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The Singapore Accountancy Commission

On 1 April 2013, the Singapore Accountancy Commission (SAC) was formally established as a statutory body of the Singapore Government. It was tasked to achieve a number of far-reaching objectives, spelled out by the ten recommendations in the Committee to Develop the Accountancy Sector report. One recommendation was the launch of a globally recognised qualification, Chartered Accountant of Singapore, also known as CA (Singapore).

The Singapore CA Qualification (formerly known as the Singapore QP) is one of the key initiatives in the SAC's drive to transform Singapore into a leading global accountancy hub for the Asia-Pacific region by 2020.

Designed to maximise the opportunities for those seeking global recognition and international portability, the Singapore CA Qualification is based on programmes offered by leading professional accountancy bodies in established jurisdictions such as Australia, Hong Kong, New Zealand and the United Kingdom.

Lending further distinction to the Singapore CA Qualification is the incorporation of professional accountancy requirements of the Asia Pacific region, taking into account the diverse socio-economic and regulatory profiles of countries in the region. The Singapore CA Qualification also meets international education standards issued by the International Accounting Education Standards Board of the International Federation of Accountants.

About Institute of Singapore Chartered Accountants

The Institute of Singapore Chartered Accountants (ISCA) is the national accountancy body of Singapore. ISCA's vision is to be a globally recognised professional accountancy body, bringing value to our members, the profession and wider community. There are over 32,000 ISCA members making their stride in businesses across industries in Singapore and around the world.

Established in 1963, ISCA is an advocate of the interests of the profession. Possessing a Global Mindset, with Asian Insights, ISCA leverages its regional expertise, knowledge, and networks with diverse stakeholders to contribute towards Singapore's transformation into a global accountancy hub.

ISCA is the Administrator of the Singapore CA Qualification and the Designated Entity to confer the Chartered Accountant of Singapore – CA (Singapore) – designation.

ISCA is a member of Chartered Accountants Worldwide (CAW). CAW brings together 12 chartered accountancy bodies connecting and representing the interests of over 1.7 million members and students globally.

For more information, visit www.isca.org.sg.
Reading the Textbook and using the Practice Workbook

Now that you are familiar with the Module Objective and the Learning Outcomes (syllabus), you have a better understanding of the learning journey ahead of you. Before you begin reading the Textbook, you should look at the Learning Outcomes listed at the beginning of each chapter, as these statements indicate the key takeaways from the chapter and will help you to focus your reading efforts. As you read each section in the Textbook, it is essential that you also read the relevant section(s) from the applicable Codes, Standards, Statutes, Regulations, and Guides. This will help you to reinforce the key concepts.

At the beginning of most chapters you will also find a list of additional essential reading that will further supplement your learning. Remember, the Textbook is a starting point only, not a comprehensive document. You are required to read widely and to keep up-to-date with the latest developments.

Each semester is approximately 13 weeks long. You should establish your own detailed study plan that fits in with your work and other commitments. There are two distinct periods during the semester that you should take note of i) gaining knowledge and developing your application skills and ii) revising for the examination, which includes honing your application skills.

A sample study plan might be to divide the semester into two with:

- The first ten weeks spent gaining knowledge and developing your application skills; and
- The final three weeks spent revising for the examination and doing practice exam questions.

Using this sample study plan, you would then divide the number of Textbook chapters by ten and plan to work through each chapter accordingly. As you complete each chapter, you should also attempt the corresponding question or questions from Section 1 of the Practice Workbook. This approach will help you to establish whether you have comprehended the concepts thoroughly and reinforces the knowledge and skills gained.

Once you have read the entire Textbook, as well as the other suggested reading materials and worked through the topic-specific questions from Section 1 of the Practice Workbook, you should then switch to intense revision mode and start preparing yourself for the examination. Remember, the end-of-module examination is 100% of your assessment and you have to attain a minimum of 50% of the available marks to achieve a pass.

Section 2 of the Practice Workbook provides exam-standard questions with suggested solutions to help you hone your skills. You should attempt each question as if it were part of a real examination, limiting the time allowed to complete, and being brutally honest with yourself when you compare your answer to the answer suggested. As part of your revision, you should refer back to the Textbook and other essential reading material to ensure that you have fully understood the concepts and noted any exceptions.

In terms of time invested, it is recommended that you spend 120 hours on gaining knowledge and developing your application skills (approximately 12 hours a week for the first 10 weeks of the semester). The last three weeks should be devoted to intensive revision and exam practice. At a minimum, you should plan to invest at least 14 hours each week in the three weeks leading up to the examination.

Remember, your investment of time and effort for this module is just a few short weeks for a rewarding professional career that will last a lifetime.

For any technical queries relating to the Textbook, please email ISCA at SingaporeCAQualification_exam@isca.org.sg.
Examinable documents

The list below indicates the Standards, Statutes, and other documents, which are regarded as examinable for this module.

The list below indicates documents in issue as at 31 December 2016 which are regarded as examinable.

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| SSA 710 | Comparative information – corresponding figures and comparative financial statements |
| SSA 720 | The auditor's responsibilities relating to other information |
| SSA 800 | Special considerations – audits of financial statements prepared in accordance with special purpose frameworks |
| SSA 805 | Special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement |
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### Statements of Auditing Practice (SAPs)

| SAP 2 | Auditors and public offering documents |
| SAP 3 | Audit of listed companies |

### Audit Guidance Statements (AGSs)

| AGS 1 | Sample independent auditor's reports |
| AGS 4 | Existence and valuation of inventories in the context of the historical cost system |
| AGS 5 | Audit of entities in specific industries, professions or vocations |
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### ACRA Audit Practice Direction

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1. Money laundering scenarios (25 mins)

(a) Your AE has recently accepted the audit of National Bank Ltd. The senior partner has just emailed you because of your role as compliance manager at the AE.

From: Senior partner  
To: Compliance manager  
Subject: National Bank and money laundering

I've just been asked what action we feel we should be taking as new auditors of National Bank in order to manage the risk of money laundering recurring at the bank and affecting shareholders. All we can do is state what the regulations tell us to do but it's a while since I was briefed!

Can you please prepare briefing notes for my use in which you:

- Identify and explain the duties of an auditor in relation to money laundering.

Thanks.

Required
Respond to the email. (7 marks)

(b) Your AE has also recently accepted the audit of Joyful Town United Ltd, a listed football club which has suffered financial fluctuation in recent years due to differing fortunes in the league. When the team is successful, income from television and sponsorship is high, but poor performance results in swift loss of such revenues. This can lead to required sales of the best players who have high wage costs associated with them.

You have been appointed audit manager for the client, and have received the following email from the AE's compliance partner:

From: T.Compliance@tta.co.sg  
To: A.Manager@tta.co.sg  
Date: 13 July 20X8

A recent report from Financial Action Task Force (FATF), an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering (ML) and terrorist financing, has just landed on my desk. Among other things, it concludes that the football sector is used for ML as well as a number of other offences. These offences are reported to have been perpetrated by football players (both domestic and overseas) as well as their agents, their employers (the football clubs and their owners), broadcasters, betting organisations and even fans following the fortunes of the sport. I am concerned about how exposed we may be in this area. Please can you supply me with a brief discussion of areas where the football sector is likely to be at risk of ML and other fraud, suggesting examples of how such activity might arise. Don't worry about the ML regulations – I know about them!

Required
Respond to the partner's email. (7 marks)

Up to 3 of these marks will be awarded in for commercial awareness, the clarity of points made and the professional nature of the discussion.

(Total = 14 marks)
1. Money laundering scenarios: Answer

(a) The auditor’s anti-money laundering duties in Singapore come from ISCA’s EP 200 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore. In summary:

- We must train staff in the relevant anti-money laundering legislation, such as how to recognise cases of money laundering and the action they should take (including avoiding tipping off potential fraudsters before they can be apprehended).
- We must establish internal systems and controls to address money laundering concerns.
- We will have to verify the identity of new clients (KYC/CDD).
- We will need to maintain all evidence of identification and all client transactions for at least five years after the client relationship has ended.
- We must be aware of the possibility of money laundering while conducting the audit.
- We must establish clear internal reporting procedures so that staff know to report suspicions to the MLRO who can determine if a report to the STRO at CAD is necessary.
- We should establish compliance management arrangements and establish an independent audit function to assess the effectiveness of our internal policies, procedures and controls and compliance with AML/CFT requirements.
- We should screen new employees when hiring.
- We must report suspicions to the relevant national authority (this is CAD) however, it is an offence to tip off fraudsters so care must be taken in how this reporting is done.

