

# Auditor & Fraud Detection : Responsibilities & Reporting

## Background

The literal meaning of the term 'audit' is "the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organisation". Cambridge English dictionary defines function of audit as "to make an official examination of the accounts of business and produce a report". The audit profession understands its role as Auditor is to assure that the Financial statements are 'True & Fair' and prepared in accordance with the prevailing accounting framework like IndAS, IFRS, US GAAP, etc and that the auditing has been done as per the prevailing Auditing Standards which cover various aspects of auditing. However the general perception or understanding of society is that once an audit is done it should assure that there is no fraud nor wrongdoing nor a misstatement (even immaterial). This is a huge Expectation Gap which despite efforts of the profession to bridge it, it still remains.

1.1. The requirement to hold a practicing certificate imposes an obligation on auditors to carry professional 'duty of care' to their clients and members of the public. The Royal Commission laid down in HIH Insurance case (2005) that '..... auditors have an obligation to ensure that they are, and are seen to be, maintaining high standards of honesty and



*probity, acting in the interests of the shareholders of the company ... and exercising independence of mind ....'* The development of the concept of 'due care', as applied to the performance of an auditor's responsibility, is considered by referring to cases decided in UK & other western countries and forms the basis for today's auditing standards and allied literature.

1.2. As early as in 1896, the famous case of "Kingston Cotton Mills" laid down some fundamental auditing principles such as the 'watchdog' role and the notion of taking reasonable skill and care. The auditor is, "not bound to be a detective, or...to approach his work on the suspicion that there is something wrong. He is a watchdog but not a



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*bloodhound ... If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful."*

1.3 Around the same time i.e. in 1895, London and General Bank case laid down an important aspect of reporting by auditors i.e. "..... the duty of an auditor is to convey information, not to arouse enquiry. Although an auditor might infer from an unusual statement that something is seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement." Thereafter, the dictum emerged that auditor should give an information and not means

to the information. These two cases have formed the basis for most subsequent decisions as to the determination of auditor negligence. The auditor is not necessarily answerable for an error of judgement, provided he or she exercises the skill and care of a reasonably competent and well-informed member of the profession. Nevertheless, a too-literal interpretation of the Kingston Cotton Mills case has been criticised as retarding the development of improved auditing practices.

- 1.4. The narrow interpretation of the Kingston Cotton Mills case concerning audit practice was put to some test by the Pacific Acceptance case (1970) which noticed the changing expectations in respect of the auditor's responsibility, with the standard of reasonable care also being raised. *'Reasonable skill and care' call for changed standards to meet changed conditions or changed understanding of dangers, and in this sense, standards are more exacting today than in 1896. .... Any person who enters a learned profession undertakes to bring to the existence of it a reasonable degree of care and skill. He does not undertake, if he is an attorney, that at all events you shall gain in your case, nor does a surgeon undertake that he will perform a cure, nor does he undertake to is the highest possible degree of care and skill. [Pacific Acceptance Corporation Ltd v. Forsyth (1970)].* Thus, 'professional skepticism' evolved over the period and concepts of 'reasonable degree of care and skill' got inbuilt to the auditing literature, under which though auditor is not 'blood hound' but is expected to be more than merely a 'watch dog'.

1.5. There have been major changes, world over, in the legal environment concerning auditor's liability over last several decades. The gigantic growth of business enterprises, ever growing separation of ownership and management, structuring of global businesses, end-to-end use of technology in business processes hardly leaving any audit trail and growing complexities necessitated most of the changed legal or standards environment.

1.6. In India, recently we are witnessing troubled scenarios in the corporate field. Several business failures, scams, bank frauds, auditors' resignations, regulatory activism, emergence of new auditing regulator (NFRA) etc. makes the situation 'never seen before' scenario. Therefore, issues pertaining to auditor's role and responsibility assume paramount importance to the profession and society at large.

1.7. Companies Act, 2013 ('the Act') was codified in the background of some of large corporate failures/scams and therefore contains numerous provisions pertaining to enhanced role and responsibilities of Auditors including their duties pertaining to reporting of frauds. Detecting Fraud, in course of audit, remains challenging even for a well-planned and well conducted audit. This write-up briefly dwells on Auditors responsibility pertaining to fraud detection and reporting.

## 2. Legal Framework pertaining to Fraud & Reporting by Auditors

### 2.1. Companies Act 2013 ('the Act')

2.1.1 Fraud as a term is easier to understand than to define. Often, some of the wrongdoings are argued to be not in nature of fraud as generally understood e.g. kickbacks for procuring orders or extensive planning for saving of taxes or excessive claims towards expense/loss etc.

