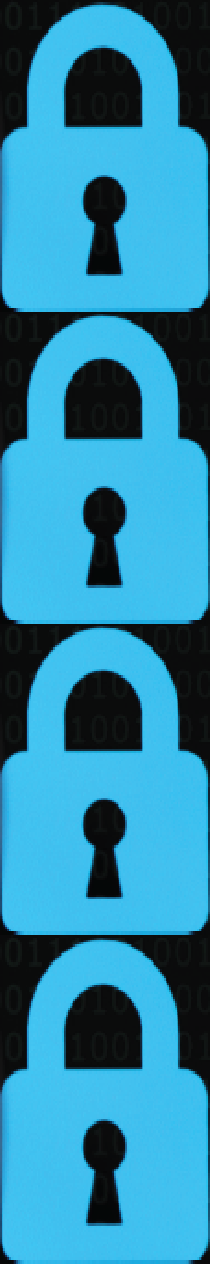
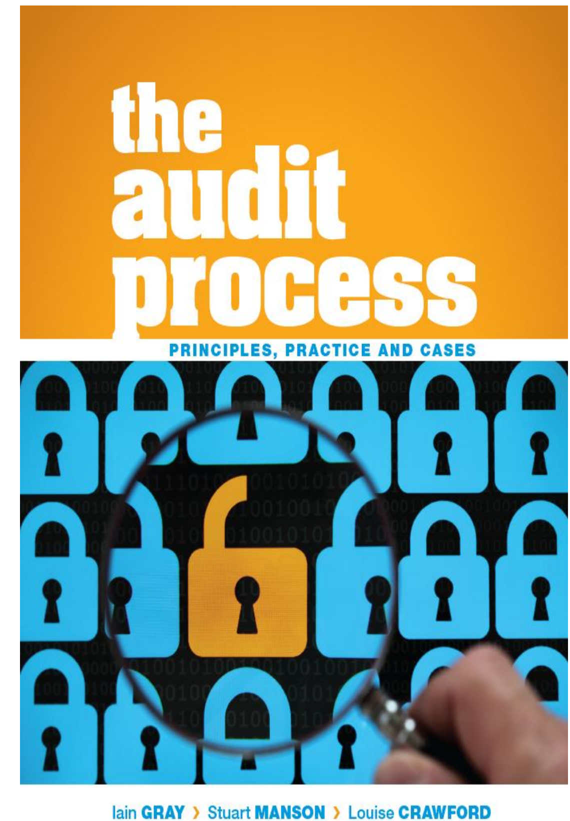


Chapter 17

Fraud and going concern



CENGAGE Learning

Use with *The Audit Process: Principles, Practice and Cases,* 6th edn
ISBN 978-1-4080-8170-9

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Learning objectives

- To describe auditors' and directors' responsibilities for deterring and detecting fraud.
- To outline the factors which may indicate a higher than usual risk of fraud.
- To discuss suggestions made by the audit profession in respect of auditors' responsibilities to detect fraud.
- To describe auditors' reporting requirements when they suspect fraud has occurred.
- To be aware of some recent financial scandals involving auditors.
- To outline the auditors' responsibilities for considering compliance with law and regulations.
- To describe the importance of the going concern concept.
- To describe the information sources directors and auditors may use to determine if a business is a going concern.
- To discuss the potential implications for auditors where there is some doubt over whether a client is a going concern.

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Introduction to fraud

- Fraud: *'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.'* (ISA 240)
- Managerial fraud or fraud by TCWG:
  - important in context of the financial statements
  - more difficult for the auditors to detect.
- Fraud can involve participation of third parties.

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Responsibility for fraud detection

- ISA 210 – management responsible for such internal control that they determine '*is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error'.*
- ISA 240 – objectives of auditor: '*To identify and assess the risks of material misstatement of the financial statements due to fraud'* and *'to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.'*

Responsibility for fraud detection – broad audit approach

- Get management estimate of extent to which financial statements materially misstated by fraud.
- Determine entity procedures to identify and respond to risks of fraud – tone set.
- Maintain attitude of professional scepticism during planning – possibility of fraud.
- Plan and conduct audit tests to limit possibility that material fraud goes undetected.
- Consider factors increasing possibility of fraud.

