Email from Mark Ballamy

For the attention of Keith Billing Esq, Project Director, Financial Reporting Council

Dear Sir,

Paragraphs 31 to 33 of ISA (UK) 240 set out certain audit procedures that are said to be responsive to the risks associated with management's override of controls, and question 6 of the *Consultation Paper and Impact Assessment* seeks comment about other audit procedures that are responsive to those risks.

As a forensic accountant with over 30 years of experience, I have encountered many sets of financial statements which have been deliberately misstated by management and in respect of which the auditors did not detect the misstatements.

The principal reason that the auditors did not detect these misstatements is that they did not perform audit procedures that were specifically designed to gain assurance about the true commercial substance of transactions between the reporting entities and their customers and suppliers.

On many occasions incomplete documentation was disclosed by management to the auditors which purported to govern the transactions between the reporting entities and their customers and suppliers. In short, contracts were disclosed to the auditors and "side agreements", which materially amended the commercial substance of the contracts, were not.

Brief descriptions of two examples may assist for purposes of illustration. Both of these examples concerned reporting entities whose securities were listed on the London Stock Exchange and both were the subject of criminal proceedings against the reporting entities' directors.

1. A retailer's management disclosed to the auditors copies of agreements with suppliers which purported to confirm the retailer's entitlement to retrospective rebates. The full amounts of these rebates were reported in the retailer's Income Statement on the basis that they related to additional rebates on historic purchases. The true commercial substance of the agreements between the retailer and its suppliers was clear from "side agreements" between the retailer and its suppliers (which were not disclosed to the auditors) which made clear that the retailer's entitlement to the additional rebates was conditional upon the levels of the retailer's future purchases. The retailer's reported EBITDA for the year in question was materially overstated. The exercise of professional scepticism by the auditors should have resulted in questions being asked about why the retailer's suppliers had (apparently voluntarily) agreed to depart from the terms of rebate arrangements that had been previously agreed for the years in question.

2. A software developer had recognised a material amount of revenue in its Income Statement on the basis that it had fulfilled, in advance of the end of its financial reporting period, its contractual obligations to a customer. The auditors were satisfied that the obligations had been fulfilled during the reporting period because monies had been received from the customer in advance of the year-end in circumstances where the contract required the customer to make payment following fulfilment of the software developer's obligations. In fact, none of the software developer's obligations had been fulfilled within the reporting period. The management of the software developer had not disclosed to its auditors a variation agreement under the terms of which the customer had agreed to make a payment in advance in exchange for a reduction in future maintenance and support fees. The

software developer's reported EBITDA for the year in question was materially overstated. The exercise of professional scepticism by the auditors should have resulted in questions being asked about how the software developer had succeeded in fulfilling its contractual obligations to its customer more than nine months in advance of the timetable set out in the contract.

In both of these examples, and in many others I have encountered, the auditors did not design and perform specific audit procedures to gain assurance about the true commercial substance of transactions between the reporting entities and their customers and suppliers, despite there being clear grounds for the exercise of professional scepticism.

Exercising professional scepticism is one thing, but designing and implementing suitable audit procedures to reveal reliable answers to the questions which arise from the exercise of professional scepticism is another. In this respect ISA (UK) 505 (*External Confirmations*) is highly relevant.

In both of the examples described above, and in many others I have encountered, the auditors did not seek the consent of the reporting entities' management to communicate directly with the reporting entities' customers and suppliers. Had the auditors communicated directly with the reporting entities' customers and suppliers in conformity with the guidance provided in ISA (UK) 505, it is virtually certain that the auditors would have detected material misstatements in the reporting entities' financial statements.

Obtaining external confirmations in accordance with ISA (UK) 505 is clearly an audit procedure which is responsive to the risks associated with management's override of controls. I strongly recommend that the revised version of ISA (UK) 240 makes this clear.

Yours faithfully,

Mark Ballamy