

# GOING CONCERN. THE AUDITOR'S LIABILITY TOWARDS THE LAWFULNESS APPEARANCE

## RENTABLS UZNĒMUMS. AUDITORA ATBILDĪBA PAR LIKUMA IEVĒROŠANU

**Miruna Lucia NACHESCU**

Univ. Assistant, PhD

**Anca Cristina MATARAGIU**

PhD

West University of Timisoara, Romania, e-mail: mnachescu@oxygencomputers.ro

**Abstract.** The increasing appetite for risk developed by companies as well as their investors lead to economic practices which from the auditor's point of view should have raised questions in regard to the company's ability to maintain as a going concern. There was also the lack of appropriate legislation which in the end allowed for a cover up of major exposures to risk and in the end for a trust put in fragile financial systems. Evaluating a company as a going concern the auditor shall have to perform not only rigorous valuations of the company's exposure to risks but also make sure he adapts its audit procedures to the assessed risks. Appearances are not to be trusted when it comes to an audit of financial statements, as in the end besides the obvious professional role it has, the auditor should also play the role of a fortune-teller or else be prepared to face the law for his negligence.

**Keywords:** risk, audit opinion, going concern, lawfulness appearance.

### 1. Introduction

For the past years, the entire globe has been experiencing what might be considered as the most complex and intelligent crisis in history. Its sophisticated character based on intelligent patterns, able to self-replicate easily, got governments, corporations, accounting professionals, lawyers and large as well as small investors in a difficult situation.

Therefore, the purpose of the present paper is to identify what caused the increase of the fraud risk and the increased liability of the auditor towards the lawfulness appearance. We also try to set clear the importance that the auditor must give to the company's ability to maintain as a going concern. In order to fulfil our objectives we use a theoretical approach, by analysing the ISA stipulations as well as the economic context. More than that, we use an empirical approach, by looking into what has happened in the case of Satyam Computer Services in India that is considered to be the India's Enron and seeing the impact such cases had on the audit's profession.

## **2. The macroeconomic context in which the auditors activate**

In order to benefit from a functioning financial system in general, and especially a stock exchange market, it is important that the financial statements of those who participate in this market benefit from a high quality audit performed by independent auditors.

The past years have been marked by an increase in the complexity of the financial accounting and of the financial reporting standards, as well by a strong diversity in the typology of the presented economic transactions. The dependence companies manifest in regard with the more complex and sophisticated modern technology as well as the international spread of a large number of companies, have also contributed to the changes brought to the audit's profession. The lack of legislation represented a favourable factor to the increase in the appetite for risk, which was forced over the limits considered as reasonable. The public regulation with all of its three main components: regulating, monitoring and reporting has a role in maintaining counterweight for the risk appetite which can be amplified on a free market. The minimum intervention of the state in the economy, minimal legislation regarding the organization of the internal control, the reporting systems and the governance have been at the base of what is widely known as : "the sleep of business common sense", which manifested itself between 1990 and 2000, prior to the failures registered by corporations such as Enron, Worldcom, Parmalat, which called for an awakening and imposed the issuance of legislation regarding the internal control, of financial reporting standards and a reorganization of corporate governance with the purpose of regaining the public trust.

The auditor's profession has known a spectacular development in the last decades. The auditors have consolidated their status and privileges on the role they should have had in the mediation of uncertainties and in the issuance of an independent opinion in regard to the correctness of the bookkeeping of operations. The auditor's expertise, required and allowed by the markets, investors, employees, citizens as well as the state has a role in the risk limitation and stimulation of its administration measures. The role of the financial auditor shall be mainly that of rigorously evaluating the risk exposure and adapting the audit procedures to the identified risks.

The experience shows us, however, that the main interest of the audit clients is to obtain a profit and to have "attractive" financial statements for the intended users, which unfortunately is also done by the attempt to put heavy make-up on the numbers presented therein. Given the actual economic conditions, the risk for audited companies to try to apply this make-up procedure is increasingly higher.

