

***Fraud in Audit of financial
statements and forensics
-Auditors responsibilities***

October 7, 2023

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Consideration of Fraud Risk

Definition of Fraud as per Explanation to Section 447(1) of The Companies Act, 2013

“fraud” in relation to affairs of a company or any body corporate, includes

any act,

omission,

concealment

of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent

to deceive,

to gain undue advantage from, or

to injure the interests of,

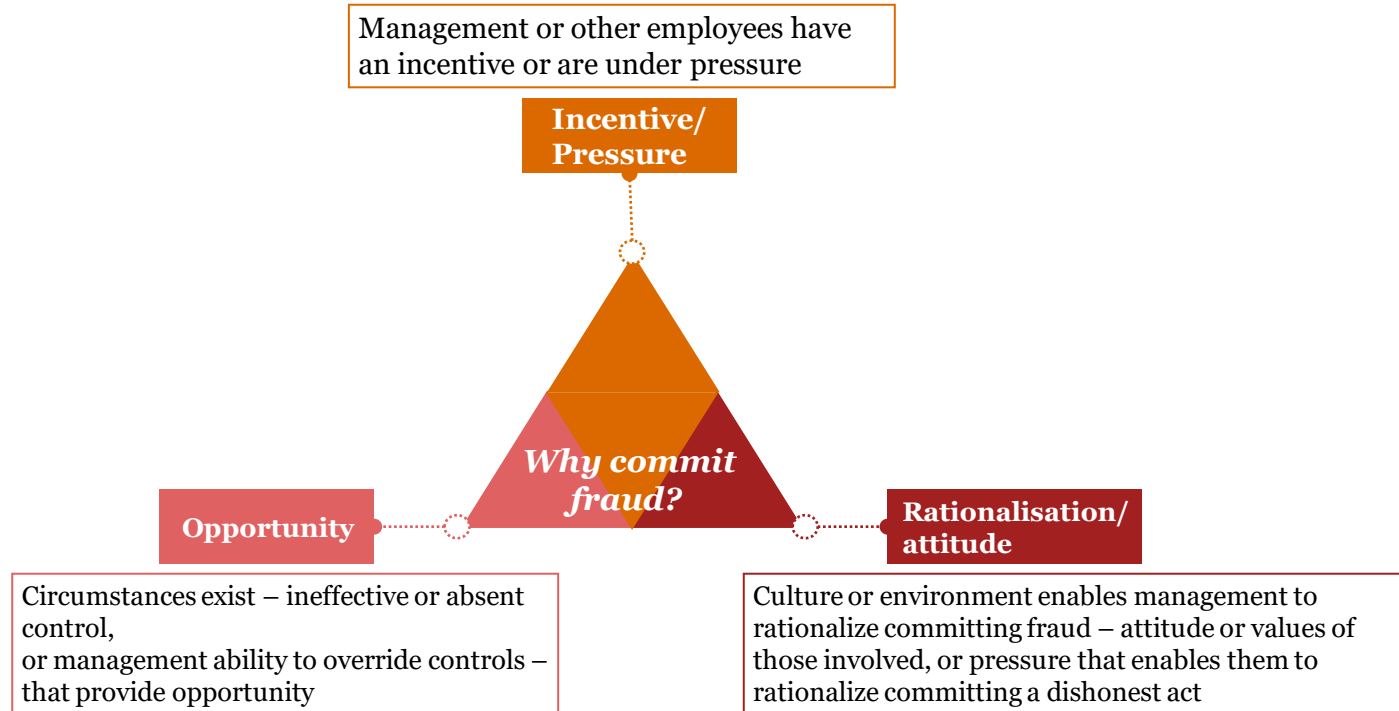
the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

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

Characteristics of Fraud:

- Misstatements in the financial statements can arise from either **fraud** or **error**.
- The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is **intentional** or **unintentional**.
- Two types of **intentional misstatements** are :-
 - a. misstatements resulting from **fraudulent financial reporting**;
 - b. misstatements resulting from **misappropriation of assets**.
- The determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of **professional judgment**.

Conditions under which fraud may occur



Questions we should keep in mind ?

- What are your views regarding the entity's fraud risks?
- Do you have knowledge of fraud or suspected fraud?
- What oversight role do you have in relation to fraud?
- What protocols have been established between those charged with governance and management to keep them informed of all fraud?
- Were any matters related to fraud reported to those charged with governance?
- What action did management and those charged with governance take?

