

Chapter 17

Fraud and going concern

17.1 (a) *False*

The statement as it stands is too wide. Directors have the prime responsibility for detecting fraud and error. ISA 240 makes it clear that the auditors' role is to identify and assess the risk of material misstatement occurring in the financial statements because of fraud, to gather evidence relating to those risks and to respond appropriately where they believe fraud may be occurring or has occurred.

(b) *True*

Sound systems of internal control should help in both deterring and detecting fraud. No system of internal fraud is, however, perfect, so there is always a possibility of fraud (or errors) occurring. This is especially so where the fraud is committed by management, well thought out and involves collusion.

(c) *False*

If auditors suspect or detect fraud they have to determine the appropriate person or persons to whom they should report their findings and this may not be the perpetrator's immediate superior. The auditors have to decide on the appropriate level of management to discuss the matter, though as a minimum it will usually be senior management. Obviously, they will not want to report it to individuals who may be implicated in the fraud. Thus, if auditors have any doubts about whether the individual's immediate superior is involved or was possibly even aware of the fraud, but took no action, they should not report it to that individual. They would also want to report it at a level where it will be taken seriously and some action can be taken. The level at which they report it will also be influenced by their judgement as to the materiality of the fraud. Other possibilities are to report the matter to the audit committee, if one exists, and in the case of regulated industries/commercial sectors to the appointed regulator.

(d) *False*

The preparation of financial statements does not imply that the company will continue trading indefinitely. Instead, its use assumes that the company will continue to be a going concern for the foreseeable future. This period, however, will vary from company to company and it is at the discretion of the directors how far ahead they look into the future. Normally this period will not be less than one year from the date of approval of the financial statements and this is the period advocated in the UK version of ISA 570 on Going Concern. Where the period is less than 12 months from the date of approval of the financial statements the directors need to consider if any additional disclosures are required relating to the assumptions underlying the use of the going concern basis. You may note that the UK version of ISA 570 differs from the International version which specifies a date of 12 months from the end of the company's financial year-end.

(e) *False?*

The directors have the prime responsibility for determining if a company is a going concern. The auditors, however, have to carry out such investigations as are necessary to arrive at an opinion about whether the directors' judgement is appropriate. When arriving at this opinion the auditors will consider how far the into the future the directors have looked when assessing going concern, the evidence the directors have used in assessing going concern and any additional information the auditors are aware of arriving from their audit investigations. We have inserted a question mark because the auditors do have this responsibility to evaluate the appropriateness of the directors' judgment and the procedures they have undertaken, but this is a second order requirement in the sense that the

directors have first to decide if it is appropriate to prepare the financial statements on a going concern basis.

(f) *True*

Where the directors have adequately disclosed the matter(s) giving rise to concern about the going concern status of the company, the auditors will include an emphasis of matter paragraph in their (unmodified) audit report drawing attention to their concerns about the going concern status of the company. Where the auditors do not believe that the directors' disclosures about the going concern status are adequate, they would modify their audit report. They would, however, only do this when their disagreement with the directors about the disclosures included in the financial statements is significant, in other words, they do not consider that the financial statements give a true and fair view. It is important to note that the auditors are only required to include reference to doubts about the going concern status of a company when those doubts are significant. It would be left to the auditors' judgement when they consider their concern about the going concern status of a client is significant. Finally, if the auditors do not agree with the financial statements being prepared on a going concern basis they should modify their audit opinion.

17.2 (a) It is difficult to come up with any definitive answer as there are reasons both why errors might be easier for auditors to detect and reasons why they may be more difficult to detect. The main reason errors should be easier to detect is that, because errors are unintentional, it is unlikely that there will be an attempt to conceal them from the auditors. This should enable auditors to detect them more easily. Fraud, however, being a deliberate act may involve sophisticated procedures to ensure it is not detected. The reasons why errors may be more difficult to detect are:

- Many errors may be for relatively small amounts and because of this they are not obvious and therefore may be difficult to detect.
- The auditors usually rely to some extent on the company's internal control system for detecting errors, so errors which have eluded that system have a high chance of also eluding the limited transactions testing performed by auditors.
- Errors are very often likely to be random events and this of itself makes their discovery more difficult.

(b) There are a number of points you should make:

- (i) If the auditors were to take greater responsibility for the detection of fraud they would have to undertake more audit testing to increase the likelihood of detecting fraud. If auditors believe that audit clients would be unwilling to pay for this additional work, they are likely to be unwilling to perform the additional work or assume the additional responsibility.
- (ii) The auditors may be concerned that if they extended their responsibilities in respect of fraud it might simply lead to the public increasing their expectations about what can be expected from an audit. In other words, it could lead to an upward spiral of what the public expects from auditors. If auditors believe this is a possibility they might conclude that it would not be in their interests to assume responsibility for fraud detection.
- (iii) Auditors may believe that it is almost impossible to detect small frauds or frauds involving the directors or top management. As such, they might consider that taking an overall responsibility for fraud without any restrictions would be an undertaking they cannot meet.
- (iv) Auditors may consider that taking responsibility for fraud would lead to them being sued for negligence every time they failed to detect a fraud. The costs of failing to detect fraud, legal costs, out of court settlements and damages awarded by courts are such that auditors are likely to be unwilling to assume greater responsibility unless some limit or restriction was placed on their potential liability.

17.3 (a) The audit procedures the auditors would undertake include the following:

- discussing with the directors the evidence they have used in forming an opinion on the appropriateness of the going concern basis for the preparation of the financial statements and how far into the future they considered.
- reviewing budgets or forecast profit and loss accounts and their sensitivity to changes in assumptions underlying them
- examination of cash flow forecasts
- determination of the company's borrowing facilities with particular regard to how close the company is to the limit on their borrowing capabilities
- checking that the company has not infringed any debt covenants or has a bank overdraft in excess of its limit
- consideration of the company's plans for the future, including any financing requirements
- assessing the company's trading position by investigating the company's order book
- calculation and the assessment of appropriate accounting ratios, for instance, liquidity ratios
- checking whether the company appears to have difficulty in paying its creditors as evidenced by repeated requests from creditors for payment by the company
- checking that the company has not needed to restructure its debts because of an inability to meet its obligations
- checking that the company is not subject to impending major litigation that could threaten the existence of the company
- checking whether there has been any changes in technology that might threaten the company's position in the market place
- checking if the company has made any staff redundant or has lost key members of staff
- ensuring that sufficient evidence has been obtained relating to any complex transactions entered into by the company particularly when they involve entities such as special purpose vehicles or financial instruments.

(b) Factors that might cast doubt on the going concern status of a company include:

- substantial and sustained losses incurred by the company over a period of a few years
- inability of the company to pay its creditors or meet debts
- poor liquidity as demonstrated by low and deteriorating current and acid test ratios.
- infringement of debt covenants giving rise to the possibility of action by lenders, such as, lenders petitioning to declare the company insolvent
- exceeding overdraft limits
- borrowing money from lenders who charge a higher rate of interest than mainstream lenders.
- a decision by management not to pay any dividend or reduce the dividend paid to ordinary shareholders
- the company cutting back on discretionary expenditure, such as staff training.
- a decision by management to factor their trade receivables
- high levels of creditors and inventory indicating an inability to pay creditors and difficulty in selling inventory
- the company losing major customers
- the company launching a new and important product which flops in the market place
- the company making a number of staff redundant
- the company having a very low order book

- high levels of gearing