The differences noticed within the business environment strengthen the opinion according to which the existence of a well-implemented set of international audit standards becomes a real necessity. The main obstacle in this sense is represented by the significant differences between countries in regard to the enforcement of the audit standards in the business environment. If at a national level the enforcement of standards is difficult, it is even harder to realize at an international level. The differences in design, regulation, and enforcement of standards from one country to another are hard to overcome.

Regrettably, the auditor's expertise is often connected to the collapse of companies, fraud and failure altogether. Such events supply the suspicions regarding the independence of auditors, of the competence and motivation in the process of fairly presenting the accounts of corporate businesses. More and more cases rise question marks in regard to the way in which the quality control is ensured in the audit activity and strengthen the idea that the role of the Public Audit Oversight Board (POB) needs to be increased.

The Public Audit Oversight Board (POB), the Forum of Firms (FOF) and the Transnational Audit Committee (TAC) must follow the increase in the quality of the audit activity and therefore must regularly set up meetings with the regulation organisms, the legislator and also with different stakeholders in order to gain a fair image on the degree in which the international audit standards are as well as on the quality control activities. The supervision of the audit activity is of great help in full financial crisis, as regrettably the accounting profession in general and especially the auditors are called to give credibility to the accounting information, and the users, especially bankers take this into account, declared Ion Mihailescu, the president of the Romanian Chamber of Auditors.

The Oversight Board contributes to the achievement of the fundamental objective of the Financial Reporting Council which is to support the faith in the financial statements of the entities quoted on the stock market and not only.

As a result of the crisis, the matter of analysing the reports issued by auditors in prior periods arises as a result of which it was noted that in numerous situations, shortly after issuing an unqualified opinion the audited companies have no longer been able to pursue their activity according to the going concern principle and entered a state of collapse. But audit standards require audit procedures to contain considerations in regard to the company's ability to continue its operations for a predictable future which cannot be smaller than 12 months from the reporting date. Some jurisdictions consider that the estimation cannot be smaller than 12 months from the date on which the financial statements of the company were

published as the audit must consider all events subsequent to the reporting date.

Still, the high level of volatility resulting from the downturn in the economy makes it almost impossible for the auditor or even the company to predict successfully what will happen 12 months from now.

For example:

- Lehman Brothers – received an unqualified audit opinion on January 28<sup>th</sup>, 2008 which on July 10<sup>th</sup>, 2008 was followed by an opinion expressing the health of its quarterly accounts. However, at the beginning of August the company had serious problems and on September 14<sup>th</sup>, 2008 it declared bankruptcy.
- Bear Sterns, the fifth American investment bank received an unqualified audit opinion on January 28<sup>th</sup>, 2008. However, in March its financial problems were announced and on March 14<sup>th</sup> with the support from the state it was sold to JP Morgan Chase.
- Carlyle Capital Corporation – received an unqualified audit opinion on 27.02.2008. On March 9<sup>th</sup> the company mentioned the precarious situation of its creditors. On March 12<sup>th</sup> the company announced that it was unable to sign an advantageous financial agreement that could support the stabilization of its financial position and filed for bankruptcy.

In regard to going concern Sarah Johnson stated in one of her articles that: “It is a financial reporting area in which the auditors are requested to play the fortune-teller. Here they must go beyond the much more comfortable examination role in which they only look over the past financial performances of the company”.<sup>1</sup>

Going-concern evaluations have been top-of-mind for the audit profession. This comes as auditors walk away from year-end reviews and the public digests the prominence of certain going-concern doubts. For instance: General Motors’ admission that its auditor, Deloitte & Touche, couldn’t foresee the automaker being able to last the year because of GM’s enormous recurring losses, stockholder deficit, and inability to keep cash.

### **3. Fraud risk and the lawfulness appearance**

The long transition process from a centralized economy to a market economy which Romania had to go through in the past 15 years, mainly characterized by a lack of a coherent legislative framework, created the premises and sustained the tendency for a part of the investors to “**discretionary**” apply the legal provisions.