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Why fraud is difficult to detect

- Inherent limitations in audit techniques and tests, including sampling.
- Use of deceit, collusion and other means to conceal well-planned and executed fraud (often by individuals with responsible role in company).
- Fact that auditors only required to arrive at an opinion on the financial statements (evidence in terms of persuasiveness) rather than give a guarantee.
- Limit to effectiveness of internal controls.

Fraudulent financial reporting achieved by…

- Manipulation, falsification, suppression or alteration of accounting documents or records.
- Misrepresentation or omission of transactions or events.
- Misapplication of accounting principles.
- Inappropriate classification or disclosure in the accounts.

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Pressure to misrepresent financial performance may be high

- Poor financial performance
- Pressure from markets
- Directors wish to show growth continuing
- Company expanding by acquiring other companies, directors have incentive to show policy resulted in group continuing to be profitable
- Where company has liquidity problems and directors do not want shareholders or the markets to become aware of this

Auditor identifies higher than usual risk

- Determine how directors and TCWG fulfil fraud detection responsibilities.
- Management/internal auditors aware of fraud?
- Internal audit conducted work to detect fraud? Test results.
- How TCWG determine risk detection procedures and responses to risks.
- Assess inherent risk – focus on factors advancing fraud.
- Increase scope and variety of tests.
- Suitably qualified staff assigned to audit.
- Audit tests to contain an element of unpredictability.
- Subjective areas – management judgement/influence.
- Areas where override of internal controls might occur.
- Personnel characteristics: autocratic and authoritarian directors – staff poorly qualified/lacking motivation – individuals paid according to results – individuals allowed too much authority – high turnover of staff.

Activities

- 17.1: Suggest occasions when a company's directors may want to suppress records or documents of the company.
- 17.2: Can you suggest any types of transactions that might be recorded but are without substance?
- 17.3: Suggest characteristics of individuals, which might influence their susceptibility to commit fraud.
- 17.4: List reasons why weaknesses in the design and operation of accounting and internal control systems and problems in obtaining sufficient audit evidence may increase the likelihood of fraud and error occurring.

Change in approach to fraud

- Greater focus on material misstatements of financial statements.
- Acknowledging greater risk to auditor lies in failure to detect misstatements rather than failure to detect the theft of inventories or cash.
- Misappropriation of assets unlikely to be sufficiently material to distort the truth and fairness of the financial statements.
- Material misstatements in the financial statements often arise from overstatement of revenue.

Reporting fraud and error internally

Auditors' procedures:

- Be aware of facts and ensure understood situation correctly.
- Discuss with management or audit committee.
- TCWG to take action on reported suspicions of fraud/error.
- Document process until satisfactory resolution.
- Obtain copies of false documents, if any.

Responsibilities of the directors:

- Develop appropriate control environment.
- Establish strong and effective internal controls.
- Encourage strong ethical environment.
- Establish audit committee to whom the auditors can report.
- Conduct review of effectiveness of company's internal controls; report to shareholders.

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Reporting fraud and error to third parties

- Reporting fraud occurred or suspected may be required by law, such as money laundering legislation (ISA 240).
- Auditors take seriously reporting of fraud because they owe a duty of confidentiality to their clients.
- Definition of money laundering is wide and includes a criminal offence that gives rise to some benefit.
- See case of *Sasea Finance Limited (In liquidation)* vs *KPMG* (2000) – an example involving fraud and auditors' duty to report to a third party.

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Recent debates relating to fraud

- The description of debates relating to fraud and contained in documents such as:
  - *The Audit Agenda: Next Steps* published by APB in 1996.
  - *Fraud and Audit: Choices for Society* published by APB in 1998.
  - *Fraud: Meeting the Challenge through External Audit* published by ICAEW Audit and Assurance Faculty in 2003.
  - Issue and withdrawal and reissue of auditing standards in the area reveal controversial nature of fraud and who is responsible for detecting and reporting on it.

Case law and auditing scandals relating to fraud

- Discussed in text:
  - *re Kingston Cotton Mill Co (No. 2)* (1896)
  - *Irish Woollen Co. Ltd* vs *Tyson and Others* (1900)
  - *re Thomas Gerrard & Son Ltd* (1967)
  - *Stone & Rolls Ltd (In liquidation)* vs *Moore Stephens (A firm)* (2009)
- Auditing scandals mentioned in text:
  - Barlow Clowes
  - Nick Leeson and Barings
  - BCCI
  - Parmalat, an Italian company
  - Satyam Computer Services, an Indian company
- These cases and scandals reveal fraud is not a new phenomenon and that it is global in its reach.