Consideration of Fraud Risk

Responsibility:



Management:

- CFO: ultimately responsible for developing and maintaining anti-fraud program.
- Finance/Legal : controls to deter/detect fraud.
- Internal Audit / Functional Head : monitoring and auditing.
- Assessing risk and designing controls to prevent or timely detect fraud
- Assess management override of controls and communicate with the audit committee or those charged with governance.

Audit Committee and the Board:

- Evaluate management's process for identifying fraud risk including risk of management override of controls
- Evaluate implementation of fraud controls.
- Reinforce "tone at the top".
- Oversee the special investigations hotline reports, internal audit reports , if any.

External Auditor:

- Evaluate management programs and controls to deter and detect fraud.
- Reasonable assurance that the financial statements are free of material misstatement due to fraudulent financial reporting or misappropriation of assets.
- Communicate identified fraud matters and material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor's attention.

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

Management Responsibility:

The auditor shall obtain **written representations** from management and, where applicable, those charged with governance that:

- a) They acknowledge their responsibility for the **design, implementation and maintenance** of internal control to prevent and detect fraud;
- b) They have disclosed to the auditor the results of management’s assessment of the risk that the financial statements may be **materially misstated** as a result of fraud;
- c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:
 - i. Management,
 - ii. Employees who have significant roles in internal control,
 - iii. Others where the fraud could have a material effect on the financial statements

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

Auditor’s Responsibility:

- An auditor conducting an audit is responsible for obtaining reasonable assurance that the financial statements taken as a whole are **free from material misstatement**, whether caused by fraud or error.
- Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements **may not be detected**, even though the audit is properly planned and performed.
- The risk of **not detecting** a material misstatement resulting from fraud is **higher** than the risk of not detecting one resulting from error.
- The auditor’s ability to detect a fraud depends on factors such as the **skillfulness** of the perpetrator, the **frequency** and **extent of manipulation**, the degree of **collusion** involved, the relative size of individual **amounts** manipulated, and the **seniority** of those individuals involved.
- The auditor is responsible for maintaining **professional skepticism** throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Regulatory Requirement

Section 143 (12) of Companies Act 2013

Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence **involving fraud** is being or has been committed against the company by **officers or employees** of the company, he shall immediately report the matter to the **Central Government** within such time and in such manner as may be prescribed.

Provided that in case of fraud involving lesser than the **specified amount (i.e., INR 1 crore)**, the auditor shall report the matter to the **audit committee** constituted u/s 177 or to the **Board** in other cases within such time and in such manner as may be prescribed.

Provided further that the companies, whose **auditors have reported frauds** under this subsection to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the **Board's report** in such manner as may be prescribed.

National Financial Reporting Authority (NFRA) Circular

Section 143 (12) of CA 2013 and related Rules places certain reporting obligations on the auditor, in relation to frauds: “Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:”

Rule 13 of the Companies (Audit and Auditors) Rules 2014, prescribes detailed steps that need to be followed by the auditor if he has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of rupees one crore or above, is being or has been committed against the company by its officers or employees. The auditor is required to report the matter to the Board or Audit Committee and to the Central Government in the form of a statement as specified in Form ADT-4.

National Financial Reporting Authority (NFRA) Circular

4 In view of the foregoing, the provisions of the Act, the relevant rules and the Standards relating to reporting of fraud and its consequences are reiterated.

4.1 Statutory Auditors are under a mandatory obligation to report fraud or suspected fraud if they observe suspicious activities, transactions or operating circumstances in a company that indicate reasons to believe that an offence of fraud is being or has been committed against the company by its officers or employees. In such an event, the Statutory Auditor shall initiate the steps prescribed under Rule 13 of Companies (Audit and Auditors) Rules 2014 which begins with reporting the matter to the Board/Audit Committee within TWO days of his/her knowledge of the fraud. 2 Standard on Auditing 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements (SA 240)2.

In the case of reporting of a fraud involving or expected to involve individually an amount of rupees one crore or above, the Statutory Auditor fails to get any reply / observations from the Board/Audit Committee within 45 days, the Auditor shall forward a report in the specified form viz., ADT-4 to Secretary, Ministry of Corporate Affairs, Government of India.

4.2 The Statutory Auditor is duty bound to submit Form ADT-4 to the Central Government u/s 143 (12) even in cases where the Statutory Auditor is not the first person to identify the fraud/suspected fraud.