---

<sup>1</sup> Sarah Johnson, “Regulators eye ”Going concern” Concerns”, CFO.com, April 2009

The role of the financial auditor in identifying operations of such nature is essential as point 19 of ISA 240 obliges him to “...**timely communicate its findings to the management in the following situations:**

- a) **The auditor suspects that a fraud might have occurred, even if the potential effect on the financial statements would be insignificant;**
- b) **A fraud or material error has been found”.**

The reasonable assurance regarding the fair presentation of the audited financial statements may be obtained only by getting sufficient and suitable audit evidence. Within the audit mission there is the non-detection risk in regard to some operations as a result of which the financial statements might prove to be misstated.

Reducing the fraud non-detection risk is directly correlated with the recommendations of **ISA 315 “Understanding the entity and its environment and assessing the risks”** according to which:

**“The auditor must obtain a sufficient understanding of the entity and its environment, including the internal control, in order to identify and assess the risks of material misstatement- whether due to fraud or error-in order to apply additional audit procedures”<sup>1</sup>.**

In general frauds have sophisticated forms, which apparently leave the impression that manifesting any professional scepticism is useless to the auditor, and as a result the non-detection risk increases and the applied procedures are inadequate.

When frauds are committed by the administrators or with their knowledge on the matter, the non-detection risk increases considerably, on the one hand as a result of the fact that they will not allow the implementation of an effective internal control, and on the other hand given the legal obligations regarding the administration of a company, they are outside the perimeter considered as susceptible to commit actions contrary to their interest.

However, in the last years, willingly or not, in the bookkeeping of certain entities there have been registered operations, which by their character should have lead to the increase in the scepticism level of the censors, internal auditors, financial consultants and financial auditors.

It is obvious that the difficulties, both companies and their employees face nowadays (situation that makes them try to obtain supplementary incomes that are not always legal) in the context of financial crisis, put a significant pressure on the auditor that has to look deeper for situations

---

<sup>1</sup> sursa-ISA315-www.cafr.ro

where laws are not respected and we are faced with just a lawfulness appearance that covers significant fraud.

#### **4. Financial reporting, a guarantee of going concern**

According to Michael Izza, CEO of ICAEW, “All those in the financial reporting chain have a responsibility to respond to going concern issues in a measured and informed way. Doing so will help support business confidence and contribute towards wider economic recovery.”<sup>1</sup>

This advice is even more welcomed as, especially given the period we are going through, there is a tendency to misstate or misinterpret the information provided by the financial statements, the fact which can determine a “misunderstanding on the market which leads to useless additional difficulties for the business”.<sup>2</sup>

Professionals predict that unlike past years, a significant proportion of the financial statements for the end of the year in December 31<sup>st</sup> 2009 will contain presentations in regard to going concern and liquidity. It is the auditor’s duty to approach them with the understanding and scepticism typical for the profession, but also to be a support for the entity in the sense of eliminating the conception that another matter paragraph in an audit report or a report containing a modified opinion, during the period of crisis, does not represent a negative aspect from the start, but only the impression of the moment.

ISA 570 specifically requires the auditor, when planning and performing audit procedures and in evaluating the results, to consider the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements and the adequacy of any relevant disclosures in the financial statements.

Among the factors that the auditors must consider during their reviews that may tip them off to the prospect that a company won't be in existence by the next time they do their next annual review, we can mention: working capital deficiencies, unlikely prospects for more financing, negative recurring operating losses, loan defaults, work stoppages, legal proceedings, the loss of a key customer or supplier. The auditor should either review management’s preliminary assessment of the appropriateness of the going concern assumption, or hold discussions with management in order to identify any relevant events or conditions which may cast doubt on its use. It is a common misconception that going concern is simply a solvency test on the balance sheet date. The occurrence of certain events since the year end, for instance major losses, cash flow problems and inability to meet

---

<sup>1</sup> ICAEW, Going concern, [www.accountancymagazine.com](http://www.accountancymagazine.com), Ianuarie 2008

<sup>2</sup> Idem

liabilities as they fall due, must be considered. Operating factors, such as the loss of key markets, suppliers or staff, may also be relevant.

