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Volume 1, Issue 10 November 2012

LALIT BAJAJ & ASSOCIATES

The Emerging Role of Auditors in Mitigating Frauds

Every organization is susceptible to fraud, but not all fraud can be prevented, nor is it cost-effective to try. An organization may determine it is more cost-effective to design its controls to detect, rather than prevent, certain fraud schemes. It is important that organizations consider both fraud prevention and fraud detection.

The need for external auditors may be seen as a response to the agency problem and the audit functions as a mechanism to attest to the accountability and stewardship of company management to reduce the possibility of innocent mistakes and deliberate misstatements such as fraud and management manipulation.

Are auditors responsible for detecting fraud in the companies they inspect? Most of the public thinks they are. Auditors often demur. This gap between the expectations of auditors has existed for a long time.

That an auditor has the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public (Gay et al 1997). This debate has been especially highlighted by the collapse of big corporations including Enron and WorldCom. The unanticipated fall of Enron and WorldCom shocked the world as both of these companies received clean bills of health from their auditors immediately prior to their for bankruptcy.

Although a series of reforms were adopted worldwide in order to protect the global economy against such financial scandals, it seems they did not produce the expected effects.

The aim of this article is to identify financial report users' perceptions of the extent of fraud, and to determine client's perceptions of the auditor's responsibilities in detecting fraud and the performance of related audit procedures.

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Just to Remind you:

- Nov 15 - E Payment of PF for Oct
- Nov 22 - Filing e-forms 23AC & 23ACA(Non XBRL) - (AGM on or after 21.09.2012)
- Nov 25 - Service Tax Return (Apr'12 - Jun'12)
- Nov 30 - MVAT Audit Report (FY 2011-12)
- Nov 30 - Transfer Pricing Audit Report

"To protect the stakeholders from frauds, an organization should understand fraud risk that applies to the organization"

Definition of fraud

Fraud is any intentional act or omission designed to deceive others, resulting in the victim suffering a loss and/or the perpetrator achieving a gain. Regardless of culture, ethnicity, religion, or other factors, certain individuals will be motivated to commit fraud. Fraud has increased considerably over the recent years and professionals believe this trend is likely to continue. Fraud is an ever present threat to the effective utilization of resources and it will always be an important concern of management.

Fraud Risk Assessment

To protect itself and its stakeholders effectively and efficiently from fraud, an organization should understand fraud risk and the specific risks that directly or indirectly apply to the organization. A structured fraud risk assessment, tailored to the organization's size, complexity, industry, and goals, should be performed and updated periodically. The assessment may be integrated with an overall organizational risk assessment or performed as a standalone exercise, but should, at a minimum, include risk identification, risk likelihood and significance assessment, and risk response. An effective fraud risk identification process includes an assessment of the incentives, pressures, and opportunities to commit fraud.

Investigation and Corrective Action

No system of internal control can provide absolute assurance against fraud. As a result, the management should ensure the organization develops a system for prompt, competent, and confidential review, investigation, and resolution of instances of noncompliance and allegations involving potential fraud. The board should also define its own role in the investigation process. An organization can improve its chances of loss recovery, while minimizing exposure to litigation and damage to reputation, by establishing and preplanning investigation and corrective action processes.

Thus, to properly address fraud risk within the organization, following principles described are needed to be made sure:

- Suitable fraud risk management oversight and expectations exist (governance)
- Fraud exposures are identified and evaluated (risk assessment)
- Appropriate processes and procedures are in place to manage these exposures (prevention and detection)
- Fraud allegations are addressed, and appropriate corrective action is taken in a timely manner (investigation and corrective action)

Auditors' responsibilities in fraud detection

It is given that it is not the prime responsibility of the auditor to prevent and detect fraud and other material misstatements, rather it is the responsibility of the management to take adequate steps to prevent and detect fraud and other misstatements. The auditor is there to establish an opinion on the truth and fairness of the financial statements. He is not there to investigate each and every transaction or its document. Coupled with the fact that owing to

the volume of transactions produced, every transaction cannot be checked as it would dramatically increase the time and cost of audit, work of the auditor gives a relative assurance and NOT absolute assurance to the client, that the financial statements are free from material misstatement.

However, if this seems to be the case, then why carry out an audit at all? Why lose time and money on work that won't give you complete assurance?