National Financial Reporting Authority (NFRA) Circular

- Clause (xi) of Companies (Auditor's Report) Order, 2020 also requires auditors to make statements relating to reporting of fraud in his/her report.
- Section 140 (5) of the CA 2013, contains consequences for auditors if they have acted, directly or indirectly, in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers. Under the section, the auditor shall also be liable for action under section 447 of CA 2013 apart from removal and debarment for a period of five years.
 - There is a **misconception** that **resigning** from an audit engagement absolves auditors of their reporting obligations relating to fraud and the consequences under CA 2013 for nonreporting of fraud.
 - In this regard, the Hon'ble Supreme Court of India in a recent judgment dated 03.05.2023 (Union of India and Another versus Deloitte Haskins and Sells LLP & Anr CRIMINAL APPEAL NOS.2305-2307 OF 2022), has held that the consequences of section 140 (5) of CA 2013 will be applicable also on those auditors who resign from their audit engagements without reporting fraud/suspected fraud.

SEBI reporting requirements for fraud

PRIOR REGULATION	AMENDED REGULATION - W.E.F. 14 JULY 2023
<p><u>Schedule III: Disclosure of events or information</u></p> <p>The following shall be events/information, upon occurrence of which listed entity shall make disclosure to stock exchange(s):</p> <p>Part A clause (6) Fraud/defaults by promoter or key managerial personnel or by listed entity.</p> <p>Note: Disclosure required irrespective of materiality threshold as provided in regulation 30 (4).</p>	<p><u>Schedule III: Disclosure of events or information</u></p> <p>The following shall be events/information, upon occurrence of which listed entity shall make disclosure to stock exchange(s):</p> <p>Part A clause (6) Fraud or defaults by a listed entity, its promoter, <u>director</u>, key managerial personnel, <u>senior management</u> , or subsidiary.</p> <p>Note: Disclosure required irrespective of materiality threshold as provided in regulation 30 (4).</p>
<p><u>Schedule III: Disclosure of events or information</u></p> <p>The following shall be events/information, upon occurrence of which listed entity shall make disclosure to stock exchange(s):</p> <p>Part B clause (9) Fraud/defaults etc. by directors (other than key managerial personnel) or employees of listed entity.</p> <p>Note: Disclosure required only if the amount crosses materiality threshold as provided in regulation 30 (4).</p>	<p><u>Schedule III: Disclosure of events or information</u></p> <p>The following shall be events/information, upon occurrence of which listed entity shall make disclosure to stock exchange(s):</p> <p>Part B clause (9) Frauds or defaults <u>by employees</u> of the listed entity <u>which has or may have an impact on the listed entity.</u></p> <p>Note: Disclosure required only if the amount crosses materiality threshold as provided in regulation 30 (4).</p>

SEBI definition of Fraud

'Fraud' is defined under **Regulation 2(1)(c)** of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, as follows.

"It includes any act, expression, omission, or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include.

- 1. a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment.*
- 2. a suggestion as to a fact which is not true by one who does not believe it to be true;*
- 3. an active concealment of a fact by a person having knowledge or belief of the fact;*
- 4. a promise made without any intention of performing it;*
- 5. a representation made in a reckless and careless manner whether it be true or false;*
- 6. any such act or omission as any other law specifically declares to be fraudulent;*
- 7. deceptive behaviour by a person depriving another of informed consent or full participation;*
- 8. a false statement made without reasonable ground for believing it to be true;*
- 9. the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price."*