Explanation to Section 447 of the Act defines fraud as *"...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;*

2.1.2 The aforesaid Section provides for penalty and consequences of fraud under the provisions of the Act, in addition to any other law or regulations. Accordingly, fraud involving an amount of at least ten lakh rupees or one per cent of the turnover of the company, whichever is lower is punishable with imprisonment for a term which shall not be less than six months (three years if public interest is involved) but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud. Frauds of lesser sums not involving any public interest attract imprisonment for a term which may extend to

five years or with fine which may extend to ₹ 50 lakhs or with both. It is imperative to note that provisions of this section would apply to auditors also in case of default of provisions under about 20 Sections of the Act e.g. Sections 7(5), 7(6), 8(11), 34, 36, 38(1), 46(5), 56(7), 66(10), 75, 140(5), 206(4), 213, 229, 251(1), 266(1), 339(3), 448.

2.1.3 Also, noteworthy that under section 140 (5) of the Act pertaining to NCLT powers to change Auditors of a Company, which results in the auditor being ineligible to be appointed as auditors of other companies also for 5 years, the explanation clarifies that for any action in fraudulent manner or abetment or collusion in any fraud, the liability shall be of the firm of auditors and that of every partner.

2.1.4 An auditor is also liable as per provisions of Section 447 for any misleading statement in the offer document or prospectus (Section 35).

2.1.5 Section 143(12) of the Act casts duty on auditors of a company if, in course of the performance of his duties as auditor, he/she has reason to believe that an offence of fraud is being or has been committed in the company by its officers or employees, to report such fraud involving amounts in excess of ₹ 1 crore to Central Government and up to ₹ 1 Crore to Audit Committee/ Board. The Company also needs to disclose frauds reported to Audit Committee / Board in its Board Report. The reporting requirement under Section 143(12) is for the statutory auditors of the company and also applies to the Cost Accountant in

practice, conducting cost audit under section 148 of the Act; and to the Company Secretary in practice, conducting secretarial audit under section 204 of the Act. The ICAI has issued a Guidance Note on reporting on Fraud under section 143(12) of the Act ('GN'). The provisions of Section 143(12) & Rules made thereunder and Guidance under GN are summarised below:

- The provisions also apply to Branch auditors;
- The fraud by officers/ employees of the Company are required to be reported under this section and fraud by third parties i.e. Vendors etc not covered under section 143(12);
- Auditor to report about fraud (involving sum of ₹ 1 crore or more) immediately after it comes to his notice, not later than 2 days, to Board or Audit committee and seek their response within 45 days. After receipt of such response, the auditor is required to report the same, along with response from Board/Audit committee, to Central Government in form ADT-4. In case, no response is received from the Company in 45 days, auditor has to report the same to Central government immediately stating the fact that no response is so received from the auditee.
- Fraud involving sum less than ₹ 1 crore are to be reported by auditor to Board or audit committee within 2 days giving full details thereof.
- Auditor to consider requirements of the Standards of Auditing ('SAs'), in regards to the risk of fraud, including the definition of

fraud as stated in SA 240 (which is almost similar to Section 447), in planning and performing the audit procedures to address the risk of material misstatement due to fraud.

- The instances of fraud identified by the management or others and reported or remediated or acted upon, are not required to be reported by auditor under section 143(12) but he is required to verify if all the aspects of events of fraud have been so detected and considered. If not, then balance aspects not reported should be considered to be reported by the auditor under section 143(12)
- The timing of reporting is important consideration. Whether at time fraud noticed by auditor or whether it is concluded to be an offence of fraud. (based on suspicion – reason to believe are terms to be carefully considered in the light of provisions of Act, SA 240 and GN).
- Further, Section 143(12) uses the words 'offence of fraud' but Form ADT-4 uses the words 'suspected offence involving fraud'; harmonious interpretation of these is that 'reason to believe' creates an objective test of existence of wrongdoings, the conclusion or legal determination whereof may not be within auditors' responsibility and hence not necessary to wait for reporting till the fraudulent act is legally determined.
- Section 147(2) proviso in the context of punishment to auditors for contravention with the provisions, *inter alia*, of Section 143 of the 2013

Act, states, "if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than fifty thousand or eight times of the remuneration of the auditor, whichever is less but which may extend to twenty-five lakh rupees.

2.1.6 Under Companies (Auditors Report) Order, 2016 ('CARO') – the clause 3(x) requires auditors to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and amount involved is to be indicated. ICAI's Guidance Note on CARO 2016 needs to be carefully referred to, to comply with this reporting obligation.

