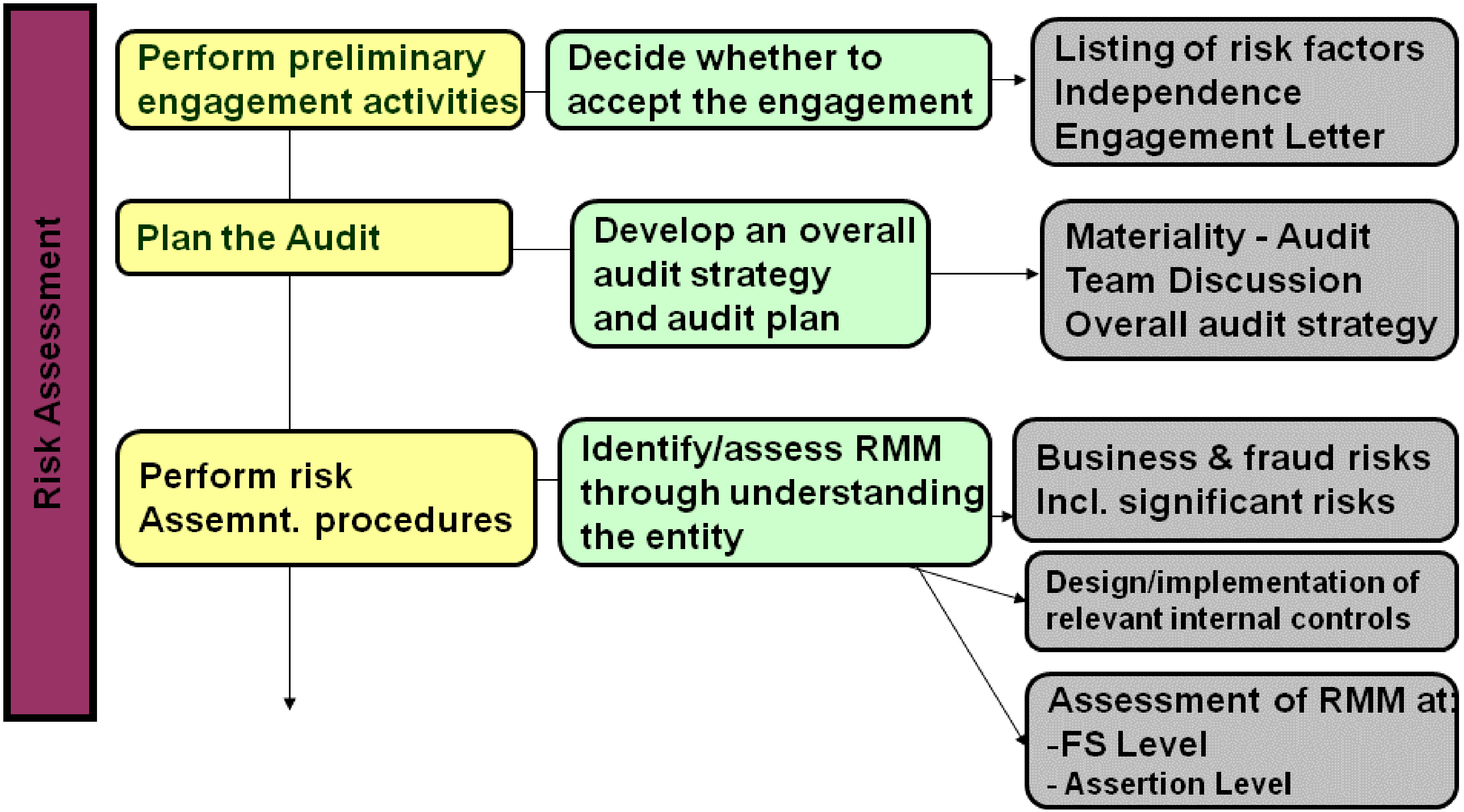
- Turning what should be a simple audit into a complex and time-consuming project.
- Failure to comply with a SA requirement
- The entire risk assessment phase becoming an ‘add-on’ to other substantive audit work performed



Relating identified risks to possible errors and fraud in the financial statements
Knowledge check

Step 1	Step 2	Step 3
Risk Source	Impact of Risk on Financial Statement (Errors or Fraud)	Financial Statement Area Affected or Pervasive Risk
Entity's Objective		
Introduction of a new product during the year	**Errors in cost allocation and inventory valuation**	**Inventory valuation**
	New product costing and pricing methodologies/systems could create opportunities for fraud to occur	**Inventory accuracy**
	The new financing required will make it difficult to comply with existing bank covenants, the loan may actually be payable on demand.	**Note disclosures on financing, debt covenants and loan classification**
	Management may be tempted to manipulate financial statements to ensure compliance with the bank covenants	**Pervasive risk**

Requirements under standard



Reading the Doosra effectively
Question/Answer