Candidates should refer to EP 200 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore for a detailed explanation of the duties of auditors in relation to money laundering.

(b) Money laundering in football (more thorough than expected to provide depth of content)

Unlike more established global industries, such as petrochemicals or fashion, football is still ill-prepared as a sector to protect itself from fraud due to its relatively recent promotion as a significant industry. As a consequence of this, the systems in place to regulate against such risks are not yet fully fit for purpose. This seemingly innocent (but financially explosive) sport now poses a serious option for criminals who find the more traditional channels of fraud and money laundering (such as extortion via protection rackets) difficult to exploit due to the widespread adoption of anti-money laundering policies in the 21st century.

Cross-border money flows associated with transfers and club acquisitions for example may operate above any one national football governing body making money laundering more easy to slip between two sets of regulations. The seemingly irrational pattern and size of football transactions has also made it very difficult to detect a pattern that sets any kind of norm and makes such risks therefore harder to identify using analytical procedures.

The proliferation of global television coverage has made some football matches attractive targets for irregular betting operations, leading to increased risks of corruption and illegal money flows between players, fans and betting organisations which have resulted in cases of match fixing for example. Similarly, the financial instability created by success and failure in the league has made clubs more desperate for funding and as a consequence, they may be less inclined to ask probing questions if an investor offers financial support.

In the UK in 2004, a ‘fit and proper persons’ test was introduced to address this problem, leading (albeit indirectly) to the removal of a former Thai Prime Minister from the control of Manchester City FC in 2008 following concerns over the legitimacy of his financial resources. Such a test is designed to eliminate the risk of a wealthy individual or group using the legitimate acquisition and
funding of a major football club as a means of laundering criminal funds from another jurisdiction, but it is not yet widely used across the whole sector. The case of Carson Yeung, the Birmingham City FC owner and Chairman who was found guilty of money laundering in March 2014, has now led some to question whether the ‘fit and proper persons’ test is fit for purpose itself. Carson Yeung paid £81.5m for Birmingham City in 2009 with earnings he claimed came from his hairdressing salons, gambling and stock market investments.

Fraud and money laundering concerns do not just relate to the entire industry or certain clubs however, as there are also significant risks associated with individual player-related transactions. These can include straightforward cases, such as a former Brazilian football star who was convicted in 2009 of tax evasion while playing for a Brazilian club a decade earlier – he claimed that he had not intended to evade tax but was found to have understated his income, leading to an estimated $500,000 of unpaid taxes.

The nature of football and its business deals has not contributed to full disclosure of such deals, helped by a combination of overseas players from varying tax jurisdictions, a competitive transfer market with the need to maintain player values and the desire to make money before an injury or loss of form restricts a player’s future earnings.

Other player-related transactions include complex arrangements for acquiring new players and recording such transfers accurately. The practice of setting up investment companies in tax havens to deal with a player’s transfer have led to the true origin of funds being obscure and the threat of money laundering being increased. Similarly, the sometimes opaque nature of transfer fees and the precise extent of agents’ fees and a player’s signing on fees therein can lead to money laundering threats and imprecise financial accounting, often due to the varying regulation of agents across different jurisdictions.

Finally, there are more sinister areas of corruption that football finds itself at risk of supporting. Young people are moved across continents in batches of potential youth talent, but are actually the subject of human trafficking for a variety of purposes (drugs mules, prostitution, illegal immigration). Similarly, illegal drugs might be supplied from other jurisdictions which purport to be training supplements for players.

Given the significant financial resources within football, assurance providers will rightly be tempted to seek engagements in such a lucrative area. However, we must also be aware of the many risks attached to such an industry, not least those from potential clients wishing to secure legitimacy via the association with an assurance provider such as ourselves.
2. Ethics (29 mins)

(a) In January 2010, ISCA issued revised and redrafted SSAs for audits of financial statements following a clarity review. One of the objectives of the clarity review was to clarify mandatory requirements. This was done by changing the wording used in SSAs to indicate requirements which are expected to be applied in all audits. Some argue that this introduced a more prescriptive (rules-based) approach to auditing, and that a principles-based approach is more desirable.

Required

(i) Contrast the prescriptive and the principles-based approaches to auditing. (2 marks)
(ii) Outline the arguments for and against a prescriptive (rules-based) approach to auditing. (5 marks)

(b) You are a senior associate in the audit department of an AE of Chartered Accountants. One of your responsibilities is to act as a mentor to new recruits into the department. The new audit assistant has asked you to answer some questions which relate to issues encountered in their first few weeks working at the AE. The questions are shown below:

(i) When I was on my initial training course, there was a session on ethics in which the presenter talked about being intimidated by a client. I assume this does not mean physical intimidation, so what is an intimidation threat? (3 marks)

(ii) When I attended the annual inventory count of designer clothes at an audit client's principal warehouse, I was invited to purchase any items of designer clothing at 50% of the client's recommended retail prices. I didn't purchase anything but would this have been allowed? (3 marks)

(iii) I heard one of the audit managers say that we have been asked to help recruit a Chief Financial Officer for an audit client but could not assist for ethical reasons. Why is this not permitted? (3 marks)

Required

For each of the three questions raised, provide a response to the audit assistant, in which you identify and explain the ethical or professional issues raised. (Total = 16 marks)
2. Ethics: Answer

(a) (i) Rules-based (prescriptive) auditing is where the auditor follows prescribed rules on how to audit a particular area, but does not use any judgment about how to apply the rules. Principles-based auditing is where no detailed rules are prescribed, but where the auditor must apply more general, guiding principles to the particular area being audited.

(ii) 
**Advantages**

Improved clarity and understandability. Prescriptive auditing standards leave the auditor in no doubt as to what he needs to do to audit a particular area. He just needs to follow the rules precisely and to the letter. As long as he has done this, he will be able to say that he has audited in accordance with the standards.

It can be argued that prescriptive standards lead to an improvement in the quality of audits because they leave less scope for the auditor to choose how to audit each area, which reduces the risk that the auditor might make the wrong choice or might make a poor judgment. This also makes it much easier for the regulatory authorities to monitor audit quality, as it is much clearer what the auditor needs to do in accordance with the standards.

**Disadvantages**

The key disadvantage is that it reduces the auditor's ability to take into account the individual circumstances of the entity that is actually being audited. There is a danger of just applying the rules irrespective of whether the audit procedures are appropriate in this particular case. Worse than this, there may not even be a rule for the particular situation being audited, leaving the auditor in a very difficult position. This would lead to audit procedures being done that may not be adequate to gather sufficient appropriate audit evidence.

Prescriptive approaches diminish the extent to which auditors need to use their own judgment. This may not be too much of a problem in the case of a simple entity that is straightforward to audit, but it can be problematic in the case of a complex entity that is difficult to audit.

There is therefore a danger that a prescriptive approach might actually reduce the quality of audits.

(b) (i) An intimidation threat is a threat to compliance with the fundamental principle of an auditor's objectivity, which is a crucial part of his independence.

An example of an intimidation threat would be a client threatening to replace the auditor if the auditor intends to qualify the audit opinion.

When an auditor identifies that there is a threat to his independence, he should apply safeguards to reduce the threat to an acceptably low level. There may, for instance, be a specific mode of recourse available through the individual regulatory framework that the auditor is operating in.

(ii) At the inventory count, the audit assistant was invited to purchase designer clothing at 50% of RRP, that is, at a 50% discount. This gives rise to a self-interest threat to objectivity whereby the audit assistant's professional judgment could be or could be seen to be influenced by the enticement of the cheaper clothes. An intimidation threat may also arise if the client threatens to make the offer public.

