2 General Auditing Principles & Auditor Responsibilities

SA – 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

Characteristics of Fraud

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves:

- **Incentive or pressure to Commit Fraud:** Arises when mngt is under pressure to achieve an unrealistic target.
- **Perceived opportunity to do so:** Arises when individual believes that IC can be overridden.
- **Rationalization to do so:** Arises when an individual possesses an attitude or character that allows them knowingly and intentionally to commit a dishonest act.

Possible Sources of Misstatements

Misstatement may result from:

A	**Fraudulent Financial Reporting**
	1. Recording fictitious journal entries to manipulate operating results. 2. Inappropriate assumptions. 3. Changing judgments to estimate account balances. 4. Omitting, advancing or delaying recognition of events and transactions occurred during the year. 5. Concealing facts that affect the amount recorded in F.S. 6. Engaging in Complex Transactions that are structured to misrepresent the financial position or financial performance. 7. Altering records relating to significant transactions.
B	**Misappropriation of Assets**
	1. Embezzling receipts. 2. Stealing physical assets. 3. Causing an entity to pay for goods and services not received. 4. Using entity assets for personal use.

Responsibility for Prevention & Detection of Fraud

- Primary responsibility for prevention and detection of fraud rests with both TCWG & Mngt.
- To ensure prevention of fraud, Mngt. must have a commitment to create a culture of honesty and ethical behaviour.

Risk associated for non-detection of material misstatements

- Due to Inherent limitations, there is always an unavoidable RoMM in F.S. due to Fraud.
- Risk of non-detecting a material misstatement resulting from fraud is higher than the risk of non-detecting one resulting from error.
- RoMM due to Mngt. Fraud is higher than due to Employee Fraud.

Auditor's Duties

- To obtain reasonable assurance that F.S. as a whole are free from material Misstatements.
- Maintain an attitude of Professional Skepticism.
- If circumstances indicate existence of MM, consider whether such misstatement is an indication of Fraud.
- If Fraud identified, communicate to Mngt. & TCWG (also to Regulatory & Enforcement authorities, if required by Law).
- Sec. 143(12) of Companies Act, 2013 read with Rule 13 of CAAR, 2014 requires that if auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 Cr. or above, is being or has been committed against company by its officers or employees, he shall report the matter to C.G.
- Para 3(xi) of CARO, 2020 also requires auditor to report whether any fraud by company or any fraud on company by its officers or employees has been noticed or reported during the year; If yes, nature and amount involved is to be indicated.

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Risk Assessment Procedures

- When performing RAP & related activities, perform procedures to obtain information for use in identifying the RoMM due to fraud like:
  (a) inquiries of mngt. and others within entity,
  (b) obtaining understanding as to how TCWG exercise oversight of mngt. processes for identifying and responding to risks of fraud in entity and IC that mngt. has established to mitigate these risks and
  (c) evaluation of unexpected relationships identified in performing analytical procedures which may indicate RoMM due to fraud.
- Evaluate whether information obtained from other RAP and related activities performed indicates that one or more fraud risk factors are present.

Responses to Assessed Risks

Overall Responses

Auditor shall:
(a) Assign & supervise personnel as per their capability;
(b) Evaluate whether a/cing policies indicate fraudulent financial reporting resulting from mngt. effort to manage earnings; and
(c) Incorporate surprise element in selection of NTE of audit procedures.

Responses to Risks Related to Mngt. Override of Controls

- Management is in a unique position to perpetrate fraud because of Mngt. ability to manipulate accounting records and prepare fraudulent F.S. by overriding controls.
- It is a RoMM due to fraud and thus a significant risk.
- Determine whether auditor needs to perform extra audit procedures.