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Consideration of law and regulations (1)

- Auditor's procedures should be designed to:
- 'Obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.'
- 'To perform specified audit procedures to help identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements.' (ISA 250 – Section A – paragraph 10)

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Consideration of law and regulations (2)

- Law and regulations relating directly to financial statements: auditors obtain audit evidence of compliance.
- Companies Acts or legislation relating to particular commercial sectors.
- Audit procedures:
  - Obtain understanding of laws and regulations of industry, determine how entity ensures compliance.
  - Inspect correspondence with regulatory/licensing authorities.
  - Discuss with management if aware of non-compliance.
  - Consult with lawyers.
  - Auditor gathers sufficient appropriate audit evidence to give assurance entity has complied with law and regulations.
  - Obtain from directors written confirmation they have disclosed all known actual or possible non-compliance and assess potential implications for financial statements.

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Law and regulations – audit reporting

- If **uncertain** about potential financial impact of significant non-compliance on financial statements, auditors should ensure matter is fully disclosed in notes to the accounts and refer to it in an explanatory paragraph in their audit report.
- If auditors **disagree** with management about accounting treatment or disclosure in financial statements of a material non-compliance, issue 'except for' or adverse opinion.
- If **limitations in scope** of audit work imposed by the entity, mean auditors are unable to determine whether non-compliance has occurred, issue an except for opinion or a disclaimer of opinion.

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Money laundering legislation

- Responsibilities of accountancy firms:
  - Appoint money laundering reporting officer (MLRO) to receive money laundering reports from other members of firm and report to the Serious and Organized Crime Agency.
  - Training employees of firm on legislation requirements and how to react to potential money laundering situation and report to MLRO.
  - Verifying new clients' identity and keeping records of evidence.
  - Establishing internal procedures to forestall/prevent money laundering.
- Potential serious impact on auditors:
  - Interim guidance for auditors stresses requirements relate to performing of accountancy services which encompass not only audit but other services also.
  - Legislation can apply to activities conducted overseas, but considered an offence if conducted in the UK.
- Auditors might have to seek advice from their legal advisor.

Thematic Review: Fraud risks and law and regulations in respect of law and regulations

- The thematic review noted some good practice, including training and guidance given to audit staff and the use of pro-forma documents identifying appropriate laws and regulations.
- Issues where there was room for improvement, including:
  - Identification and evaluation of laws and regulations that might impact on the financial statements.
  - Greater and more focused discussion with managers with responsibility for compliance issues and obtaining assurance that the client is in compliance with laws and regulations.
  - Evaluation of the company's internal control systems, designed to ensure that the company complies with laws and regulations.
  - When evaluating possible noncompliance of specific laws and regulations that might impact on the financial statements the auditor should exercise greater professional scepticism.
  - Greater emphasis on regular and up-to-date training particularly on the impact of the Bribery Act 2010

Introduction to going concern (1)

- The unease with going concern has come to the fore in the last few years particularly in light of the financial crisis 2007/8.
- House of Lords Economic Affairs Committee (2011) – Auditors: Market concentration and their role – expressed concern there was little warning so many banks were in financial trouble and 'wanted to know on what basis the auditors had signed off financial statements – opined banks were still going concerns.' – 'we do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent' – 'a going concern qualification was clearly warranted in several cases.'
- FRC set up a committee (The Sharman Panel) to investigate the issue arising around going concern and liquidity during the financial crisis and to make recommendations to improve the 'existing reporting regime' and related guidance for companies and auditors.

Introduction to going concern (2) general discussion

- Management of an entity using FRS 102 required to make an assessment of the entity's ability to continue as a going concern.
- Listing rules applying to listed companies in the UK require company directors to make a statement in the financial report that the company is a going concern together with supporting assumptions or qualifications.
- Use of basis means no intention to liquidate the entity or to cease trading. Assets stated on continuing use basis and not break-up or liquidation values.
- Financial statements usually most relevant if prepared assuming entity is to continue in operational existence for foreseeable future. Break-up values not relevant to users assessing entity's cash-generation ability and financial adaptability.
- When financial statements are prepared on going-concern basis, users assume the company is going to survive beyond short term.
- Difference in perception between users and auditors concerning going concern is one reason for audit expectations gap.
- Going-concern status considered during final review.