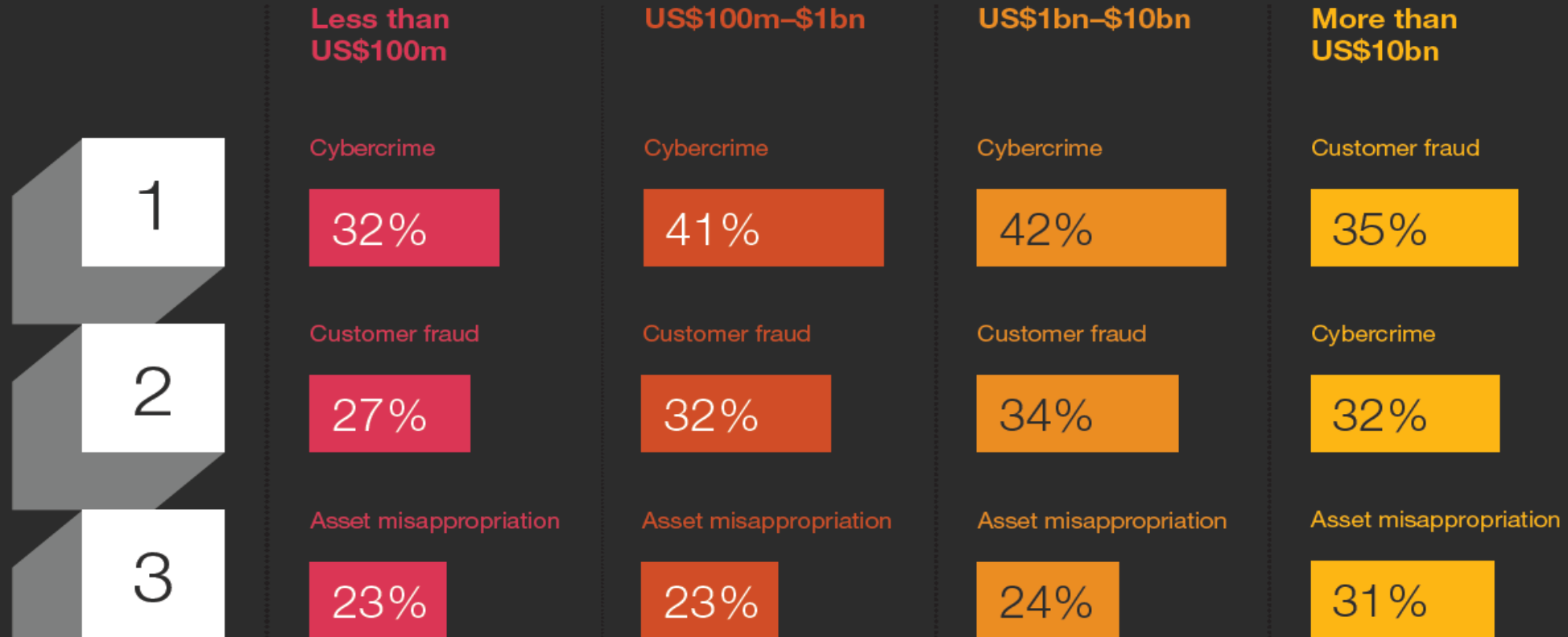
Global Economic Crime and Fraud Survey

- 46% of companies suffered fraud in the last 24 months (compared to 47% in 2020)
- Nearly 70% of organisations experiencing fraud said the most disruptive incident came via an external attack or collusion with external parties

- The 2022 survey revealed new and increased fraud as a result of COVID-19
- Keep the following two emerging threats on our radars:
 - ESG reporting fraud
 - Supply chain fraud

Global Economic Crime and Fraud Survey

Types of fraud experienced, by organisation size (in global revenue)



Global Economic Crime and Fraud Survey

Key Considerations for protecting your perimeter are:

1

Understand the end-to-end life cycle of customer-facing products. Take the time to identify where opportunities exist for a fraudster to exploit a product and cause financial, legal or reputational damage. How could it happen, what would it take to prevent it from happening, and what type of response is needed if it happens?

2

Strike the proper balance between user experience and fraud controls. Protecting customer-facing channels will require a delicate balance between ensuring that users have a great experience and detecting and stopping fraudsters. The dual objectives of keeping false positives as low as possible and catching true fraud can be achieved through a combination of fraud technology, strategy and processes.

3

Orchestrate data. Often, fraud signals will come from disparate, disconnected systems and are only detectable through the occasional manual review. It is crucial that fraud indicators are orchestrated into a centralised platform that can track the end-to-end life cycle of users (fraudsters or not) and generate meaningful alerts.

Global Economic Crime and Fraud Survey

Emerging Threats:

The challenge with managing emerging fraud risks is to avoid falling into the trap of only seeing what is known and not seeing what is unknown. What are those emerging fraud risks of potentially greatest concern?

- 1. ESG Reporting Fraud:** Trust has become a key lever for value creation. Trust is fragile. A perceived or real misstep in transparency can wreak havoc on brand reputation and underlying trust. With environmental, social and governance (ESG) responsibility growing in importance to stakeholders, accuracy in ESG reporting is essential. Just 8% of those organisations encountering fraud in the last 24 months experienced ESG reporting fraud, but the incentive to commit fraud in this area is only going to increase- as will the consequences.
- 2. Supply Chain Fraud:** One in eight organisations experienced new incidents of supply chain fraud as a result of the disruption caused by COVID-19. One in five sees supply chain fraud as an area of increased risk as a result of the pandemic. Few companies are aware of the fraud and misconduct risks within their supply chain, making this an area of exposure now and into the future.