The significance of this threat depends on the nature and value of the designer clothing and the intent behind the offer. The intent behind the offer is unknown but it would not be unreasonable to assume that the value of designer clothing is high.

ISCA's guidance on accepting goods states that unless the value of the designer clothing is trivial and inconsequential, the threats to independence cannot be reduced to an acceptable
level by the application of any safeguard. The offer of designer clothing at a 50% discount is likely to be material to the audit assistant who is the most junior grade of staff. In this context, the benefit is not trivial or inconsequential.

Additionally, it would be inappropriate to take up the offer at the inventory count, since this would constitute movement of inventory during the count, which would be wrong. If mistakes were to be made on the inventory count, the AE might be open to charges of negligence if it appeared its staff members indulged in a shopping trip when they should have been auditing.

(iii) Providing assistance with recruitment to the audit client may create a self-interest threat where the AE feels pressured to overlook any audit issues relating to the Chief Financial Officer they have been responsible for recruiting.

The AE must consider the role of the individual being recruited when looking at the significance of this threat. A Chief Financial Officer is definitely in a position to affect the subject matter of a financial statement audit and so the significance of the threat is high. Moreover, the ISCA Code forbids ‘the provision of recruitment services to a financial statement audit client where the relevant position is that of a… Chief Financial Officer’. No safeguards are likely to be sufficient to overcome the threat to independence since the threats are so significant. Hence, the AE cannot help recruit the Chief Financial Officer for the audit client.
3. Professional responsibilities  

You overhear the managing director of your client commenting to his shareholders over the phone that the audited financial statements will be free of fraud and other irregularities as it had been audited. You realise there is a need to clarify that misunderstanding and decided to draft a letter to the director to clarify your duty as auditors in relation to detecting fraud and other irregularities. The content of your letter should:

**Required**

(a) Briefly outline the extent to which an auditor is responsible for detecting irregularities and fraud (as expressed in the auditing guidelines).  

(b) Consider the extent to which it would be reasonable to extend the auditor’s responsibilities beyond that and the practical problems of extending auditor’s responsibilities.  

(c) Reach a conclusion on and provide a definition of the extent to which you consider it reasonable for an auditor to be responsible for detecting irregularities and fraud.  

(Total = 15 marks)
3. Professional responsibilities: Answer

Dear Managing Director

Please find below some notes which clarify the duty of auditors in relation to detecting fraud and other irregularities.

(a) Responsibility of auditors

Before considering whether it is practical or desirable for auditors to accept a general responsibility to detect fraud and other irregularities, it should be recognised that they already have a responsibility to obtain reasonable assurance that the financial statements are free from material misstatements whether caused by fraud or error.

It must also be acknowledged that the primary responsibility for preventing and detecting fraud must always rest with the management of the entity. It is they who have been given the responsibility to safeguard the assets of the enterprise while the auditor's primary responsibility is to express an opinion on the financial statements.

(b) Extend responsibility?

However, it can be seen that the shareholders', the Government's and the public's expectations of the auditor are changing and they are increasingly calling on the auditor to widen his responsibility.

One of the problems that may arise is the difficulty of defining fraud. Associated with this is the need for the auditor to determine an appropriate level of materiality.

Currently the auditor assesses materiality in relation to the true and fair view shown by the financial statements. This may no longer be the correct basis if all or most frauds have to be detected.

Fraud itself can cover several types of activities at various levels within the company. Should the auditor be expected to detect a petty theft committed by a junior employee? If not, how is a line drawn between insignificant and important frauds? The guidelines define fraud as involving the use of deception to obtain an unjust or illegal financial advantage.

The desirability of changing the auditor's responsibility has to be considered in the light of different types of organisations and different interested parties. It would seem to be reasonable for the auditor of a financial institution, where depositors' savings are at risk, to have a greater responsibility for the detection of fraud than the auditor of a small private company run by proprietors. Similarly the auditors of public companies should have a greater responsibility than those of private companies. This would reflect the public's expectations of the role of the modern auditor and legislation should react to these expectations.

Since fraud invariably has an impact on either the accounting records or the financial statements, it is generally accepted that auditors need to plan their audits so that they have a reasonable expectation of detecting material misstatements caused by fraud.

While few people would disagree that the auditor should have some responsibility for the detection of fraud, it may be that widening the auditor's role would mean that additional audit costs would be incurred by all organisations to detect fraud in a mere handful of cases.

Perhaps auditors should advise management how to prevent and detect fraud and penalties for it should be increased so that there is a greater deterrent. If organisations could prevent fraud more effectively there would not be such a need for auditors to try to detect it.

As to the practicalities of detection, fraud can be very difficult to detect where internal control systems are very weak. Some types of fraud may require special expertise to be detected. All auditors should already be detecting frauds and irregularities which give rise to material errors in financial statements. Procedures used to detect immaterial frauds would principally be an extension of the usual audit procedures but the time taken to extend the level of testing would be considerable.
The auditor judges the amount of work necessary on the need to obtain sufficient, reliable evidence on which to form an opinion on the view shown by the financial statements. If the auditor's objective was changed, whilst the method would principally be the same, the amount of work necessary would increase significantly. The auditor would not accept a greater responsibility for detecting fraud without a substantial fee increase. It is questionable whether this would be considered worthwhile for most organisations.

There is also the practical difficulty of to whom the auditors report a fraud. If senior management is involved and the auditor has no real proof and there is no material effect on the financial statements, then the auditor will have to seek legal advice on what action should be taken. The auditor is bound by his duty of confidentiality from disclosing it to the appropriate authorities without the client's permission. However, the duty of confidence is not absolute, and the auditors may disclose matters to a proper authority either in the public interest or for other specific reasons.

An associated problem which might arise is a deterioration in the relationship between the auditor and the client. If he had to report directly to the authorities, the client may be reluctant to provide information which might cast suspicion over everyone.

(c) Conclusion

The primary responsibility for preventing and detecting fraud lies with management and management should work with auditors to develop preventive internal controls, rather than depend on auditors to detect. The approach I advise is for the auditor to make recommendations to management about how they could reduce the likelihood of fraud or irregularities and increase the possibility of detection.

If you require any further information, please feel free to contact me.

Yours faithfully,

Audit partner
4. Orchard Trading Pte Ltd

Zig and Zag (ZZ), an AE in Singapore, has 20 partners and 87 audit staff. The AE provides a range of audit, assurance, tax and advisory services. The AE has clients ranging from sole traders to a number of large companies (none of which are listed).

The quality control partner has recently resigned to take up a position in industry. The quality control partner has not yet been replaced as the board of ZZ have not been able to find a suitable replacement. Prior to departure, the quality control partner was in the process of implementing a system of ethical compliance for assurance staff. Staff would be required to confirm in writing their compliance with ISCA's Code of Professional Conduct and Ethics. Implementation of this system is incomplete.

Orchard Trading Pte Ltd (Orchard) is one of the AE's largest clients for whom ZZ provides audit services, preparation of tax computations and other advisory services. A new engagement partner has been assigned to the audit as the previous partner has retired. The fee for the audit work and other services has been set at the same level as last year in spite of the fact that additional work will need to be performed as Orchard has introduced a new computer system. The starting date of the audit has been delayed due to problems with the new system. The management of Orchard was very insistent that the fee should not be increased because of this.

Required

(a) List the six elements of an AE's system of quality control identified by SSQC 1. (3 marks)

(b) Identify and explain the quality control issues in the scenario above and the action which should be taken by ZZ. (10 marks)

(Total = 13 marks)
4. Orchard Trading Pte Ltd: Answer

(a) The six elements of an AE's system of quality control are:

- Leadership responsibilities for quality within the AE
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

(b) The issues are as follows:

**AE culture**

SSQC 1 requires that AEs implement policies such that the internal culture of the AE emphasises the importance of quality control. It is the leaders of the AE who are responsible for creating and maintaining this culture through their actions and messages. In other words the entire business strategy of the AE should be driven by the need for quality in its operations. The personnel responsible for establishing and maintaining the AE's system of quality control must understand SSQC 1.

