Menzies LLP Cardiff, 2 Sovereign Quay, Havannah Street, Cardiff Bay, Cardiff CF10 5SF
+44 (0)29 2049 5444 | cardiff@menzies.co.uk | menzies.co.uk

MENZIES
BRIGHTER THINKING

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Hilde Blomme
Accountancy Europe

By e-mail only: julia@accountancyeurope.eu

Please ask for: John Cullen
DDI: 029 2044 7510
JCullen@menzies.co.uk

Dear Hilde

I hope you are keeping well. Thank you for your invitation to submit comments regarding going concern and fraud. It is excellent work.

The following is a summary of the thoughts of Menzies LLP. The firm is a mid tier accountancy practice within the United Kingdom and is multi-disciplinary. It has a turnover of over £40M and is part of the worldwide HLB group.

The response is in no particular order and the responses should be seen as a combined response to both papers.

We start with our thoughts on the audit landscape generally and their impact on fraud and going concern issues. We then move on to some of the more specific points covered by the recommendations in the papers.

Level of fees charged for audit work

We feel that one of the underlying problems which is contributing to the audit process not being as strong as it could be is that clients may not be charged sufficient sums for the audit in comparison to the important role that audit plays in providing confidence to stakeholders in the financial statements.

We recognise that audit firms operate in a competitive environment, which we very much welcome and would not wish to change. However, we believe that competitive forces are pushing prices down. This disincentivises the audit firm from doing any more work than the minimum and, as a result, means that fraud is less likely to be detected by the auditor and that issues surrounding the entity's ability to continue as a going concern may not be considered sufficiently.

Audit work is sometimes treated as a "loss leader", i.e. the work itself does not make a profit but leads to the audit firm cross selling other services which are profitable. We recognise that this approach is changing and welcome the separation of audit from other business areas. Where an audit firm provides advice outside of the audit to an entity, there is a risk that the firm finds itself advising on a fraudulent matter which the audit is designed to detect.

Culture and training

We consider a barrier to the detection of fraud by auditors is the culture which has subsisted in audit teams for many decades. The general intention of the auditor is often to provide a “clean” audit report with the overall objective of retaining the client for next year’s audit and the resulting fees payable to the auditor’s firm. The day to day work of the audit tends to be carried out by audit juniors, supervised by seniors with limited experience. Staff may be encouraged to explain away any issues which arise rather than raise them with the audit partner.

In this regard we welcome the proposed change to ISA 240 para 12-1: “The auditor shall undertake risk assessment procedures and design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.” However, it is unlikely to change a culture of seeking to get the entity through the audit without issue.

Another aspect of the culture problem is that audit partners may be unwilling to challenge management effectively, for fear of the relationship deteriorating and losing the client. This aspect in particular may lead to auditors placing too much reliance on the representations of senior management and failing to use sufficient professional scepticism, with the result that senior management fraud remains undetected.

It is recognised that a good working relationship between the auditor and management is important, but this should not be to the detriment of the quality of the audit; indeed, it should improve the quality as the auditor has a better basis on which to make their assessments.

Staff training is often linked to culture and is driven by the tone from the top of the organisation. More training may be required to enable audit teams to spot and deal with issues. The audit planning may result in a series of tick boxes, with the audit juniors responsible for ensuring that every box is ticked. This may mean that other issues not planned for, such as fraud, are overlooked.

Categories of fraud

We consider that there is a third category of fraud which does not fit squarely into either of the categories identified in your paper. The category relates to cases where the entity itself is carrying out the fraud. For example, this could involve a situation where the entity obtains business though fraudulent means such as bribery and corruption. This is not asset misappropriation (stealing by staff or third parties), nor is it an intentional misstatement or omission in the financial statement. At one level, the fraudulent business may be accounted for correctly (i.e. in accordance with accounting standards on revenue etc.) However, it cannot be the case that there is a legitimate method of accounting for fraud. Financial statements cannot possibly show a true and fair view if they include unlawful transactions. Applying accounting standards can in fact help to disguise the true nature of the transaction.

We consider that the correct identification of legitimate business is an important part of the preparation of financial statements and consequently of the audit. The corporate culture of the audit client is a key consideration here and is something which we consider auditors should seek to understand in their overall consideration of the reliability of the financial statements.