The auditors shall have to revise the proof on the basis of which the management motivated the way it followed the going concern principle, and provided they notice that the management's valuation of the going concern is insufficient they will have to "put pressure on the management in the sense that they will have to consider the risks threatening their future, which the management would not have done otherwise"<sup>1</sup>.

If there is potential doubt about the company's going-concern status, the audit firm is expected to talk to the management about how they plan to keep the company afloat and the feasibility of such plans. If, after assessing management's strategies, the auditors still have "substantial doubt" about the company's ability to continue as a going concern, they will explain that in their report. Otherwise, without a going-concern qualification, auditors "presume you will stay in business".

ISA 570 mentions a series of answers to the findings resulting from going through the established procedures in regard to going concern, namely:

- When the auditor notices a significant uncertainty in regard to the going concern presentations, he will be obliged to mention this in his audit report; however, specialists<sup>2</sup> appreciate that this uncertainty shall have to be regarded from the point of view of the financial statement, and providing that the misstatement is not considered to have significant effects on the opinion of the intended users, and unmodified report is allowed;
- In the situation in which the auditor finds that the "uncertainty" of the management in regard to the going concern was presented in the financial statements, but there are reasons to believe that these presentations are misstated, it is the auditor's duty to present these misstatements in his report as well as the reasons which led him to this conclusion;
- When the financial statements presentation are adequate, the auditor is suggested to "express an unqualified opinion, but to put another matter paragraph in his audit report...which should draw attention to the relevant presentation in the financial statement"<sup>3</sup>;
- One will also consider the situation when the presentations in the financial statements are not adequate, and the methods used by the management to reach those conclusions likewise, is the case in

---

<sup>1</sup> Graham W. Cosserrat, *Modern Auditing*, ediția a 2a, Editura Wiley, 2008, pg. 94,

<sup>2</sup> Andrew Teague, „The audit of going concern”, *Revista In practice Ireand*, Junie 2008

<sup>3</sup> Idem

which a qualified opinion in the audit report is very necessary, at least in regard to this element of the financial statements;

- Not least, one will consider the situation in which the auditor believes the entity will no longer be able to continue its activity, reason for which, even in the situation when the management prepared the financial statements considering the going concern, the auditor will be in a position to express a qualified opinion in regard to the financial statements.

## **5. Auditors, solely responsible for the past years major scandals?**

The Public Company Accounting Oversight Board is warning auditors to take special care in the current down market, scouring for places where, stimulated by the economic instability, management manipulation or mistakes will be more likely than ever. In these cases they must take extra care in order not to take the blame for potential frauds. The top problem areas are reviews of companies' fair-value measurements, their ability to continue as a going concern, and their other-than-temporary impairment recordings. Auditors must pay particular attention to the adequacy of disclosures and accounting estimates, such as allowance amounts assigned to uncollectible receivables and deferred tax assets.

Along with outside forces having an effect on companies of all industries, internal changes could also cause problems. The crises most companies face today raise the possibility that a company's employees will take fraudulent steps to meet shareholders' and board's expectations. Auditors' attention should also turn toward the internal control over financial reporting, in light of the fact that large restructuring moves could damper companies' abilities to monitor and keep track of their data.

One of the big scandals regarding the risk of fraud and also of going concern of a company is that of the Satyam Computer Services in India that was threatening to taint the whole Indian outsourcing market. PWC, after performing the audit of the company and saying that all audits were carried out correctly had the "surprise" of finding out about the firm's chairman admitting that he had modified the books over the course of several years. He wrote to directors and confessed to inflating profits and claiming non-existent assets and cash reserves. The chairman Ramalinga Raju and other directors were arrested and replaced by three government-appointed directors. The disgraced IT mogul was charged with crimes including forgery, which could lead to him spending life in jail. Mr. Raju is one of nine people that have faced criminal charges. The Central Bureau of Investigation (CBI), India's version of the FBI, also accused two of his brothers, two Price