In this case two factors indicate that there is a lack of leadership on quality control:

(i) The partner responsible for quality control has resigned and has not been replaced. While this may not have a direct impact on the audit of Orchard, the fact that there is no one responsible for quality control in the AE increases the risk that quality control deficiencies will go undetected.

(ii) The AE is under pressure to complete the audit and provide other services for the same fee as last year in spite of the fact that additional work will be required. There is a risk that quality will suffer as audit work will not be carried out as thoroughly as it should be in order to complete the work within budget. This problem is exacerbated by the potential lack of proper quality control review due to the departure of the quality control partner.

The quality control partner should be replaced as soon as possible. The budget for the audit of Orchard should be monitored carefully. The audit should be conducted properly and in accordance with SSAs. Any cost overruns should be discussed with the client and additional fees negotiated if necessary.

**Ethical requirements**

An AE should have procedures in place to ensure that staff are aware of ethical requirements and comply with these. In this case the implementation of the system has not been completed. Whilst members of staff who are members of a professional body eg ISCA should be aware of their responsibilities they may not have all the relevant information to avoid an inadvertent breach of the regulations eg details of all companies who are clients of the AE.

The implementation of the system started by the previous ethics partner should be completed.

**Monitoring**

The fact that the auditor partner is new, and the previous partner is no longer with the AE increases the risk regarding audit monitoring. As the current audit partner is new they will not have an extensive knowledge of the audit client initially. The tight deadline for the audit accentuates this problem.

To decrease this risk the audit partner must gain an understanding of the business in accordance with SSAs. If possible, it may be appropriate to retain the audit manager and audit senior from the previous year to aid continuity. ZZ may also consider a second partner review to ensure that quality control standards have been maintained.
5. RH Manufacturing

Your AE has been invited to tender for the audit of RH Manufacturing Pte Ltd, a private family-owned and run company that is a leading computer parts manufacturer. Its customer base includes a significant number of branded customers across various countries. The company has 18 factory plants across the world and employs over 3,000 employees.

RH Manufacturing wish to change their auditor because they believe they are being overcharged for their annual audit. Tentative investigations made so far by the commercial partner seem to suggest that price will be the deciding factor when the tender is awarded. The company has become something of a pioneer in its industry, streamlining its production and support functions by extensive outsourcing of its core activities.

You have been approached by the commercial partner to consider the likely strategy that your AE should adopt if it is going to stand a chance of being awarded this tender. He has asked you to 'think outside the box' and consider how the client might think and what the AE's tender price should be.

Required

(a) Discuss the likely reasons for the objections displayed by some companies about the cost of the statutory audit. Your answer should consider the case of RH Manufacturing as well as companies in general. (6 marks)

(b) How can existing auditors help their clients to keep audit fees at a level acceptable to the client? (7 marks)

(c) ‘In the 21st century, AEs are just like any other business and have to find work however and wherever they can.’

Critically discuss this statement. Your answer should briefly consider the situation of tendering for the audit of RH Manufacturing. (7 marks)

(Total = 20 marks)
5. RH Manufacturing: Answer

(a) The likely reasons for such objections on the part of the client may start with the perception that the audit is treated as a commodity and priced on the basis of it being bought and sold in a market regardless of its value to the client or society due to it being a legal requirement. This is further reinforced by the perception that value for money (VfM) is questioned when compared with other services, such as management consultancy.

This sense of disconnection between the statutory requirement and the benefit obtained is bound to generate resentment among companies whose profits are being squeezed already by the harsh trading environment.

Commentators often state the benefits of audits as a form of reassurance to shareholders who struggle with the lack of visibility of their directors (also known as the agency problem). For companies like RH Manufacturing however, as the company is run and owned by the same family, this is not an argument that will carry much weight. Similarly, although other public listed companies have many shareholders who can use the audit as a form of control over their agents, the inflexible approach and limited liability attached to the auditors' work makes the fees still seem unfair.

It seems as though the only parties to really benefit from the audit are third parties such as lenders and the tax authorities as they stipulate the requirement for an external audit (and even who should do it, such as a ‘Big 4 AE’ in the case of some restrictive covenants placed on companies by their banks) and yet it is still the company who has to pay for the audit fee.

All these factors lead to companies feeling frustrated with the costs of the audit and may go some way towards understanding why they may seek an audit at minimal cost.

(b) Taking the points raised in part (a) into account, there are things that the auditors can do to try and help keep the audit fee at a level deemed acceptable by the client. Co-operating with the company's internal audit department (if one exists) as much as is possible is a good starting point to try and avoid unnecessary duplication in areas such as testing internal controls.

This raises an issue that has become more prevalent in recent years, that of the same AE providing both internal and external audit services. In Singapore, listed companies may not currently obtain internal audit services from their external auditor unless certain conditions apply (for example, internal audit services supporting a significant or material part of the financial statements cannot be provided). However, since RH Manufacturing is not listed, the provision of internal audit services might be a possibility in this case.

While question marks remain over the professional issues surrounding closer working with internal auditors, advising the client to improve its internal control systems so as to enable greater reliance on internal control systems, and thus reducing expensive substantive procedures is a far more straightforward suggestion for reducing the fee burden.

Sometimes, the fee level may not be the issue and instead, the client may not feel it is getting what it agreed to pay for. This is a perennial problem for auditors, so explaining the fee structure to the client so that there is no misunderstanding (in line with SSA 210 Agreeing the Terms of Audit Engagements) may be a quick win for the auditor in managing such expectations.

Similarly, highlighting those areas to the client where the auditor adds value might help make the fee seem more acceptable. Auditing standards such as SSA 260 (Revised) Communication with Those Charged with Governance and SSA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance specifically improve valuable feedback from the audit process and hence remove the perception that the audit is simply a necessary evil.

The auditor can also suggest to the client that they adopt some organisational changes to reduce the likely cost burden of the statutory audit. Advising companies to simplify their structures to keep the audit fee low rather than simply to avoid tax is one idea. Advising clients that are groups to use one AE for all components and therefore maximise any efficiencies is another.
After experiencing financial reporting problems in 2005, Royal Dutch Petroleum Company and Shell Transport and Trading decided to adopt one corporate and listing entity under the name Royal Dutch Shell, removing among other things the need for two separate audits in the Netherlands and the UK.

In summary, there are plenty of way that the 21st Century auditor can make the fee more acceptable to the client, but overall, a sound working relationship based on constructive dialogue is a good start.

(c) ‘In the 21st century, AEs are just like any other business and have to find work however and wherever they can.’

This statement opens up a debate that is at the very heart of being a professional – how do you find the right balance between professional duty and commercial success? The suggestion made by the statement is that we should make money regardless of the professional duty placed upon us – there are certainly three issues that are raised by this:

1. It would be unethical for us to tender for an engagement that we are not technically competent to perform, as it reflects badly on us in the long run (unlike emergency surgery, where incompetence is identified very quickly).

2. From the discussion in part (b) above, there would appear to be a business case for providing both internal and external audit services to the same client (a case that satisfies both the client and the auditor) but the fact remains that the self-review threat is still something that could affect audit independence (which shareholders and other stakeholders may have concerns about).

3. It would adversely affect our independence if we were to ignore the guidance on rotation put forward to counter the threat of familiarity with our clients.

So the fundamental ethical principles have something to say in this debate – what about the market? Taking RH Manufacturing as a case in point, the implication is that the prospective auditor should submit a tender at a price that satisfies the client regardless of whether it covers the true cost of the audit – the practice of setting fees at such a level is referred to as lowballing and while not unethical, it does raise questions about the quality of an audit where the fees do not cover the necessary costs for delivering an opinion.

Competition is a tricky subject in the audit profession, as it raises the issue of value for money which assumes that all AEs can be compared on a like-for-like basis where the amount of ‘utility per $’ is the common principle used for comparison. However, while competition is supposed to focus on all factors, inevitably cost will be considered in times of financial austerity and the simple facts of commercial life dictate that, while large professional services AEs may have sprawling overheads to cover, they can often under-cut the smaller AEs meaning that competition is not on a level playing field and quality is again ignored.