Designing and performing Audit Procedures

(a) Test appropriateness of journal entries recorded in GL & other adjustments made in preparation of F.S.
(b) Review accounting estimates for biases & evaluate whether circumstances producing bias, if any, represent a RMM due to fraud.
(c) For significant transactions, outside normal course of business, or that otherwise appear to be unusual, evaluate whether business rationale (or the lack thereof) of transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

Auditor Unable to Complete Engagement

If it is concluded that it is not possible to continue performing audit as a result of misstatement resulting from fraud or suspected fraud, auditor should:

(i) Consider professional & legal responsibilities including whether there is a requirement for him to report to person who made audit appointment or, in some cases, to regulatory authorities;

(ii) Consider possibility of withdrawing from engagement; and

(iii) If auditor withdraws:

- **discuss with appropriate level of mngt. & TCWG, withdrawal from engagement & reasons for withdrawal; &**
- **consider whether there is a professional or legal requirement to report to person who made appointment or, in some cases, to regulatory authorities, withdrawal from engagement & reasons for withdrawal.**

Management Representation

Auditor shall obtain WRs from Mngt. and, where applicable, TCWG that:

(a) They acknowledge their responsibility for design, implementation & maintenance of IC to prevent and detect fraud;

(b) They have disclosed to auditor, results of Mngt. assessment of risk that F.S. may be materially misstated as a result of fraud;

(c) They have disclosed to auditor their knowledge of fraud or suspected fraud affecting entity involving Mngt., employees who have significant roles in IC or others where the fraud could have a material effect on the F.S.; and

(d) They have disclosed to auditor their knowledge of any allegations of fraud, or suspected fraud, affecting entity's F.S. communicated by employees, former employees, analysts, regulators or others.

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Fraud Risk Factors

Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. E.g.:

(a) Need to meet expectations of 3rd parties to obtain addl. equity financing may create pressure to commit fraud;
(b) Granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; &
(c) Control environment that is not effective may create an opportunity to commit fraud.

	Examples of Fraud Risk Factors relating to Misstatements arising from Fraudulent Financial reporting	Examples of Fraud Risk Factors relating to Misstatements arising from Misappropriation of Assets
Incentives/ Pressures	Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as: (a) High degree of competition or market saturation, accompanied by declining margins. (b) High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates. (c) Significant declines in customer demand and increasing business failures. (d) Operating losses making threat of bankruptcy, foreclosure, or hostile takeover imminent. (e) Recurring negative cash flows from operations or an inability to generate cash flows from operations. (f) Rapid growth or unusual profitability. (g) New accounting, statutory or regulatory requirements.	Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: (a) Known or anticipated future employee layoffs. (b) Recent or anticipated changes to employee compensation or benefit plans. (c) Promotions, compensation, or other rewards inconsistent with expectations.
Opportunities	Nature of industry or entity operations provides opportunities to engage in Fraudulent FR that can arise from: (a) Significant RP transactions not in ordinary course of business. (b) Strong financial presence or ability to dominate a certain industry sector. (c) Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate. (d) Significant, unusual or highly complex transactions, to period end. (e) Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist. (f) Significant bank accounts or subsidiary or branch operations in tax haven jurisdictions.	Opportunities to misappropriate assets increase in case of: (a) Large amounts of cash in hand. (b) Inventory items that are small in size, of high value. (c) Easily convertible assets, such as bearer bonds. (d) Fixed assets which are small in size or marketable. Inadequate IC over assets may increase susceptibility of misappropriation of assets, e.g.: 1. Inadequate segregation of duties. 2. Inadequate oversight of Senior Mngt. Expenditures. 3. Inadequate job applicant screening of employees. 4. Inadequate record keeping with respect to assets. 5. Inadequate system of authorization and approval of transactions. 6. Inadequate physical safeguards over cash, investments, inventory, or fixed assets. 7. Lack of complete and timely reconciliations of assets. 8. Lack of timely documentation of transactions. 9. Lack of mandatory vacations for employees.
Attitudes/ Rationalizations	(a) Communication, implementation or enforcement of entity's values or ethical standards that are not effective. (b) Non-financial Mngt. excessive participation in selection of a/cing policies or determination of significant estimates. (c) Known history of violations of securities laws or other laws and regulations. (d) Excessive interest by Mngt. in maintaining or increasing entity's stock price. (e) Management failing to correct known material weaknesses in IC on a timely basis. (f) Low morale among senior management. (g) Dispute between shareholders in a closely held entity. (h) Relationship between Mngt. and current or predecessor auditor is strained.	(a) Disregard need for monitoring or reducing risks related to misappropriations of assets. (b) Disregard IC over misappropriation of assets by overriding existing controls or by failing to correct known IC deficiencies. (c) Behaviour indicating displeasure or dissatisfaction with the entity. (d) Changes in behaviour or lifestyle that may indicate assets have been misappropriated. (e) Tolerance of petty theft.

