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Fraud & going concern: restoring public trust in the financial reporting ecosystem

When a company collapses, all stakeholders are affected, from employees to investors, and it eventually erodes the public's trust in financial markets. The COVID-19 crisis has further increased the pressure and made companies more vulnerable to fraud and corporate failures. This has led Accountancy Europe to issue two publications¹ (and their summaries) with recommendations to strengthen the financial reporting ecosystem, respectively on Going concern and Fraud.

Fraud and going concern issues are often correlated. Fraud can threaten a company's ability to continue as a going concern; it deteriorates investors' trust in the company and can lead to its failure. Conversely, fraudulent behaviour may aim to hide a company's going concern issues.

Auditors and all other stakeholders in the financial reporting ecosystem (companies' boards and management, legislators, standard setters, regulators, public oversight authorities) are crucial to improving its resilience. Our publications propose to redefine their roles and interactions and call for a joint and coordinated effort between all parties to achieve tangible results.

The pandemic has shown that it is impossible to prevent all corporate failures. However, a stronger financial reporting ecosystem could enable entities to timely adopt preventative measures or better manage their consequences.

Recommendations for a stronger ecosystem

Our recommendations focus on financial reporting and audit of European public interest entities (PIEs). Some may also be relevant for non-PIEs and their auditors. The recommendations start from the requirements in relevant international standards and EU legislation.

Fraud

Company's management and board hold the primary responsibility for preventing and detecting fraud. The most cost-effective

way to limit fraud losses is to prevent fraud from occurring. This is why an appropriate and effective corporate governance system is key as a first line of defence against fraud.

Auditors apply a risk-based approach and their main responsibility concerning fraud is to identify, assess and respond to risks of materially misstating the financial statements. They consider the events or conditions that indicate an incentive or pressure; or provide an opportunity to commit fraud.

Fraud: Our Main proposals

Require companies to have, and publicly report on, a fraud risk management program

Companies' management should be required to operate a fraud risk management program based on a well-defined framework. This framework should prescribe procedures on fraud risk assessment, internal controls and responses to allegations and incidents of fraud. Legislation should require the board and management to publicly disclose a statement about the effectiveness of this program and relevant controls.

Pay specific attention to senior management fraud

Boards and audit committees should pay specific attention to senior management fraud and include fraud risks relevant to the company as a recurring item on their agenda. Having a trustful relationship should not stop board and audit committee members from asking controversial questions to management or making appropriate enquiries in the organisation.

¹ *Going concern: recommendations to strengthen the financial reporting ecosystem*
(<https://www.accountancyeurope.eu/wp-content/uploads/Going-concern-recommendations-to-strengthen-the-financial-reporting-ecosystem.pdf>)
Fraud: recommendations to strengthen the financial reporting ecosystem
(<https://www.accountancyeurope.eu/wp-content/uploads/Fraud-recommendations-to-strengthen-the-financial-reporting-ecosystem.pdf>)

Mandate an audit committee in all public interest entities

It should be mandatory for all PIEs to have a separate audit committee that is independent from company's management. This committee should have a sufficient number of members with competence in accounting and/or auditing, and risk management.

Legislators should abolish provisions that allow EU Member States to derogate from such requirements.

The audit committee's effectiveness should be supported by well-established whistleblowing structures and an internal audit function.

Make early warning mechanisms for auditors effective

National legislation should specify the competent authority and the related procedures for PIE auditors to report irregularities suspected during the audit, including fraudulent acts. There should be a designated competent authority for every type of PIE and clear guidance for auditors on how to comply with their legal obligations.

Clarify auditing standards for a common understanding of the auditor's role

International (and national) standard setters should clarify the auditing standards to better explain commonly misunderstood requirements and concepts about the auditor's role on fraud. Auditing standards should also require specific procedures addressing the risk of senior management fraud.

Improve auditors' access to knowledge and awareness about fraud

An alliance among firms should establish and maintain a platform to share (anonymised) case studies and experiences on discovered fraud. Such a platform should be supported by professional organisations and audit oversight bodies. It should provide secure and controlled access to audit firms and other relevant parties. The main characteristics of more frequently occurring types of fraud (per region, sector, and type of business) should be made available for audit teams' consideration.

Auditors to clearly communicate their work and conclusions about fraud

Auditors of PIEs should report their work on fraud and present related findings to boards and audit committees, even

when they have not identified any issue to report as a key audit matter or to modify their opinion. Auditors could also be required to publicly report their conclusion on the management's statement on fraud risk management program according to an acceptable framework. In practice, such an engagement might necessitate auditors to consider the internal controls over financial reporting as a whole.

Fraud: Ideas to be explored

The auditor has the overall responsibility for planning and performing the audit and for reporting its results. Based on their judgement, auditors may decide to use experts and computer-assisted audit techniques during an audit engagement.