This can have dangerous implications if the profession promotes a market where auditors are chosen simply on the basis of commercial criteria alone, as it may risk devaluing our services to such an extent that they are viewed as just another homogeneous commodity (Note. to some extent, audit is generic – reforming audits to be more than just a ‘health-check’ however is a debate for another day) open to basic supply and demand economics. Supermarkets are very open about selling products at competitive prices, some at levels below cost to tempt the shopper into the marketplace for other more lucrative products. This ‘loss-leading’ approach is fine for groceries, but we have seen the same thing in the audit profession before – Arthur Andersen losing money on the Enron and WorldCom audits simply to secure more lucrative consultancy work – and that can only be a bad thing for a profession already with question marks over its reputation.

Perhaps the secret for professional services AEs is to find a way of differentiating themselves when the audit is so regulated and the outcome is in such a standard format so as to avoid charges of simply selling on price alone. We face a curious contradiction that in order to create a better
impression of quality, we have to increase our fees and 'market' our services at the luxury end of the market, where value rises along with price. This 'designer' approach to audit creates a unique brand but can back-fire as the fees charged may be too high to attract clients.

So, it seems clients hold the key to commercial success then – fees should follow the 'Goldilocks' approach of 'not too high, not too low' – but engagements should be agreed with clients so the process is also considered, rather than just the input (fees) and the output (the auditor's report).
6. Risk and materiality

You are involved with the audit of Tantpro Ltd, a small company. You have been carrying out procedures to gain an understanding of the entity. The following matters have come to your attention:

The company offers standard credit terms to its customers of 60 days from the date of invoice. Statements are sent to customers on a monthly basis. However, Tantpro does not employ a credit controller and, other than sending the statements on a monthly basis, it does not otherwise communicate with its customers on a systematic basis. On occasion, the receivables ledger clerk may telephone a customer if the company has not received a payment for some time. Some customers pay regularly according to the credit terms offered to them, but others pay on a very haphazard basis and do not provide a remittance advice. Receivables ledger receipts are entered onto the receivables ledger but not matched to invoices remitted. The company does not produce an aged list of receivables balances.

Required

From the above information, assess the risks of material misstatement arising in the financial statements. Outline the potential materiality of the risks and discuss factors in the likelihood of the risks arising.

(Total = 10 marks)
6. Risk and materiality: Answer

The key risk arising from the above information is that trade receivables will not be carried at the appropriate value in the financial statements, as some may be irrecoverable. Where receipts are not matched against invoices in the ledger, the balance on the ledger may include old invoices that the customer has no intention of paying.

It is difficult to assess at this stage whether this will be material. Trade receivables is likely to be a material balance in the financial statements, but the number of irrecoverable balances may not be material. Analytical procedures, for example, to see if the level of receivables has risen year-on-year, in a manner that is not explained by price rises or levels of production, might help to assess this.

A key factor that affects the likelihood of the material misstatement arising is the poor controls over the sales ledger. The fact that invoices are not matched against receipts increases the chance of old invoices not having been paid and not noticed by Tantpro. It appears reasonably likely that the trade receivables balance is overstated in this instance.
7. Geylang Gasoleum

Your AE is the auditor of Geylang Gasoleum Pte Ltd (GG) which operates 15 petrol stations in and around Singapore. You are the senior in charge of the audit for the year ending 31 December 20X1, and are engaged on the audit planning.

Most of the company’s sites are long established and, as well as supplying petrol for cars, sell air for pumping up tyres, and have a car wash and shop. Customers wishing to use the car wash or air facilities must first purchase a token in the shop. After inserting one token into the air machine, a customer can operate the air pump for five minutes. To use the car washing machine the customer must purchase three tokens which are then inserted into the operating slot to start the machine.

Over the last few years, the shops have been expanded into mini-markets with a wide range of motor accessories, food, drinks and household products. They also sell tickets for Singapore Sweep (a sweepstake lottery with a seven digit number drawn once a month).

Point-of-sale microcomputers are installed in all the petrol stations. Customers pay for fuel, tokens for services or items in the mini-marts using a mixture of cash and cards. The microcomputers are linked online via a network to the computer at head office. Sales and inventory data are input direct from the microcomputers.

Notes from the prior year audit file indicate difficulty with measuring the value of petrol in inventory at year-end. This is because the sites use dipsticks to measure the amount of petrol left in the central storage tank. Dipsticks can only be read to a certain level of accuracy and a reading can be up to 100 litres either side of the actual amount.

Required

Prepare notes for a planning meeting with the audit partner which:

(a) Identify areas of potential risk which will have to be addressed by the audit. (10 marks)

(b) Detail the analytical procedures that you would adopt to obtain audit evidence on revenue and gross profit as part of your substantive testing. (5 marks)

(Total = 15 marks)
7. Geylang Gasoleum: Answer

Notes for planning meeting

(a) Areas of potential risk to be addressed by the audit

Income

A substantial proportion of sales made at the stations may be cash based therefore making completeness of income difficult to establish.

Sales records are updated via an online computer ie records are updated automatically and instantly. Any deficiencies in the operation of the computer be it manual input or systematic error will directly impact income. The key risk is however weak control over manual input.

Income could be missed via deficiencies in controls over the sale of car wash and air tokens.

Misclassification of income would render management accounts meaningless for analytical review purposes.

Inventories

The nature of inventories (ie petrol) requires an unusual method to quantify – dipping of tanks. This increases the risk that the value is inaccurate.

All goods stocked within the mini markets are potentially desirable by both staff and customers. They are also easily moveable and thus inventory losses could occur. If this remains undetected, year-end inventories and thus profit will be overstated.

Goods are also perishable. There is therefore a risk of inventory valuation being overstated where no provision/write-off is made.

Singapore Sweep outlet

There is a potential risk that income from sales of tickets is inappropriately included within the company's income, if the tickets are sold on a commission basis.

We will need to determine how the sale of lottery tickets should be accounted for, whether there is commission or the sale of a lottery ticket constitutes a direct sale of GG. There is a risk of inappropriate classification and also overstatement if weak controls exist over the handling and storage of lottery tickets.

Multi-locations

As there are 15 garages to audit, there is increased risk of not detecting error as it is more complicated to control and co-ordinate the audit.

(b) Analytical procedures on income and GP margin:

Income

(i) Obtain an analysis of income per petrol station and perform inter-branch comparisons to identify any branch with unusually high/low total income.

(ii) Obtain an analysis of income per source for each station and again carry out inter-branch comparisons to identify any branch with an unusual mix/split of income.

(iii) Compare income per source and per branch to last year. Are changes in line with our expectations and industry norms?

(iv) Obtain management accounts and perform a month by month review of sales comparing with both previous years and other branches.

(v) For all the above we need to discuss fluctuations with management, follow up any discrepancies and confirm any statements made by the directors.
Gross profit

(i) Perform a comparison of gross profit percentage per branch.

(ii) Compare gross profit percentage this year to last year and against budget.

(iii) Review aged inventories analysis between this year and last year for slow-moving products, to identify any overstatement of closing inventories and thus gross profit.

(iv) Compare percentage of inventories written-off after inventory counts branch by branch and investigate branches with low gross profit percentages.

(v) Compare margins on petrol to industry norms.

(vi) Consider the impact that fluctuations in oil prices would have on profits made.

(vii) Again, for all of the above we would need to discuss fluctuations with management, follow up any discrepancies and confirm any statements made.
8. Audit evidence considerations  
(18 mins)

Required

(a) Discuss how analytical procedures can be used as substantive audit procedures to provide audit evidence. Illustrate your answer with an example.  
(5 marks)

(b) SSA 500 Audit Evidence requires auditors to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their audit opinion. Discuss the different sources of evidence available to auditors and assess their relative appropriateness.  
(5 marks)

(Total = 10 marks)
8. Audit evidence considerations: Answer

(a) Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigations of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predictable amounts. Analytical procedures include comparisons with similar information from prior periods, comparisons to budgets and forecasts, comparisons with predictions prepared by auditors, and comparisons with industry information.