Waterhouse auditors and four others with criminal conspiracy, cheating, and falsification of accounts. Satyam had more than 50,000 staff so, the Indian government got involved. First the company needed to find out how much money and debt it had – so, the first task was to appoint new accountants. Srinivas, ex CFO of the company blamed PWC (for never having noticed any problems with the accounts) and the chairman for the fraud. He said Raju and the auditors dealt with bank deposits between themselves and that a big part of the missing £1bn is in bank accounts. The interim CEO Ram Mynampati said that it is important to understand what processes were used by the auditor to verify accounts. Still, the PWC speaker kept the media away from the company declaring that the obligations for client confidentiality do not give him the right to comment. The only comments upon the alleged irregularities were for the use of regulators and police use.

Among the biggest puzzles is what exactly Mr. Raju did with the “fictitious cash”, about \$1 billion, he entered on Satyam’s books. It is thought that Mr. Raju duped Price Waterhouse by showing the auditor, which had overseen Satyam’s accounts for seven years before being replaced, forged proof of funds on deposit. However, investigators are sceptical of Mr. Raju’s claims that he created the money by inflating profit margins. They are probing the possibility that much of the cash was actually siphoned off and used to fund property deals and are not yet confident that they have discovered the extent of the crime. Indian investigators have alleged that two PricewaterhouseCoopers auditors were aware that accounts of Satyam, the IT outsourcer at the centre of India’s biggest corporate fraud (known as “India’s Enron), were being misstated but signed them off in return for an “exorbitant audit fee”. Mr. Raju, two of his brothers and four other Satyam executives committed the fraud by forging more than 7,000 fake invoices and dozens of bogus bank statements to inflate Satyam’s earnings. The auditors, S. Gopala Krishnan and Srinivas Talluri, who have been suspended from Pricewaterhouse, the Indian audit arm of PricewaterhouseCoopers (PwC), received certificates of deposit from Satyam’s banks that were in “great variance with the figures provided by the company’s management” but signed off the fudged accounts anyway. The bureau alleged that Pricewaterhouse received the market rate for the work that it carried out for Satyam several times. Mr. Krishnan and Mr. Talluri are being held in prison in Hyderabad, along with the other accused. Furious investors have been demanding to know how PWC missed a systematic fraud that has severely dented confidence in India’s regulatory regimes. On April 13, Tech Mahindra, the IT group part-owned by BT, agreed to buy Satyam despite the full nature of the scandal remaining a mystery. The sale, conducted by auction and rushed through by the Indian Government, valued Satyam at about £670 million and will transform Tech Mahindra, in which BT holds a

stake of 31 per cent, into an outsourcing group employing about 75,000 people.

Pricewaterhouse (PW), Satyam's former auditor, said it was "surprised and disappointed" that two of its employees face charges. "Both partners continue to vigorously deny any wrongdoing ... The fraud perpetrated by Mr Raju ... was designed to and did circumvent PW India's audit process; the two Satyam audit partners - and PW India - were victims of that fraud," it said in a statement.

All of the above lead us to reminding what Michael Izza, chief executive of the Institute of Chartered Accountants in England and Wales (ICAEW), said. "Auditors should be responsible for their own mistakes but not for the mistakes of others." At present, auditors can be sued for the full amount of losses in the event of a corporate collapse even if they were found to be only partly to blame. Directors can agree to restrict an auditor's liability, provided that shareholders approve, but to date no blue-chip company has done that.<sup>1</sup> The Big Four - Deloitte, Ernst & Young, KPMG and Pricewaterhouse Coopers (PwC) - have been pushing for proportionate liability of the auditor since the collapse of Arthur Andersen, then one of the world's five biggest accounting firms, over its involvement in the Enron scandal in 2002. They fear that a blockbuster lawsuit, if successful, could put one or more of them out of business. That could trigger the collapse of the audit market and cause chaos for business, they say.