We invite relevant parties to explore how to use forensic experts and technology in the most effective way within financial statements audits. This should include the challenges associated with the ideas below and relevant cost and benefits.

Considering more extensive use of forensic experts by auditors

Some stakeholders believe that the use of forensic experts should be mandatory for PIE audits. Others suggest that audit firms should analyse their audit client portfolio and use forensic experts for companies with a high(er) inherent risk of fraud.

Considering more extensive use of data and technology by auditors

Some stakeholders suggest that analysing publicly available external data and selected internal data, captured in systems that companies use to manage their operations, could provide useful insights to auditors in their fraud risk assessment.

Going concern

The financial reporting ecosystem should become better at dealing with and communicating on issues with a company's ability to continue as a 'going concern'. Simply put if it will remain in business for the next 12 months.

Assessing a company's ability to continue as a going concern has its inherent limitations as such assessment is based on forecasts and cannot foresee all future events.

Going concern: Our Main proposals

Broaden companies' work effort

Standards and/or relevant legislation need to broaden companies' work effort on going concern assessments. Companies should implement integrated systems and have adequate procedures to prepare reliable cashflow forecasts. They should also stress test and reverse stress test the validity of their going concern analysis. Management should have the necessary education, competences and skills to prepare such forecasts and analyses.

Mandate disclosure on companies' risk management systems on going concern and expand the auditor's involvement

Standard setters and/or legislators should require companies to provide disclosure on the functioning of their risk management systems on going concern. The auditor's role should evolve to either provide assurance on these parts of the risk management systems, or these should be audited within the financial statements audit. For this to work in practice, auditors might need to consider internal controls over financial reporting as a whole.

Mandate going concern disclosure even if no uncertainties

We propose introducing mandatory management disclosure on the basis of its going concern assumption. This should focus on the relevant key judgements of the going concern assessment. Such disclosure should be required even when no material uncertainty is identified. This will require a change in relevant standards.

Subsequently, standards should require auditors to always provide:

- a statement on their consideration of management's going concern assumption, even in case of no material uncertainty or issues identified with management's assessment;
- a conclusion on management's statement that no material uncertainty has been identified.

Some countries are considering the idea of 'gradual' reporting on going concern for both management and auditors. International standard setters and/or EU legislators could also explore whether this could replace the current 'pass/fail' outcome of the going concern assessment.

Change in mindset, transparency and communication

Companies' and auditors' mindsets need to move away from fears about negative implications of going concern disclosures. Both should rather demonstrate their knowledge and competency in this area through disclosing additional information. Management's disclosures and related auditor's communication should not be boilerplate but should instead provide useful information understandable to stakeholders.

Mandate an audit committee in each public interest entity

It should be mandatory for all PIES to have a separate audit committee that is independent from company's management. This committee should have a sufficient number of members with competence in accounting and/or auditing. Legislators should abolish provisions that allow EU Member States to derogate from these requirements.

Clarify and harmonise the period for going concern assessment

Standard setters and/or legislators should mandate a disclosure specifying what period managements going concern assessment covers. We believe that they should also ensure harmonisation of the starting date and length of the period for the assessment across European countries.

Broaden auditors' area of consideration and work effort

Audit legislation and/or auditing standards should proactively support the widening role of auditors on going concern. This should enhance auditors':

- risk assessment adaptability and agility;
- work effort in terms of considering wider context in evaluating companies' assessment of going concern, including relevant contradictory evidence that challenges management's assessments, external red flags and analyst reports;
- communication in the auditor's report on why they agreed with management's assessment of going concern and what they did to satisfy themselves with it.

Make early warning mechanisms for auditors effective

Alert procedures for auditors should be more effective to help prevent corporate failures and enable timely restructuring when insolvency is looming. Legislators and dedicated competent authorities need to ensure more clarity and harmonisation



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across Member States. National legislation should specify the competent authority for each type of PIE and the related procedures for PIE auditors to report such issues.

Beyond going concern: Ideas to be explored

Assessing companies' longer-term viability and resilience

The current work of companies and auditors on going concern focuses on the next 12 months. Some stakeholders suggest that on top of this, legislators could consider introducing a longer-term assessment of PIEs' viability and resilience. This would concern a company's ability to adapt to changes to survive and thrive in the long run. Viability and resilience statements would be prepared by management and the auditor's involvement could follow a staggered approach, ie, with more involvement in the short-term assessments.

Interconnecting financial and non-financial information

Understanding a company's resilience requires looking at both financial information and non-financial information (NFI). Legislators could consider requiring all PIEs' management to consider financial information and NFI to have a complete picture about the company. Legislators could also consider mandating assurance on certain parts of NFI reporting for all PIEs.

Send us your feedback

We call for a joint effort of key parties to strengthen the ecosystem. To this end, we ask you to send your thoughts and opinions on our recommendations to

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by 30 April 2021.