In an attempt to answer these questions, the auditing profession has developed standards that address these very issues. The standards state that although the auditor isn't liable to uncover each and every fraud or misstatement, he is still held accountable and responsible for any fraud or misstatement that has the tendency of otherwise being caught by an auditor carrying out his work to the proper standards. If the auditor fails to catch such fraudulent activities that another auditor of the same standard would otherwise discover, then he is liable for his work in this case.

The factors that would mitigate this responsibility are that the auditor properly plans, records and controls his work. This means that:

- The auditor follows the proper auditing standards
- Sends engagement letters to his clients to state his and their responsibility
- Attend audit planning meetings
- Makes permanent and temporary audit files
- Engages competent staff, and
- Obtains overall knowledge of the client's environment and internal control

The factors that would compound this responsibility are:

- If the auditor fails to plan properly
- If the auditor misjudges the level of risk and materiality
- If the audit carelessly keeps audit files
- If he doesn't follow the audit procedures to the book
- If he obtains the wrong sample sizes
- Engages incompetent staff
- Doesn't have adequate knowledge of the internal control mechanism of the business

Fraud detection has been considered a major purpose of auditing for very long time. Auditors are expected to inquire more closely into reasons behind such matters as, for example, errors in accounting estimates, unusual transactions that appear to lack business rationale, and a reluctance to correct immaterial errors discovered by the audit.

Lack of understanding

The study also found a lack of understanding among respondents of the statutory duties of auditors. The lack of understanding is because the users may not have read the statutory provisions for auditors, or have chosen to ignore or forget them.

The present situation may be improved through several strategies, the two most likely to succeed being: i) educating the users on the role and the actual duties of auditors, through better com-

IDENTIFY the Risks AND REDUCE the Damage

munication by auditors; and ii) by expanding the scope of the audit to meet market expectations. Porter (1997) believes that education may help in solving the misconception problem as it may reduce the “misunderstanding gap” caused by ignorance. On the other hand, expanding the scope of an audit may help to mitigate the “expectation gap” problem as auditors would then be performing additional duties not previously required. It is hoped that by implementing both approaches, the public’s expectation and auditor’s duties will be brought into closer accord.

Summary

The implementation of the risk assessment auditing standards and similar relevant standards by other standards setting bodies raises the likelihood of discovering fraud during an audit. In addition, organizations increasingly employ antifraud controls and systems to encourage fraud reporting and improve fraud detection. The chance of discovering fraud during the normal course of an audit is no longer remote. CPA firms should provide mandatory fraud training to auditors to enhance their fraud knowledge and establish guidance and protocols for auditors to respond to situations wherein potential fraud is reported or suspected. A few key points to take away:

Auditors should refrain from providing forensic accounting and fraud investigation services to an audit client if independence is or may become impaired.

Firms should evaluate if the requisite resources and skills to perform a fraud investigation are available. If not, the recommendation that the client engage a competent fraud investigator should be made.

√ Auditors should ensure that the scope and procedures of the investigation satisfy audit needs, and obtain updates at every stage of the investigation.

√ When the potential impact of fraud on financial statements can be material, auditors should not issue an audit opinion until the investigation is completed and the extent and impact on the financial statements has been evaluated.

√ Auditors should consider the results of the investigation as they pertain to prior period financial statements audited by the CPA firm. To the extent fraud discovered is material to the prior period financial statements; auditors must follow through on related professional responsibilities.

√ With respect to audit procedures, auditors should set aside materiality when indications of fraud surface. Proper planning and execution of extended audit procedures should be implemented to evaluate the extent and full impact of fraud on the financial statements. Involvement of forensic specialists may be necessary to assist in the audit.

√ Communication protocols should be established with the client and those communications should be properly documented in the audit working papers.

√ Auditors need to understand relevant legal, regulatory, and agency reporting requirements, and fulfill their duty to disclose.

Revised Procedure for Appointment of Cost Auditors

Ministry of Corporate Affairs had prescribed a revised procedure to be followed for appointment of cost auditors. As per the revised procedure, each company is required to e-file its application with the Central Government in the prescribed Form 23C within ninety days from the date of commencement of each financial year, which shall be approved by MCA within 30 days.

1. Upon approval by MCA, the company is required to issue formal letter of appointment to the cost auditor, who shall, within 30 days of receipt of such letter of appointment, inform the Central Government in the prescribed Form 23D along with a copy of such appointment.