SA – 250 "Consideration of Laws and Regulation in an Audit of F.S."

Management Responsibilities

Compliance of L&R is duty of Mngt. & TCWG & may be performed through:

1. Monitoring legal requirements & ensuring that operating procedures are designed to meet these requirements.
2. Instituting & operating appropriate systems of IC.
3. Developing, publicising and following a code of conduct.
4. Ensuring employees are properly trained & understand code of conduct.
5. Monitoring compliance with code of conduct & take actions to discipline employees who fail to comply with it.
6. Engaging legal advisors to assist in monitoring legal requirements.
7. Maintaining a register of significant L & R with which entity has to comply.

Potential effects of inherent limitations on auditor's ability to detect MM

In context of L&R, potential effects of inherent limitations on auditor's ability to detect MM are greater for following reasons:

- Many L&R (relating principally to operating aspects) do not affect F.S. and are not captured by entity's information systems relevant to FR.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, mngt. override of controls or intentional misrepresentations being made to auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Auditor's Responsibilities

Basic Responsibilities

Obtain general understanding of

- Legal & Regulatory Framework applicable
- Compliance by Entity with that Framework.

Specific Responsibilities w.r.t.

L&R having direct effect on determination of material amount and disclosures in F.S.

→ obtain SAAE

→ to ensure compliance

Other L&R that do not affect amount and disclosures in F.S. but compliance with which may be fundamental to operating aspects.

Perform limited procedures:

- Inquiring of Mngt & TCWG; and
- Inspecting Correspondence with relevant Licensing / Regulatory authority

→ to identify instances of noncompliance.

Obtain ***WR*** that all instances of non-compliance or suspected non-compliance have been disclosed to auditor.

Reporting responsibilities

To TCWG

- Matters involving non-compliance.
- If TCWG is involved, communicate to Higher Level, if any
- Otherwise, obtain Legal Advice

Auditor Report

- Material Effect on F.S. → Q/A
- Unable to conclude due to Limitation imposed by
  - Mngt. → Q/D
  - Circumstances → Consider the Effect

Regularity & Enforcement Authorities → If required by Law

Auditor Procedure in case any Non-Compliance is identified / Suspected

1. Obtain understanding of nature of Act and circumstances in which it is occurred.
2. Evaluate possible effects on F.S.
3. Discuss the matter with Mngt. & TCWG.
4. If info not provided, consider need to obtain legal advice;
5. Evaluate lack of SAAE on the Auditor's Opinion.
6. Evaluate implications on other aspects of audit.

Indicators considered by Auditor

1. Investigations by regulatory bodies.
2. Payment of fines or penalties.
3. Payments for unspecified services to consultants, RP etc.
4. Excessive Sales commissions or agent's fees.
5. Purchasing at prices significantly above or below market price.
6. Unusual payments in cash.
7. Unusual payments towards legal and retainership fees.
8. Payments without proper exchange control documentation.
9. Existence of an information system which fails, to provide an adequate audit trail or sufficient evidence.
10. Unauthorised or improperly recorded transactions.
11. Adverse media comment.

SA – 260 "Communication with TCWG"

Auditor's Responsibilities

- Determine appropriate person to whom communication is to be made.
- Determine need to communicate with Governing body, if communicates with subgroup.