Still, the SEC fears that directors and auditors could cut secret deals under which auditors are given proportionate liability in return for glossing over the company's accounts. The accountants want the Government to placate the SEC by putting the issue of liability directly to shareholders in the form of a standardized resolution to be voted on at annual meetings. That would remove suspicion that an auditor's independence had been compromised.

## **6. Conclusions**

The past years have been living proof of the fact that sophisticated schemes able to self-replicate and develop in time may lead to situations where not only investors, corporations and professionals are in difficulty but also the governments. The risk of fraud and also the going concern of a company become a core concern in the auditor's work. Past experience should teach us that appearances are not to be trusted when it comes to an audit of financial statements, as in the end besides the obvious professional role it has, the auditor should also play the role of a fortune-teller or else be prepared to face the law for his negligence.

---

<sup>1</sup> Alex Spence - „Auditors plead for help amid fear of lawsuits”, The Times Magazine, April 24, 2009

## **Bibliography**

1. Graham W. Cosserrat, Modern Auditing, Second edition, Wiley Publishing house, 2008, pg. 94
2. A. Eilifsen, W.F. Messier Jr., S. M Glover, D. F. Prawitt, "Auditing and assurance services", International edition, Mc.Graw Hill Publishing House, 2006
3. Sarah Johnson, "Regulators eye "Going concern" Concerns", CFO.com, April 2009
4. P. Sikka, Financial crisis and the silence of the auditors, Accounting, Organizations and Society, 2009
5. Alex Spence – "Auditors plead for help amid fear of lawsuits", The Times Magazine, April 24, 2009
6. Alex Spence – " Auditors face scrutiny over independence", The Times Magazine, October 6, 2009
7. Andrew Teague, "The audit of going concern", In practice Ireland Magazine, June 2008
8. ICAEW, Going concern, [www.accountancymagazine.com](http://www.accountancymagazine.com), January 2008
9. "Can auditors be sure a firm will survive the next 12 months?", Economist Staff - The Economist, November 21, 2008
10. "Satyam founder faces life imprisonment" ", Times Online, April 8, 2009
11. "Tech Mahindra wins bid for 'India's Enron'", Times Online, April 13, 2009
12. "PwC auditors 'ignored' Satyam fraud for fees", Times Online, April 24, 2009
13. OUG no. 90/2008, regarding the statutory audit of the consolidated annual financial statements published in the Official Journal of June 30<sup>th</sup> 2008 (later modified by Law 278/2008 and by OUG 78/2009)
14. The 2006/43/CE Directive from May 17<sup>th</sup> 2006 of the European Parliament and of the Annual and consolidated statutory audit Counsel, to modify the Counsel directives 78/660/CEE and 83/349/CEE
15. ISA 240 "The auditor's responsibility to consider fraud in an audit of financial instruments"
16. ISA 315 "Understanding the entity and its environment and assessing the risks"
17. ISA 570 "Going Concern"

## **Summary**

The past years have been a living proof of the fact that sophisticated schemes able to self-replicate and develop in time may lead to situations where not only investors, corporations and professionals are in difficulty but also governments.

The increasing appetite for risk developed by companies as well as their investors lead to economic practices which from the auditor's point of view should have raised questions in regard to the company's ability to maintain as a going concern. There was also the lack of appropriate legislation which in the end allowed for a cover up of major exposures to risk and in the end for a trust put in fragile financial systems.

Given this past two years experience it is more and more obvious that in evaluating a company as a going concern the auditor shall have to perform not only rigorous valuations of the company's exposure to risks but also to make sure he adapts its audit procedures to the assessed risks.

The risk of fraud and also the going concern of a company were not always a core concern in the auditor's work and this has been confirmed by the downfall of many companies in the past years, shortly after having received positive audit opinions. Besides the obvious research into the company's accounts, the investors turned their heads

towards the auditors looking for the answers on how the situation could have appeared in the context of a positive review of the past year's financial statements.

Past experience should teach us that appearances are not to be trusted when it comes to an audit of financial statements, as in the end besides the obvious professional role it has, the auditor should also play the role of a fortune-teller or else be prepared to face the law for his negligence.