When using analytical procedures as substantive tests, auditors need to consider the information available in terms of its availability, relevance and comparability. They also need to consider the plausibility and predictability of the relationships they are testing. Other factors to consider include materiality, other audit procedures, the accuracy with which the expected results can be predicted, the frequency with which a relationship is observed and the assessments of inherent and control risks.

An example of an analytical procedure that can be used as a substantive test is a proof in total test on depreciation and amortisation. In this test, the auditor predicts the expected charge for the year for depreciation and amortisation by using the client's accounting policy for depreciation and applying this to the brought forward figures for non-current assets from the prior year audited financial statements, factoring in additions and disposals for the year. The figure obtained can be compared to the charge in the draft financial statements to assess its reasonableness and accuracy.

(b) Audit evidence is available to auditors in a variety of forms. These include auditor-generated evidence (e.g., analytical procedures), external sources of evidence from third parties (e.g., solicitors' correspondence, valuation reports from surveyors for land and buildings), internal sources of evidence from within the entity being audited (e.g., minutes of meetings from the Board of directors, reports generated from the accounting system), and oral or written evidence. Another factor to consider is whether the evidence, if written, is from an original document or a copy.

Audit evidence from external sources to the entity is more reliable than that obtained from the entity's records. Evidence from the entity's records is more reliable when the related internal control system is operating effectively. Auditor-generated evidence is more reliable than that obtained indirectly or by inference. Evidence in the form of documents or written representations is more reliable than oral representations. Where evidence is written, original documents are more reliable than photocopies which can be altered by the client relatively easily.
9. Lion

The following is the draft statement of financial position of Lion Trading Pte Ltd (Lion) for the year ended 31 December 20X3.

**Lion Trading Pte Ltd**

**Statement of Financial Position as at 31 December 20X3**

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<thead>
<tr>
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<th>20X2</th>
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<td>Tangible assets</td>
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<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>58,190</td>
<td>63,010</td>
</tr>
<tr>
<td>Receivables</td>
<td>184,630</td>
<td>156,720</td>
</tr>
<tr>
<td>Cash at bank and in hand</td>
<td>9,970</td>
<td>62,620</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>252,790</strong></td>
<td><strong>282,350</strong></td>
</tr>
<tr>
<td>Payables: amounts falling due within one year</td>
<td>231,510</td>
<td>170,900</td>
</tr>
<tr>
<td><strong>Net current assets</strong></td>
<td><strong>21,280</strong></td>
<td><strong>111,450</strong></td>
</tr>
<tr>
<td>Total assets less current liabilities</td>
<td>265,590</td>
<td>285,850</td>
</tr>
<tr>
<td>Payables: amounts falling due after more than one year</td>
<td>101,180</td>
<td>93,840</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>164,410</strong></td>
<td><strong>192,010</strong></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>89,700</td>
<td>89,700</td>
</tr>
<tr>
<td>Share premium account</td>
<td>11,300</td>
<td>11,300</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>19,750</td>
<td>9,750</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>43,660</td>
<td>81,260</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>164,410</strong></td>
<td><strong>192,010</strong></td>
</tr>
</tbody>
</table>

Lion produces furniture and has incurred expenditure during the year ended 31 December 20X3 on the development of mouldings for a new range of plastic garden furniture. The directors wish to carry forward the development expenditure indefinitely as they feel that the company will benefit from the new moulding for many years. The product range is being developed because profits have been declining over the last few years. This has been a result of a lack of competitiveness of the products made by the company. The company has sold many of its non-current assets during the year and purchased new machinery which will enable the company's productivity to increase. The directors decided not to fund the above expenditure using outside finance but to generate the necessary resources internally by taking extended credit from its suppliers and utilising its liquid funds held at the bank. The company also sold part of its investments, which are made up of stocks and shares of public limited companies.

One of the reasons for this method of financing the expenditure was that the company already has a loan of $45,000 outstanding which has been included in the figure for 'payables: amounts falling due after more than one year'. This loan is secured on the non-current assets of the company and is repayable over ten years. The sale of non-current assets and investments did not yield as much as was expected and a small loss on sale of $1,200 has been included in the statement of profit or loss as part of the amounts shown for 'other expenses'.

The company had the non-current assets revalued by a professional valuer, at the year-end. The gain on revaluation of non-current assets has been credited by the company to the revaluation reserve.

The directors felt that the shareholders should share in the gain on the revaluation of the non-current assets and increased the proposed dividend accordingly. Over 90% of the shares of the company are held by the directors.
Required

(a) Describe the audit work to be performed to verify the value attributed to the development expenditure in the statement of financial position of Lion.  

(b) Describe the audit procedures which should be carried out to verify the gain arising on the revaluation of non-current assets.  

(c) Explain to the directors why development expenditure should not be carried forward indefinitely in the financial statements, and describe the circumstances in which the costs may be deferred to the future.  

(d) Describe the implications for the company and the auditors of the directors' decision to generate internally the funds required for the development of the business.  

(Total = 25 marks)
9. Lion: Answer

(a) The relevant audit tests are as follows.

(i) The auditors should obtain a breakdown of the figure for development expenditure from Lion management which makes it possible to trace the amounts spent to the nominal ledger and the final financial statements.

(ii) Tests of controls should be performed to ensure that a system exists for controlling the authorising and recording of development expenditure, and that the system is operating adequately. (This work may be covered where practicable by the audit tests performed on the company's purchases and payroll systems.)

(iii) Individual amounts should be vouched by reference to supporting documentation. The relevant documentation will vary according to the type of expenditure, but tests might include the following.

1. Agree purchases to requisitions, orders, goods received notes, invoices, cash book and bank statement.
2. Agree labour costs to the payroll and to supporting evidence, such as time sheets or job cards.
3. If overheads have been included in the development figure, ensure that they have been calculated on a basis consistent with that used generally by the company.

The auditors will wish to set a materiality level for testing individual items; this will have to be established when the breakdown of the total figure is known. For instance, it may be possible to restrict testing considerably if one or two large invoices represent the bulk of the relevant expenditure.

(iv) The arithmetical accuracy of the schedule of expenditure should be checked.

(v) The auditors should ensure that there has been no double-counting, that is, that development items capitalised have not also been charged as an expense in the statement of profit or loss.

(vi) Finally, the auditors should carry out a review of the development figure in order to be satisfied that it is reasonable and consistent with what else is known about the company and its business.

(b) The following audit procedures may be performed to verify the revaluation gain arising on non-current assets.

(i) Ensure that the valuer appears to be appropriately qualified and independent of the company. If these conditions are not fulfilled, the auditors will need to consider their possible impact on the results of the valuation.

(ii) By reference to the instructions given to the valuer and the valuer's report, ensure that the valuation has been performed on a basis reasonable and consistent with previous valuations.

(iii) Check that profits or losses on individual non-current assets have been correctly calculated by reference to the non-current asset register and the detailed analysis of the revaluation.

(iv) Check the arithmetical accuracy of the compilation of the revaluation schedule and of the calculation of asset profits and losses.
(c) SFRS(I) 1-38 lays down the basis on which development costs may be carried forward. They may be carried forward only if, and to the extent that, they represent an asset which is likely to generate income for the company in the future.

According to SFRS(I) 1-38, development expenditure should be recognised in the statement of profit or loss in the year it is incurred, unless it meets all the following criteria:

(i) The technical feasibility of completing the intangible asset so it will be available for use or sale can be demonstrated

(ii) The entity can demonstrate its intention to complete the intangible asset and use or sell it

(iii) The entity can demonstrate its ability to use or sell the asset

(iv) The entity can show how the asset will generate probable future economic benefits

(v) The availability of adequate technical, financial and other resources to complete the development and to use or sell the asset can be shown

(vi) The entity can measure reliably the expenditure attributable to the asset during its development

If, taking a reasonable view of the available evidence, these conditions are met, development costs may be deferred and amortised over the period expected to benefit.