Directors' and auditors' responsibilities for going concern

- Responsibility of TCWG to determine if the application of the going concern assumption is appropriate (ISA 570). Thus management has prime responsibility.
- Auditors' responsibility to be satisfied going concern basis is appropriate and use has been adequately disclosed in the financial statements:
  i. auditor determines if management has already performed a preliminary assessment of entity's ability to continue as a going concern – using 'appropriate financial information'.
  ii. if yes, auditor discusses assessment with management and determines if management has identified events or conditions that … may cast significant doubt on entity's ability to continue as a going concern and, if so, management's plans to address them.
  iii. if no, auditor discusses with management basis for use of the going concern assumption, and inquire whether events or conditions exist that … may cast significant doubt on the entity's ability to continue as a going concern.

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Going concern – appropriate financial information

- Particular audit activities are:
  - Assessment of business/inherent and, to a lesser extent, control risk.
  - Analytical procedures.
  - Major problem in assessing going concern – requires auditors (and directors) to look into the future.
- Appropriate financial information includes:
  - Cash flow budgets or forecasts.
  - Forecast profit and loss accounts and balance sheets.
- Auditors check key assumptions and that they are consistent with their knowledge of the business and determine how good management has been in the past in judging the future.

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Indicators suggesting going concern problems

- Negative cash flows
- Significant losses
- Substantial debts trouble servicing
- Substantial overdraft close to/exceeding limit
- Current net liabilities
- Renegotiation of bank loan repayments/overdraft facilities
- Reduced dividends
- Longer to pay creditors
- Employees redundant; reorganizing operations
- Declining market and/or products out of fashion
- Major customers in bankruptcy
- Forced sale of fixed assets

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The foreseeable future

- ISA 570: auditors consider same period in future as management but, if less than 12 months *from the balance sheet date*, auditors ask directors to extend its period of assessment to 12 months. In the UK and Ireland normal for directors to consider a period of at least 12 months *from the date of approval of the financial statements.*
- If directors refuse, auditors decide if they have sufficient audit evidence to arrive at conclusion about use of going concern assumption. If insufficient, may issue modified audit opinion.
- UK and Ireland: where directors look at period of less than 1 year after approval of financial statements: determine if additional disclosure required.
- UK and Ireland: where directors do not disclose period they have used is less than 1 year from date of approval, auditors disclose it in audit report.
- Auditors must remain alert to possible conditions or events beyond the 12-month period which might affect going concern status.

Reporting on going concern – basic rules (1)

- If no doubt about going concern, management and auditors no need to report (ISA 570).
- Combined Code on Corporate Governance requires directors to report the business as a going concern, with supporting assumptions or qualifications.
- If doubts about going concern, auditors consider if additional disclosures required in financial statements.
- Where management aware of material uncertainties casting significant doubt about going concern, disclose those uncertainties in financial statements.
- If sufficient appropriate disclosures in financial statements (including management plans to deal with the uncertainties) and auditors are of the opinion that the statements give a true and fair view, need not modify audit opinion.

Reporting on going concern – basic rules (2)

- Auditors issue unqualified audit report but include emphasis of matter describing the material uncertainty and directing reader to the note disclosure.
- Where auditors consider the disclosures to be inadequate: issue an except for qualification for disagreement or an adverse audit report. Audit report will contain details of the material uncertainty casting significant doubt on going concern.
- Unqualified report where auditors agree that the use of the going concern basis in preparing the financial statements is still appropriate.
- But where the auditors do not agree its use is appropriate, they should issue an adverse opinion.

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Going concern – final remarks

- If auditor has concerns about appropriateness of the use of the going-concern assumption: raise concerns with management and audit committee. Directors might need legal advice about continuing to trade.
- If auditors believe level of assessment used by management is not sufficient for them to adequately determine if the entity is a going concern: ask them to extend their analysis. If the directors do not, auditor might be faced with limitation of scope.
- The auditors' main concern is whether management's statement on going concern is consistent with knowledge they have gained during the audit.
- The corporate governance requirements in the UK reinforce management's responsibility for reporting on going concern and clarifies the auditors' duty to form an opinion on the statement on the basis of their **general audit work**.