SYNOPSIS

SA 240 — *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* — Effective since April 1, 2009

The SA deals with the auditor's responsibilities relating to fraud in an audit of financial statements generally, and specifically in the backdrop of SA 315 and SA 330 on *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* and *The Auditor's Responses to Assessed Risks* respectively.

I. The underlined objective of the SA is that the auditor is to —

(a) identify and assess the risks of material misstatement in the financial statement due to fraud

(b) obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses, and

(c) respond appropriately to identified or suspected fraud

II. SA 240 requires the **auditor** to —

(a) though cannot be expected to disregard past experience of the honesty and integrity of the management (or those charged with governance), remain professionally skeptical throughout the audit in recognition of the possibility that a material misstatement due to fraud could exist (in accord with SA 200)

(b) investigate the matter further 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 him
- Responses of the management to inquiries are inconsistent

It also requires that particular emphasis on 'how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur' be placed in the discussion among the engagement team members [in accord with SA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*]

III. For the purpose obtaining an understanding of the entity and its environment, including entity's internal control, and, resultantly, to obtain information for use in identifying the risks of material misstatement due to fraud, SA 240 requires the auditor to —

(a) make inquiries of management, and to also obtain written representation from them, regarding —

(i) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments

(ii) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist

(iii) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity, and

(iv) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour

(b) make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud

(c) make inquiries of internal audit (in entities that have an internal audit function) to determine whether it has knowledge of any actual, suspected or alleged fraud, as well as to obtain its views about the risks of fraud

(d) make inquiries of those charged with governance (unless all them are involved in managing the entity) —

(i) to obtain an understanding of how they exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks, and

(ii) to determine whether any one of them have knowledge of any actual, suspected or alleged fraud

Arising out of the above, the auditor is required to evaluate as to whether unusual or unexpected relationship(s), if any, identified, including those related to revenue accounts, indicates risks of material misstatement due to fraud. Similarly, he is required to consider whether any other information obtained indicates such risk a risk. Besides, assessment of such a risk is required to be made at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. Where the auditor concludes that the presumption that there are risks of material misstatement due to fraud is not applicable, he is required to document the related reasons.

IV. On the contrary, where any risks have been identified, the auditor is required to obtain, if not already so done, an understanding of the entity's related controls, including control activities relevant to risks identified. In determining overall response to address the assessed risks of material misstatement due to fraud, the SA requires the auditor —

(i) at the financial statement level

   (a) to assign and supervision personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the [identified] risks of material misstatement due to fraud

   (b) to evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings, and

   (c) to incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures

(ii) at the assertion level to 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, to —

   (a) test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such test, the auditor is required to —

   - make inquiries of individuals 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 for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the SA requires the auditor to —

   - evaluate whether the judgments and decisions made by the management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias that may represent a risk of material misstatement due to fraud.
   - If so —

     the auditor is required to 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 year.

(c) For significant transactions that are outside the normal course of business, or that otherwise appear to be unusual given the auditor’s understanding of the entity and its environment, the SA requires the auditor to evaluate whether the business rationale of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

V. The SA requires the auditor to evaluate whether analytical procedures performed while forming an overall conclusion as to the financial statements as a whole are consistent with the auditor’s understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.

If any misstatement is identified, the auditor is required to —

(i) evaluate whether the identified misstatement is indicative of fraud.

If so, he is required for further evaluate the implication of that misstatement in relation to other aspects of the audit, particularly the reliability of management representation recognizing that an instance of fraud is unlikely to be an isolated occurrence

(ii) re-valuate, where he has reason to believe that the identified misstatement - whether material or not - is or may be the result of fraud and that management [in particular, senior management] is involved, 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.

While so doing, he is also required to consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties.

VI. In the event, as a result of misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question his ability to continue performing the audit, the SA requires the auditor to –

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

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

If, as a result, the auditor decides to withdraws, he is required to —

(i) discuss with the appropriate level of management and those charged with governance, his withdrawal from the engagement and the reasons therefor, and

(ii) determine whether there is a professional or legal requirement to report about his withdrawal and the reasons therefor to the person(s) who made the audit appointment or, in some case, to regulatory authorities

Further, the SA requires the auditor to inform, on timely basis, appropriate level of management / those charged with governance, including those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

VII. The documentation required to be maintained by the auditors include —

(a) the significant decisions reached during the discussion among the engagement regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, *[SA 315]* and

(b) the identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level, *[SA 315]* including

the overall responses to the assessed risks of material misstatement due to fraud at the financial level *[SA 330]* and

the nature, timing and extent of audit procedures, *[SA 330]*and

the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level, *[SA 330]* and

(c) the result of audit procedures, including those designed to address the risk of management override of controls

(d) communications about fraud made to management, those charged with governance, regulators and others

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