(d) The decision to finance development internally has resulted in a large increase in payables and a decrease in cash and bank balances. This may lead to liquidity problems, especially since the company will still need funds to finance the new product. These funds will have to be generated either by the sale of further investments, the raising of a loan from the directors or an outside investor, or by the issue of shares. If funding is not available, the development expenditure should be recognised in the statement of profit or loss on the basis that it will not be possible to complete the project. This would eliminate the retained earnings reserve and would create doubts about the company's status as a going concern.

The auditors should discuss with the directors their plans for obtaining additional finance, and request that they produce cash flow predictions in support of these. If the auditors do not obtain satisfactory evidence of the company's ability to obtain finance, it may be necessary to qualify the auditor's report on the grounds of going concern problems which have not been fully disclosed.
10. Recognition

Required

Discuss the impact on the auditor's report of the proposed treatment of the following items in the financial statements.

(a) Balestier Estates Pte Ltd (BE) sells land to a property investment company, Yang Investments Pte Ltd (YI). The sale price is $20 million and the current market value is $30 million. BE can buy the land back at any time in the next five years for the original selling price plus an annual commission of 1% above the current bank base rate. YI cannot require BE to buy the land back at any time.

The Chartered Accountant of BE proposes to treat this transaction as revenue in the financial statements. You may assume that the amounts involved are material.

(b) A car manufacturer, Auto Make Pte Ltd (AM), supplies cars to a car dealer, Car Sales Pte Ltd (CS), on the following terms.

CS has to pay a monthly fee of $100 per car for the privilege of displaying it in its showroom and is also responsible for insuring the cars. When a car is sold to a customer, CS has to pay AM the factory price of the car when it was first supplied. CS can only return cars to AM on the payment of a fixed penalty charge of 10% of the cost of the car. CS has to pay the factory price for the cars if they remain unsold within a four-month period. AM cannot demand the return of the cars from CS.

The Chartered Accountant of CS proposes to treat the cars unsold for less than four months as the property of AM and not show them as inventory in the financial statements. At the year-end the value of car inventory shown in the statement of financial position was $150,720. The total assets on the statement of financial position are $1.3 million. The cars unsold for less than four months have a factory cost of $22,500.

(Total = 15 marks)
10. Recognition: Answer

(a) Accounting treatment

BE has sold the land to YI at a price well under current market value for no discernible reason. It is able to repurchase that land at cost at any time in the next five years but cannot be forced to do so. Therefore unless the land value falls significantly it can be assumed that BE will repurchase the land. YI will not use the building or the land for redevelopment in that period otherwise on repurchase they would lose any investment they had made.

The commercial effect of this transaction, assuming land values do not fall significantly, is that of a loan to BE secured on the land. The commission is in effect interest on the loan, payment being deferred until the repurchase takes place.

Hence BE should not treat this transaction as a sale as YI do not appear to have bought anything, so no performance obligations have been met. The land should continue to be shown as an asset in the BE statement of financial position and a loan of $20 million should be recorded. The statement of profit or loss should be charged annually with the commission charge and the accrual shown as a deferral liability in the statement of financial position.

As this would be a material misstatement the effect on the audit opinion would be to require a qualified 'except for' opinion. The auditor's report would also require a 'basis for qualified opinion' section explaining the nature of the misstatement and how the transaction should have been treated. However, since the Chartered Accountant is only proposing the accounting treatment, they may be advised to adjust their proposal and account for the sale differently which would lead to an unmodified audit opinion.

(b) Accounting treatment

The substance of this transaction appears to be that the cars are part of the inventory of CS from the time they take delivery of them from AM. This is because CS has control, ie it has to insure the cars, but only pays the wholesale price in force on the date the cars were first supplied, so avoiding subsequent price rises. The monthly rental is a form of interest charged by AM, varying with the length of time CS holds the inventory.

This interpretation of the transaction is also supported by the fact that AM cannot demand the return of the cars from CS.

The cars unsold for less than four months should be treated as inventory in the financial statements and the liability to AM for them recognised.

Materiality considerations

The auditors should make a judgment as to whether they feel the amounts are material. The value of the additional inventory represents 15% of their inventory already recognised on the statement of financial position. It is 1.7% of the statement of financial position total. Bearing in mind a general guideline for materiality of 1–2% of total assets, this is likely to be material.

Impact on auditor's report

If the matter is material to the statement of profit of loss (these details are not given in the question), or there are other errors in inventory which would result in inventory being increased in the statement of profit or loss, they should issue a qualified 'except for' opinion and include the details in the 'basis for qualified opinion' section of the auditor's report.

This would be on the grounds of material misstatement as before.
11. Venus Group

You are auditing the accounts of Venus Group for the year ended 30 June 20X1. The group comprises Venus Ltd, a public company and its wholly owned subsidiary corporation Mercury Pte Ltd. The main activities of both companies are the manufacture and sale of household textiles. During the year under review Mercury made a substantial trading loss and the board of directors of Venus decided to sell the subsidiary corporation. A suitable buyer was found and the sale which was approved and announced by the board on 31 May 20X1, was legally completed on 30 June 20X1.

A summary draft statement of profit or loss for the year ended 30 June 20X1 (which is shown below) has been prepared, which divides the group profit between continuing operations (those of Venus) and discontinued operations (those of Mercury).

<table>
<thead>
<tr>
<th></th>
<th>Continuing operations</th>
<th>Discontinued operations</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$25,700</td>
<td>$10,000</td>
<td>$35,700</td>
</tr>
<tr>
<td>Profit/(loss) before tax</td>
<td>1,300</td>
<td>(1,000)</td>
<td>300</td>
</tr>
<tr>
<td>Tax expense</td>
<td>(700)</td>
<td>450</td>
<td></td>
</tr>
<tr>
<td>Profit/(loss) before exceptional item</td>
<td>600</td>
<td>(550)</td>
<td>50</td>
</tr>
<tr>
<td>Loss on sale of subsidiary corporation (Note 1)</td>
<td>600</td>
<td>(450)</td>
<td>(450)</td>
</tr>
<tr>
<td>Loss for the period</td>
<td></td>
<td></td>
<td>600</td>
</tr>
</tbody>
</table>

Notes to the accounts (extract)

Loss on sale of subsidiary corporation.

Net assets of Mercury at 30 June 20X1 1,800
Cash proceeds (1,350)
Loss arising on disposal of subsidiary corporation 450

The results of Mercury, included above, have been obtained from the company's management accounts. No audited accounts of Mercury are available as Mercury's new owners have a different year-end from Venus and Venus no longer has control over Mercury.

In view of the substantial loss of Mercury, the directors of Venus do not want to include the trading results of Mercury in the consolidated financial statements. They have suggested that the loss on disposal of the subsidiary corporation should be shown as an exceptional item.

You have approached Mercury, and in view of the change in ownership, they have said that they are not prepared to allow you to carry out an audit of their accounts or to answer questions on the management accounts to 30 June 20X1. However, the directors of Venus are prepared to give you as much information about the preparation of Mercury's accounts as they are able.

Required

Assuming that the results of Mercury for the year ended 30 June 20X1 are consolidated into the accounts of Venus, describe the audit work you would perform and the matters you would consider in relation to the statement of profit or loss of Mercury which is included in the consolidated financial statements of Venus as shown in the schedule above. Your answer should include consideration of:

(a) The factors you would take into account in deciding whether the results of Mercury are sufficiently reliable to be included in the consolidated financial statements. (5 marks)

(b) The level of materiality (or acceptable error) you would accept in the results of Mercury which are included in the group statement of profit or loss. (5 marks)
(c) How you would audit the item in Note 1 to the accounts: 'Loss on sale of subsidiary corporation'.