**2.2 Frauds noticed during limited review/ interim review/other attest functions** - Provisions of Section 143(12) are applicable whenever auditor performs attest functions even under other Acts e.g. (a) Regulation 33 of SEBI (Listing Obligations and Disclosure Requirements, 2015) requires the Statutory Auditor to perform Limited Review/Audit of quarterly financial results published by listed companies for Detail Guidance reference may be made to "Guidance Note on Reporting on fraud under section 143(12) of the Companies Act, 2013" issued by ICAI (b) The Auditor may also be engaged by the Board of Directors of the company to carry out audit of interim financial statements (c) The Auditor may also perform Tax Audit under the Income Tax Act 1961 and under indirect tax laws, which also require diligent

reporting of the matters contained in those reporting formats.

### 2.3 Bank Audit :

The RBI Circular No. DBS.FGV. (F).No.BC/23.08.001/2001-02 dated May 3, 2002 requires auditing professional to report any fraud to the RBI. RBI has issued a Master Circular no. DBS.CO.CFMC.BC.No. 1/23.04.001/2015-16 dated July 1, 2015 on "Frauds-Classification and Reporting" on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As such, Auditor has to report the frauds to the RBI in addition to the Chairman/ Managing Director of the concerned Bank.

**2.4 The Chartered Accountants Act, 1949** contains penal provisions for 'professional misconduct', 'negligence' and lack of 'duty of care' by Chartered Accountants. The schedules to that Act contain list of such offenses. Some clauses of Second Schedule being relevant for failure to detect/report fraud are reproduced below:

A Chartered Accountant in practice, shall be deemed to be guilty of professional misconduct, if he.....

- *Clause (5): fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity;*
- *Clause (6): fails to report a material misstatement known to him to appear in a financial statement with which he is concerned with that financial statement in a professional capacity;*
- *Clause (7): does not exercise*

*due diligence, or is grossly negligent in the conduct of his professional duties;*

- *Clause (8): fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion;.....*

2.5. Recently, SEBI Appellate Tribunal (SAT) reversed most part of SEBI's order for banning an audit firm for two years in case of Satyam Computers. Whilst, SAT upheld the disgorgement penalties levied by SEBI on the audit firm for its negligence, it quashed the SEBI order banning the firm from auditing other listed companies/entities regulated by SEBI. In a way, SAT order echoes the dictum of century old case of Kingston Cotton Mills and states that auditor is required to employ reasonable skill and care unless there are reasons evident of any fraud or wrongdoings. The order of SEBI, according to SAT, fails to prove the 'mens rea' on part of the partners/Firm and on facts of the case, banning the firm from auditing other Companies is held to be not within SEBI's jurisdiction.

## 3. Summary of Guidance from Auditing Literature

The entire gamut of Standards on Auditing (SA) provide useful and comprehensive guidance on the manner of audit process and documentation thereof. Some of the salient matters out of the ocean of such guidance, which are considered relevant from the point of view of reporting on fraud are summarized hereinbelow:

### 3.1. SA 200-Overall objectives of the Independent Auditor and the conduct of an Audit in accordance with SA

Paragraph 15 - The auditor

shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

- Paragraph A18- Professional skepticism includes being alert to, for example:
  - Audit evidence that contradicts other audit evidence obtained.
  - Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
  - Conditions that may indicate possible fraud.
  - Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- Paragraph A22- The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than persuasive audit evidence when obtaining reasonable assurance.

### 3.2. SA 230- Audit documentation

Paragraph 106 of Guidance note on reporting on Fraud under section 143(12) of the Companies Act, 2013 requires auditors to maintain as part of the audit documentation, Minutes of

Inquiry, Fraud risk factor, Copy of correspondence, Management response and Memo documenting Professional Judgment, Additional audit procedures carried out, etc.

Paragraph 58 of the Guidance note requires that Auditor should consider Para A-19, A-20 and 28 of SA 250 where fraud is consequent to corruption, bribery and money laundering and non-compliance with other laws and Regulations.

### 3.3. SA 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statement:

Most relevant and important SA pertaining to fraud reporting obligation of auditors, which needs to be thoroughly considered by the auditors for implementing the guidance contained therein. Salient contents of this SA are highlighted hereinbelow:

- Paragraph 5 - An auditor conducting an audit in accordance with SAs 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.
- Paragraph 10(b) - An auditor to obtain sufficient appropriate evidence about the assessed risk of material misstatement due to fraud.
- Paragraph 11(a) - "Fraud - 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.
- Paragraph 40 - An Auditor has to communicate to appropriate level of management if he has identified or has obtained information about fraud.
- Paragraph 27 of SA 315

"Identifying and assessing the risk of material misstatements through understanding the entity and its environment" requires auditor to identify fraud risks from amongst significant risks and to prepare for responses to such identified significant risks as per guidance of SA 330 "The Auditors responses to assessed risks.