Forensic Audit

What is Forensic Audit ?

- A forensic audit is an analysis and review of the financial records of a company or person to extract facts, which can be used in a court of law.
- Forensic auditing is a specialty in the accounting industry, and most major accounting firms have a department forensic auditing.
- Forensic audits include the experience in accounting and auditing practices as well as expert knowledge of forensic audit's legal framework.
- Forensic audits cover a large spectrum of investigative activities. There may be a forensic audit to prosecute a party for
 - a. fraud,
 - b. Embezzlement, or
 - c. other financial crimes.

Forensic Audit

Reasons for conducting Forensic Audit

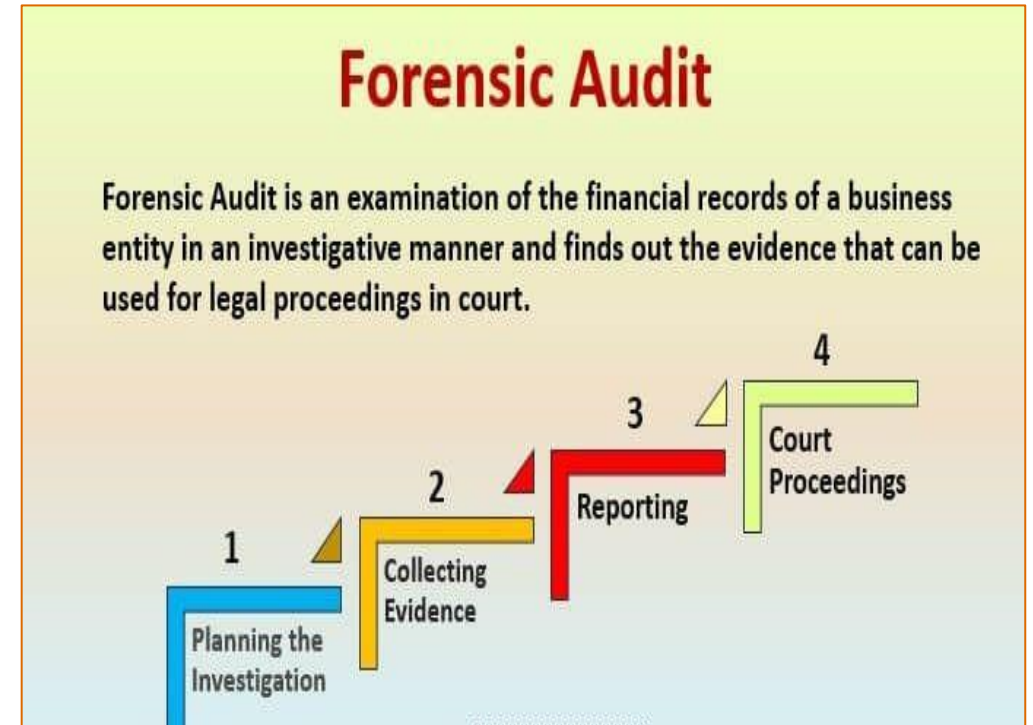
- Forensic audit investigations may expose, or confirm, various kinds of illegal activities. Normally, instead of a normal audit, a forensic audit is used if there is a possibility that the evidence gathered would be used in court.
- The forensic audit process is similar to a traditional financial audit — planning, gathering evidence, and writing a report — with the additional step of a possible appearance in court.
- There are many reasons for conducting forensic audit some are listed below:
 - a. Strict governance and regulatory framework for business
 - b. Increasing non-performing asset accounts with lenders
 - c. Banking sector in India being under stress
 - d. Regular update & the change in guidelines & regulations by Reserve Bank of India

Forensic Audit

Functioning of Forensic Audit

A forensic audit comprises the following steps:

- **Planning the Investigation:** The forensic auditor and the team will plan their investigation in order to meet their objectives.
- **Collecting Evidence:** The evidence gathered should be sufficient to prove in court the identity of the fraudster(s), reveal the details of the fraud scheme and document the financial loss suffered and the parties affected by the fraud.
- **Reporting:** A forensic audit will need a written report on the crime to be given to the client, so that if they desire, they can continue to file a legal case.
- **Court Proceedings:** During court proceedings, the forensic investigator must be present to clarify the evidence collected and how the suspect(s) were found by the team.



Questions?

Thank You