Auditors need to be alive to the possibility of all types of fraud which may affect an entity and hence the financial statements. We believe that the definition of fraud currently within auditing standards is too narrow, causing the mind of the audit team to be closed to other types of fraud which may impinge on the truth of the financial statements.

Guiding principles

As mentioned above, professional scepticism is vital to ensure that auditors remain sufficiently independent of management and are able to form their own view. We appreciate that professional scepticism is already a facet of auditing standards, but feel that the lack of it may, in some cases, lead to a failure to detect fraud and/or going concern issues and therefore fell it is worth mentioning here.

Linked is a need for the auditor to look at the bigger picture, such as the corporate culture in the entity and the nature of the business, which may be overlooked when the focus is on testing each figure in the financial statements.

We would suggest that this may be well placed as a guiding principle for developing the recommendations.

Senior management fraud and whistleblowing

The paper suggests that fraud committed by senior management is rare. Our experience suggests the people at the bottom of the entity tend to steal when the people at the top do. When it is material, it is almost always involving senior management. Serious fraud involving management is one of the biggest risks to an entity.

The control environment begins at senior management prior to imposing a control environment at employee level. As mentioned earlier in this response, corporate culture is hugely important and is something which the auditor should seek to understand when considering the risk of fraud, especially fraud at senior management level.

Linked is the corporate governance framework within an entity. Whistleblowing hotlines or reporting structures should be in place in every Public Interest Entity (PIE). Matters raised through these channels should be made available to the auditor to assist in the detection of fraud and other matters which may impact on the integrity of the financial statements.

We would encourage further emphasis on cultural issues when planning and carrying out an audit, as well as considering the culture within the audit team itself.

Materiality of fraud

We consider that all fraud has the potential to be material. It cannot correctly be assumed that a “small” fraud does not lead to unreliable financial statements. A fraud which is considered immaterial may point to a larger fraud which has been hitherto undetected. We therefore consider it important that no fraud is ignored but is brought to the attention of management or the audit committee.

Any instance of fraud should also be regarded as a “red flag” which may have an impact on going concern. Once identified, it should be considered further by the auditor.

Cashflow forecasts are key

A lack of cash is one of the most common reasons for insolvency which we see time and time again. An entity may appear to be profitable and be balance sheet solvent but if it has insufficient cash to meet liabilities it will not be able to continue. Cash flow forecasts are key in assessing going concern.

Where management do not have the skills or experience to do the work themselves, we consider it would be acceptable to seek professional assistance, such as from an external accountant.

Balance between disclosure and commercial sensitivity

We recognise and welcome the recommendation that a mindset of transparency is needed when presenting financial statements to stakeholders. However, openness about risks faced by the business has the potential for creating a competitive disadvantage e.g. by analysing the position of competitors or important customers. It could also lead to a widening of the expectation gap between what users expect to see and what is contained in financial statements, which could lead to some stakeholders being unnecessarily concerned. To avoid disclosing commercially sensitive information, statements provided around risk management may be so vague as to be useless or contain significant “spin” such that the message may get lost.

We consider that financial statements and other publicly available information should strike a balance between transparency and commercial considerations.

Use of forensic accountants

We agree that forensics accountants have an important and unique skill set which may complement that of the auditor. We have reservations about auditors sub-contracting part of their work out to experts such as forensic accountants. There is a risk that the experts are used as scapegoats when a point such as fraud is missed. We do believe that there is a merit in forensic accountants providing training for audit teams and passing on knowledge to assist in the identification of fraud. They could also be used as a sounding board for members of the audit team during an audit assignment.

Mandating audit committees

We absolutely endorse the recommendation that every PIE should have an audit committee. This is vital to ensure separation of the auditor’s reporting lines from management.

Period for going concern assessment

We agree that a harmonised period for the assessment of going concern is important and believe that the period should be 12 months from the date of the approval of the financial statements, in order to be most use to stakeholders.

Summary

We are pleased that issues around going concern and fraud are being brought to the fore, especially in light of recent corporate failures. We believe that a wholesale change in culture is needed in order to transform the audit profession to ensure that it is fit for purpose and to allow stakeholders to have a high level of confidence in audited financial statements.

We thank you once again for the opportunity to contribute and would be delighted to discuss any matters raised with you.

Yours sincerely

Menzies LLP

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