2. It is, however, observed that since April 1, 2011, though all the appointment applications made by the companies concerned in Form 23C have already been approved by the MCA, a large number of cost auditors have defaulted in filing the required Form 23D within the stipulated time. In many cases, the default period is even more than a year. This has been viewed very seriously by the Ministry.

3. Keeping in view the initial operation of the revised procedure, all the defaulting cost auditors are requested to file their required Form 23D that have already become due till date, by December 16, 2012 positively. In case of any further default, names of such defaulting members shall be sent to the Institute on December 17, 2012 intimating the Institute to initiate Disciplinary Proceedings against them under the relevant provisions of Cost and Works Accountants Act, 1959.

"Companies to file its application with Central Govt. in form 23C within 90 days of commencement of each Financial Year"

4. In cases where the company concerned, after approval of Form 23C, has failed to issue the formal letter of appointment to the cost auditor, they shall do so within 15 days of the issue of this Circular enabling the cost auditor to file Form 23D within the extended time indicated above. In case of non-compliance, the company and every officer thereof who is found to be in default shall be punishable as per provisions of the Companies Act, 1956.

Carbon Credit - A Capital Receipt

Carbon credit is in the nature of "an entitlement" received to improve world atmosphere and environment reducing carbon, heat and gas emissions. The entitlement earned for carbon credits can, at best, be regarded as a capital receipt and cannot be taxed as a revenue receipt. It is not generated or created due to carrying on business but it is accrued due to "world concern". It has been made available assuming character of transferable right or entitlement only due to world concern. The source of carbon credit is world concern and environment. Due to that the assessee gets a privilege in the nature of transfer of carbon credits. Thus, the amount received for carbon credits has no element of profit or gain and it cannot be subjected to tax in any manner under any head of income. It is not liable for tax for the assessment year under consideration in terms of sections 2(24), 28, 45 and 56 of the Income-tax Act, 1961.

Carbon credits are made available to the assessee on account of saving of energy consumption and not because of its business. Further, in our opinion, carbon credits cannot be considered as a bi-product. It is a credit given to the assessee under the Kyoto Protocol and because of international understanding. Thus, the assessees who have surplus carbon credits can sell them to other assessees to have capped emission commitment under the Kyoto Protocol. Transferable carbon credit is not a result or incidence of one's business and it is a credit for reducing emissions. The persons having carbon credits get benefit by selling the same to a person who needs carbon credits to overcome one's negative point carbon credit. The amount received is not received for producing and/or selling any product, bi-product or for rendering any service for carrying on the business. In our opinion, carbon credit is entitlement or accretion of capital and hence income earned on sale of these credits is capital receipt.

Therefore, the receipt of such consideration cannot be considered as business income and it is a capital receipt. Accordingly, we are of the opinion that the consideration received on account of carbon credits cannot be considered as income as taxable in the assessment year under consideration. Carbon credit is not an offshoot of business but an offshoot of environmental concerns. No asset is generated in the course of business but it is generated due to environmental concerns. Credit for reducing carbon emission or greenhouse effect can be transferred to another party in need of reduction of carbon emission. It does not increase profit in any manner and does not need any expenses. It is a nature of entitlement to reduce carbon emission, however, there is no cost of acquisition or cost of production to get this entitlement. Carbon credit is not in the nature of profit or in the nature of income.

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Income Tax Update

In exercise of its powers under clause (ii) of Para 14 read with clause (7) of Para 4 of the 'Centralized Processing of Returns Scheme, 2011', issued vide CBDT Notification No. SO 16(E) dated 4.1.2012, the Director General of Income Tax (System) hereby extends the time limit for filing ITR-V forms relating to Income Tax Returns filed electronically (without digital signature Certificate) for **A.Y. 2010-11 (filed during F.Y. 2011-12) and for A.Y. 2011-12 (filed on or after 1st April, 2011).** These ITR-V forms can now be filed **upto 31st December, 2012** or within a period of 120 days from the date of uploading of the electronic return data, whichever is later. This direction is issued to mitigate the hardship and grievance of the tax payers who have been prevented by reasonable causes to file the ITR-V in time.

MCA Update

Filing of Balance Sheet and Profit and Loss Account in Extensible Business Reporting Language (XBRL) Mode for the financial year commencing on or after 1.4,2011

In continuation of the Ministry's General Circular No. 16/2012 dated 06.07.2012, it is stated that the time limit to file the financial statements in the XBRL 'mode without any additional fee/ penalty has been extended up to 15th December,2012 or within 30 days from the date of Annual General Meeting of the company whichever is later.

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