- Appendix 1 to SA 240 lays down examples of fraud risk factors leading to fraudulent financial reporting, which include: (i) Pressure of competition or market saturation accompanied by declining margins (ii) high vulnerabilities to rapid changes in technology or other factors (iii) slowdown in customer demand and business failures (iv) operating losses, threats of bankruptcy (v) fear of declining ratings leading to costlier finance (vi) rapid growth or unusual profitability compared to general trend of same industry. Further, personal financial situation of management or senior team members may also lead to falsification of financial reporting like (i) significant financial interest in the entity (ii) risk of losing or reduced compensation like performance bonus or stock options depending upon performance (iii) personal guarantees of debts taken by the entity etc.
- Some other factors contained in the said appendix include (i) significant related party transactions (ii) budgetary pressures in dwindling markets (iii) employing third parties/intermediaries without adequate business justification (iv) governance related issues (v) management override of control environment.

- Appendix 2 to SA 240 contains guidance on audit process and assertions for identified risks of possibilities of misstatement due to fraud. A brief check list for the procedures guided by SA 240 in summarized form is given at the end of this write-up.

#### 4 Some thought on fraud detection

4.1 The Auditors of today are equipped with latest Techniques, Standards, professional education, technical training, skill sets etc. The regulatory activism also helps in instilling fear in wrongdoers. Yet, we witness several instances of fraud/scams involving huge sums. Some managements or some individuals resort to hide the details as it suits them because unethical business practices have become rampant. In a race to show good numbers and a rosy picture, businesses try to avoid serious Audits and just try to engage into formalities. They pay least possible fee, give little importance to Audit and Auditor, try to manipulate records, hide facts, indulge in various kinds of unethical business practices, keep transactions off the records. While some do this out of compulsion, others have fraudulent intentions.

4.2 There is no end to greed and there is gradual erosion in ethical values in case of some auditees. Professional skepticism, therefore, is something that should be instilled deeply in auditors' way of functioning. Questioning mindset, number crunching abilities and critical analytical approach to details/ data, received in course of auditing as also in certifying any financial information is utmost necessary.

4.3 Following are some of the practical actions and thought process in course of audit to sense some wrongdoing in the midst of 'timeline' pressure of completion: Stringent scrutiny of design and

effectiveness of Internal control systems. Advisable to squeeze full potential of Internal Control over Financial Reporting rather than making it a check-list filling exercise.

However, looking beyond controls is also necessary. The governance practices, overall surrounding and quality of personnel are the factors to be considered appropriately.

Identify things or situations that appear 'too good to be true' and probe them.

Ability to extract 'exception reports' from auditee's operating systems would go a long way towards quality checks. Leveraging technology by use of CAATs or other means can be immensely useful.

Sometimes details may lie in what one tends to ignore as too simple to be looked into. Analytical and pattern studies often produce good results and provide useful hints .

Interaction with not-so-senior personnel of the auditee often helps in deciding problem areas within the entity. The senior personnel tend to provide dressed up information or data/details.

4.4 The auditors' presence in office or plants or locations of the auditee are for limited time and often visit plans are pre-determined in consultation with auditees. The element of surprise is generally missing. Further, audit processes and plans are becoming predictable; the element of unpredictability in questioning of data/details by the auditors is also severely missing. These factors pose challenges in qualitative audit/verification and therefore need to be suitably tackled in course of transactional audit or verification programs.

#### 5 Conclusion

Though, detecting fraud in course of normal auditing process is neither probable nor is expected

as laid down in several judicial decisions, it is imperative for auditors to demonstrate effectively and visibly the 'professional skepticism' in course of audit. Maintenance of independence from auditee is utmost necessary.

Appropriate documentation of the audit processes like planning, risks identification, determination of responses to identified risks, verification, control testing, use of sampling techniques, third party confirmations, analytical procedures, trend and business analysis, minuted interactions with auditee personnel, bouncing of queries and seeking explanations, consultations and conclusions etc would help in demonstrating carrying on of quality audit. These would help over the years reducing, if not eliminating, the expectation gap in audit.

Suggestive checklist /actionable steps for implementing SA 240:

- SA 315 requires a discussion among the team members along with the Engagement partner as to where the financial statements may be susceptible to fraud including how fraud might occur.
- Make enquiries of Management regarding Management's Assessment of the risk, its process for identifying and responding to the risk of fraud in the entity.
- Make enquiries of Management and others within an entity to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.
- Make enquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity and to obtain its views and risk about the fraud.
- Understand how those charged with governance

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exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

- Whether the auditor has evaluated unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts which may indicate risk of material misstatement due to fraud.
- In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.
- In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.
- Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements.
- Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.
- 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 and other information, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

- If the auditor identifies a misstatement, and the auditor has reason to believe that it is or may be the result of fraud and that management is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures.
- When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.
- 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:
  - (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
  - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally

permitted; and

- (c) If the auditor withdraws:
  - (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
  - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.
- If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.
- If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. ■