Matters to be Communicated

(a)	**Auditor's responsibilities in relation to F.S. Audit.**
(b)	**Planned scope & timing of audit**
(c)	**Significant findings from audit:** • **Auditor's views about qualitative aspects of entity's accounting practices, including accounting policies, accounting estimates and F.S. disclosures.** • **Significant difficulties, if any, encountered during audit;** • **Significant matters, arising from audit, discussed with management; and** • **WR, auditor is requesting.** • **Circumstances that affect form and content of auditor's report, if any.** • **Other significant matters that in auditor's professional judgment are significant to oversight of FR process.**
(d)	**Auditor Independence: In case of listed entities, auditor shall communicate with TCWG:** **(a) Statement that ET & Others has complied with relevant ethical requirements regarding independence;** **(b) All relationships & other matters between firm, network firms, and entity that bear on independence; and** **(c) Related safeguards applied to eliminate identified threats or reduce them to an acceptable level.**

Examples of Significant difficulties

- Significant delays or an unwillingness by mngt to provide necessary information.
- Unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain SAAE.
- Unavailability of expected information.
- Restrictions imposed on auditor.
- Mngt. unwillingness to make or extend its assessment of entity's ability to continue as a going concern when requested.

Examples of Significant matters

- Significant events or transactions occurred during the year.
- Business conditions affecting entity, business plans & strategies that may affect RoMM.
- Concerns about mngt. consultations with other accountants on a/cing or auditing matters.
- Discussions w.r.t. initial or recurring appointment of auditor regarding accounting practices, application of auditing standards, or fees for audit or other services.
- Matters on which there was disagreement with mngt., except for initial differences because of incomplete facts or preliminary information that are later resolved by auditor obtaining additional relevant facts or information.

Circumstances in which auditor consider it necessary to include additional information in auditor's report in accordance with the SAs

- Auditor expects to modify opinion in auditor's report in accordance with SA 705.
- Material uncertainty related to going concern is reported in accordance with SA 570.
- KAM are communicated in accordance with SA 701.
- Auditor considers it necessary to include an EoM Para or OM Para in accordance with SA 706 or is required to do so by other SAs.
- Auditor has concluded that there is an uncorrected material misstatement of Other Info. in accordance with SA 720.

SA - 299 "Joint Audit of Financial Statements"

A joint audit is an audit of F.S. of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

Audit Planning and Allocation of Work

1 Development of Audit Plan

In developing joint audit plan, joint auditors shall:

a. Identify division of audit areas & common audit areas amongst joint auditors that define scope of work of each joint auditor;
b. Ascertain reporting objectives of engagement to plan the timing of audit and nature of communications required;
c. Consider & communicate among all joint auditors, factors that are significant in directing ET efforts;
d. Consider results of preliminary engagement activities.
e. Ascertain NTE of resources necessary.

2 Allocation of Work

- Joint auditors should, by mutual discussion, divide audit work among themselves.
- Division of work would usually be in terms of audit of identifiable units or specified areas.
- In some cases, due to nature of business of entity, such a division of work may not be possible. In such situations, division of work may be with reference to items of assets or liabilities or income or expenditure.
- Certain areas of work, owing to their importance or owing to nature of work involved, would often not be divided and would be covered by all joint auditors.

Documentation of Work Allocated

- Work allocation document shall be signed by all joint auditors & same shall be communicated to TCWG.
- Documentation of allocation of work helps in avoiding any dispute or confusion which may arise among joint auditors regarding scope of work to be carried out by them.
- Communication of allocation of work to entity helps in avoiding any dispute or confusion.

Responsibility of Joint Auditors

- In respect of audit work divided among joint auditors, each joint auditor shall be responsible only for work allocated to him including execution of audit procedures.
- All joint auditors shall be jointly & severally responsible for:
  b. audit work which is not divided;
  c. decisions taken by all joint auditors under audit planning in respect of common audit areas concerning NTE of audit procedures to be performed.
  d. matters brought to notice of joint auditors by any one of them;
  e. examining that F.S. comply with the requirements of relevant statutes;
  f. presentation and disclosure of the F.S. as required by the applicable FRF;
  g. ensuring that audit report complies with requirements of statutes, applicable SAs and other relevant pronouncements.
- It shall be responsibility of each joint auditor to determine NTE of audit procedures to be applied in relation to areas of work allocated to said joint auditor.
- It is individual responsibility of each joint auditor to study & evaluate prevailing IC System and assessment of risk relating to areas of work allocated to said joint auditor.

Audit Conclusion and Reporting

Reporting Requirements

- Joint auditors are required to issue common audit report.
- However, in case of any disagreement with regard to opinion or any matters to be covered by audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by views of majority of joint auditors regarding opinion or matters to be covered in the audit report.
- In case of separate reports, audit report(s) issued by joint auditor(s) shall make a reference to separate report(s) issued by other joint auditor(s). Such reference shall be made under heading "Other Matter Paragraph" as per SA 706.

