ADVANCED AUDIT AND ASSURANCE

CORPORATE LEVEL

TUTE 02

by

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The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements - (S.L.Au.S 240)

Introduction

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Definition – What is 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"

Fraud can be segregated into two segments.

a) Fraudulent Financial Reporting

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b) Misappropriation of Assets

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Important

Although fraud is a broad concept, for the purpose of audit, the auditor is concerned about frauds that cause material misstatements in the financial statements.

Responsibility for the Prevention and Detection of Fraud

a) Responsibility of the Management

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b) Responsibility of the Auditor

Auditor who conducts in accordance with S.L.Au.S is responsible for obtaining a reasonable assurance that the Financial Statements are taken as a whole are free from material misstatements, whether due to Fraud or Error.

Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements due to fraud, may not be detected and the potential effects are significantly high.

This is because a fraud may involve sophisticated and carefully organized scheme designed to conceal it. Further, the fraud may be perpetrated by individuals by collusions. Frauds committed by the management are harder to detect because management is in a position to manipulate accounting records or override controls. Therefore, the Auditor should perform following audit procedures to reduce the risk.

Therefore, the auditor should perform following procedures when conducting the audits to reduce the risk.

Communication to Management and Those Charged with Governance

If the auditor identifies fraud or receives information that a fraud may exist, the auditor shall report this on a timely basis to the appropriate level of management. If the auditor identifies or suspect fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements, he shall communicate this on a timely basis to those charged with governance.

The auditor also needs to consider Confidentiality when deciding the responsibility with regard to a third-party disclosure

What are Fraud Risk Factors?

Conditions or events which increase the Risk of Fraud and Errors are refereed as Fraud Risk Factors.

Fraud Risk Factor	Fraudulent Financial Reporting	Misappropriation of Assets
Opportunities	Weaknesses in the internal control systems	Weaknesses in the internal control systems
	High complex transactions	Large amount of cash on hand or processed daily
Employee Attitudes	Integrity of Management/Board of Directors	Integrity of Management/Board of Directors
Incentives and Pressures	Higher level of competition accompanied by declining margins	Personal financial obligations
	Increase in operating losses, which creates a treat of Bankruptcy.	Recent changes of employee benefits plans
	Negative cashflows	

GOING CONCERN - (S.L.Au.S 570)

A) Introduction

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so. The going concern assumption is a fundamental principle in the preparation of the financial statements and therefore requires management to assess whether the entity is a going concern.

It is vital that the going concern assumption is considered, since it affects the value of many areas of the financial statements, how account balances are presented and the financial statement disclosures. Since the going concern assumption has such significance in the preparation of the financial statements, the going concern review is a very important part of the audit.

The objectives of the auditor in respect of going concern are:

A) To obtain ***sufficient appropriate audit evidence*** regarding the appropriateness of management's use of the going concern assumption.

B) To conclude whether a ***material uncertainty*** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

C) To determine the ***implications for the auditor's report.***

B) Events or Conditions that may cast doubt about the Going Concern assumption

A) Financial Indicators

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows (historical or prospective)
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with terms and conditions of the loan agreements
- Change from suppliers from credit to cash basis

B) **Operating Indicators**

- Management intentions to liquidate or cease operations
- Loss of key management without replacement
- Loss of a major market, key customers, licence, or principal suppliers
- Labour difficulties
- shortages of important supplies

C) Other Indicators

- Non-compliance with capital or other statutory requirements
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- Changes in laws/regulations/government policy expected to adversely affect the entity

'C) Management's Responsibilities for Going Concern

Management has specific responsibilities relating to going concern that may be set out in law or regulation and in the financial reporting framework. LKAS 1 Presentation of financial statements contains a specific requirement that management makes an assessment of an entity's ability to continue as a going concern. Because general purpose financial statements are prepared on a going concern basis, the going concern assumption is a fundamental principle in the preparation of financial statements. Therefore, management's responsibility for the preparation and presentation of the financial statements also encompasses a responsibility to assess the entity's ability to continue as a going concern, even if there is no explicit requirement to do so in the financial reporting framework.

From Managements perspective, they are responsible to perform a proper assessment with regard to the Going Concern ability of the organization

Important

If, during their assessment, management becomes aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then those uncertainties must be disclosed in the financial statements

D) Auditor's Responsibilities in relation to Management's Assessment

The auditor must remain alert throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

E) Events or Conditions Identified

If events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by,

- Requesting management to make its assessment, where this has not been done
- Evaluating management's plans for future action and having discussions with Management
    a) Analyse and discuss cash flow, profit and other relevant forecasts with management
    b) Analyse and discuss the entity's latest available interim financial statements (or management accounts)
    c) Evaluating the reliability of underlying data used to prepare a cash flow forecast and considering the assumptions used to make the forecast
    d) Confirm the existence, terms and adequacy of borrowing facilities
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference for the matters which is applicable for Going Concern Assumption
- Enquire of the entity's lawyer regarding litigation and claims
- Requesting written representations from management and those charged with governance about plans for future action and the feasibility of these plans

F) Communicating with Those Charged with Governance

The auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern.

Such communication with those charged with governance shall include the following:

- Whether the events or conditions constitute a material uncertainty
- Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements
- The adequacy of related disclosures in the financial statements

G) Audit Reporting

The auditor shall consider whether a material uncertainty exists related to events or conditions which may cast doubt on the entity's ability to continue as a going concern, as this will have an impact on the opinion issued in the auditor's report because the uncertainty must be disclosed.