Review of work by Other joint auditor

- Each joint auditor is entitled to assume that other joint auditors have carried out their part of the audit work and the work has actually been performed in accordance with the SAs.
- It is not necessary for a joint auditor to review the work performed by other joint auditors.
- Each joint auditor is entitled to assume that the other joint auditors have brought to said joint auditor's notice any departure from applicable FRF or significant observations that are relevant to their responsibilities noticed in the course of the audit.

SA – 402 "Audit Considerations relating to an Entity Using a Service Organisation"

Factors to be considered related to FR in case of user entities using services of SO

SO services are part of user entity's Info system, including related business processes, relevant to FR if these services affect any of the following:

a. Classes of transactions that are significant to the user entity's F.S.;
b. Procedures, within both IT & manual systems, by which user entity's transactions are initiated, recorded, processed, corrected & transferred to GL and reported in F.S.;
c. Accounting records (electronic or manual), supporting info. & specific accounts in user entity's F.S. that are used to initiate, record, process and report the user entity's transactions;
d. How user entity's Info. system captures events & conditions, other than transactions, that are significant to F.S.;
e. FR process used to prepare user entity's F.S., including significant accounting estimates and disclosures; and
f. Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Obtaining understanding of services provided by SO

User auditor shall obtain an understanding of how user entity uses services of SO in user entity operation, including:

(a) Nature of service provided by S.O. and significance of services to user entity.
(b) Nature and materiality of transactions processed or FR processes affected by SO.
(c) Degree of interaction between activities of S.O. and those of user entity.
(d) Nature of relationship between user entity and SO including relevant contractual terms for the activities undertaken by the

User Auditor's considerations

- *Evaluate design and implementation of relevant controls of user entity* that relate to services provided by SO.
- *Determine whether sufficient understanding of nature & significance of services provided by SO* and their effect on user entity IC relevant to audit has been obtained.
- If *unable to obtain a sufficient understanding from user entity*, obtain that understanding from following procedures:
  (a) Obtaining a Type 1 or Type 2 Report, if available.
  (b) Contacting SO, through user entity.
  (c) Visiting SO and performing procedures that will provide necessary info above relevant controls at SO.
  (d) Using another auditor to perform procedures that will provide the necessary Info about relevant controls at S.O.

Using Type 1 or Type 2 Report

- In determining sufficiency and appropriateness of audit evidence provided by Type 1 or Type 2 report, user auditor shall be satisfied as to:
  (a) Service auditor's professional competence and independence from SO; and
  (b) Adequacy of standards under which Type 1 or Type 2 report was issued.
- If user auditor plans to use a Type 1 or Type 2 report as audit evidence to support understanding about design and implementation of controls at SO, he shall:
  a. Evaluate whether description & design of controls at SO is at a date or for a period that is appropriate for his purposes;
  b. Evaluate sufficiency & appropriateness of evidence provided by report for understanding of user entity's IC relevant to the audit; and
  c. Determine whether complementary user entity controls identified by SO are relevant to user entity and, if so, obtain an understanding of whether user entity has designed and implemented such controls.

When user auditor's risk assessment includes an expectation that controls at SO are operating effectively, he shall obtain audit evidence about operating effectiveness of those controls from following procedures:
(a) Obtaining a Type 2 report, if available;
(b) Performing appropriate tests of controls at the service organisation; or
(c) Using another auditor to perform tests of controls at SO on behalf of user auditor.

Reporting by User Auditor

⇒ Modify opinion if unable to obtain SAAE, regarding services provided by SO, relevant to audit of User Entity F.S.
⇒ Do not refer to report of Service auditor unless required by Law & Regulation.
⇒ If reference is required by L&R, user auditor's report shall indicate that reference does not diminish user auditor's responsibility for audit opinion.
⇒ If reference to work of service auditor is relevant to understanding of a modification to user auditor's opinion, user auditor's report shall indicate that such reference does not diminish user auditor's responsibility for that opinion.