(5 marks)

(Total = 15 marks)

Note. You should assume that the disposal of Mercury meets the criteria to be classed as a discontinued operation under SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations.
11. Venus Group: Answer

(a) Availability and reliability of information

Since no direct communication with subsidiary company management is possible, and audit results are not available, the auditor should consider the results of Mercury in the light of:

(i) The reliability of management accounts in previous years
(ii) Any evidence that this year's management accounts have been prepared on a basis consistent with that applied in earlier years
(iii) The amount of information and explanations which the management of Venus are able to provide from their knowledge acquired whilst still in control of Mercury
(iv) Any audit work carried out on an interim visit and the extent to which useful audit evidence may be obtained by reviewing the work of Venus' internal auditors on the financial statements of Mercury in respect of the year ended 30 June 20X1
(v) Any year-end audit work, such as attendance at inventory count and receivable circularisation, carried out before control of Mercury was lost

(b) Materiality level in relation to Mercury's results

The main question mark would be against the extent of the pre-tax loss. The reliability of the figure for the reported loss would be very dependent on the matters considered above.

Under the circumstances prevailing, over or understatement of the pre-tax loss would be offset by a corresponding decrease or increase in the exceptional item, loss on sale of subsidiary company. In the light of this compensating effect, the auditor of Venus would be able to accept a higher level of error than would have been the case if the group structure had continued as before.

(c) Audit of loss on disposal of subsidiary company

The auditor of Venus should check the loss arising on the disposal of its subsidiary company Mercury as follows:

(i) Confirm that the net assets of Mercury at 30 June 20X1 are equivalent to the reported net assets at 30 June 20X0 less the reported trading loss for the year ended 30 June 20X1.
(ii) The cash proceeds should be confirmed to any agreement in relation to the sale of Mercury and agreed to post year end receipts.
(iii) The sale of the subsidiary company should be confirmed to board minutes and a sales agreement.
(iv) The journal posting the loss should be traced through to the nominal ledger.
(v) The notes to the financial statements should be checked to ensure that adequate disclosure of the disposal is given.
12. Jurong Electronics

Your AE is the auditor of Jurong Electronics Ltd, a listed company, which assembles microcomputers and wholesales them and associated equipment to retailers. Many of the parts for the computers and the associated equipment are bought from other countries. These computers are used by businesses for accounting, word processing and other computing tasks.

You have been asked by the partner in charge of the audit to consider your AE’s audit responsibilities in relation to subsequent events, and the audit work you will carry out on these matters.

Required

(a) Describe the responsibilities of the auditors for detecting misstatements in the financial statements during the following periods:

(i) From the period-end to the date of the auditor's report
(ii) From the date of the auditor's report to the issue of the financial statements
(iii) From the date the financial statements are issued to the date they are laid before the members

(5 marks)

(b) Describe the audit work you will carry out in period (a)(i) above which involves consideration of subsequent events.

(11 marks)

(c) Describe the work you will carry out in period (a)(ii) above to ensure no adjustments are required to the financial statements.

(4 marks)

(Total = 20 marks)
12. Jurong Electronics: Answer

(a) (i) Auditors should perform procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of their report which require adjustment of, or disclosure in, the financial statements have been identified and properly reflected therein.

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the year-end. They are in addition to tests on specific transactions after the period-end, eg cut-off tests.

Non-adjusting subsequent events should be disclosed in the notes to the financial statements of the company, whereas all adjusting events should be incorporated in the financial statements.

(ii) The financial statements are the directors’ responsibility and they would therefore be expected to inform the auditors of any material subsequent events between the date of the auditors’ report and the date the financial statements are issued. The auditors do not have any obligation to perform procedures, or make enquiries regarding the financial statements after the date of their report.

When, after the date of their report but before the financial statements are issued, the auditors become aware of subsequent events which may materially affect the financial statements, they should:

- Establish whether the financial statements need amendment
- Discuss the matter with the directors
- Consider the implications for their report, taking additional action as appropriate

When the financial statements are amended, the auditors should extend the procedures discussed above to the date of their new report, carry out any other appropriate procedures and issue a new auditor's report. The new report should not be dated earlier than the date of approval of the amended financial statements.

In the situation where the statements are not amended but the auditors feel that they should be, the auditor's action depends on whether they have already provided their signed auditor's report to the client.

If the auditor's report is still in the AE’s possession, then the AE can simply provide a new modified auditor's opinion. If however, the signed auditor's report has been given to the client, the auditor must notify the client not to issue the financial statements to third parties until the necessary amendments have been made. If the client ignores the auditors and issues the financial statements anyway, the auditor may need to seek legal advice in order to prevent reliance on the auditor's report.

(iii) Auditors have no obligations to perform procedures or make enquiries regarding the financial statements after they have been issued.

When, after the financial statements have been issued, but before they have been laid before the members or equivalent, auditors become aware of subsequent events which, had they occurred and been known of at the date of their report, might have caused them to issue a different report, they should:

- Consider whether the financial statements need amendment
- Discuss the matter with the directors
- Consider the implications for their report, taking additional action as appropriate
There are two cases:

1. An event which occurred before the date of the auditors' report, but which the auditors became aware of thereafter

2. An event which occurred after the date of the auditors' report

Under (1), the auditors and directors should consider whether the financial statements should be revised. In situation (2) the auditors might take legal advice on withdrawing their report. In both cases, a statement by the directors or auditors at the AGM may be feasible, but in any event legal advice may be helpful.

Where the directors do not revise the financial statements but the auditors feel they should be revised, and where the statements have been issued but not yet laid before the members; or if the directors do not intend to make an appropriate statement at the AGM, then the auditors should consider steps to take, on a timely basis, to prevent reliance on their report eg a statement at the AGM.

(b) The audit work for subsequent events will normally be concerned with asset values at and after the year-end. The following procedures will be carried out.

(i) **Non-current assets**
   - (1) Check for any sales or proposed sales after the year-end which may trigger a write down to net realisable value at the year-end.
   - (2) Consider obsolescence of non-current assets, for example, plant used to make a discontinued line, which might only become apparent after the year-end.

(ii) **Inventory**
   - (1) Check post year end selling price of major items of inventory and compare to value in year-end financial statements. Consider write downs to net realisable value.
   - (2) Consider the possible existence of obsolete, damaged or slow moving inventory and the consequent value of any write down.
   - (3) Perform a (limited) inventory count after the year-end if the existence of all inventory is not known for certain.

(iii) **Receivables**
   - (1) Review post year end receipts to determine recoverability.
   - (2) Take doubtful debts paid out of the provision and consider writing parts of the provision off for which no money has been received.
   - (3) Review trade press and correspondence and consult the sales manager about any major customers who have become insolvent recently.
   - (4) Check the issue of credit notes and return of goods after the year-end to determine the provision for credit notes required in the financial statements.

(iv) **Cash at bank**
   - (1) Check that outstanding items on the bank reconciliation have cleared promptly after the year-end (to spot teeming and lading and late payment to payables).
   - (2) Write back any old cheques not cleared (over six months old).
   - (3) Check all material payments and receipts around the year end to check the completeness of both accruals and prepayments.
(v) **Trade payables**

1. Check reconciling items on suppliers' statements have cleared promptly after the year-end.
2. If the payables circularisation has been carried out then examining post year end payments will help to verify balances where there was no supplier's statement and no reply.

(vi) **Going concern problems and other matters**

The subsequent events review is important in terms of going concern investigations. The following procedures should be carried out as a matter of routine.

1. Check profit and cash flow predictions.
2. Review management accounts and reports after the year-end.
3. Review board minutes after the year-end.
4. Request any information on subsequent events and going concern matters from the directors and check their information.
5. The directors should also state they have given all such information in the letter of representation.

(vii) **Non-adjusting events**

Look for any matters which are non-adjusting but which should be disclosed in the financial statements, for example, major sales of non-current assets, accidental losses and issues of shares and debentures.

(c) I will check whether there have been any material events after the reporting period in this period, particularly if there is a significant delay between the date of the auditors' report and the issue of their financial statements. I will not undertake such detailed enquiries as in (b) above, but I will perform the following procedures.

1. Ask the management or directors if any further material events have occurred which might affect my opinion on the financial statements.
2. Review the latest board minutes, reports and management accounts issued since the end of the audit.
3. Any matters which were uncertain at the end of the audit should be reviewed again to establish an outcome and any effect on the financial statements. Examples would include doubtful debts, contingencies and inventory obsolescence (perhaps due to new developments).
4. Consider any matters which have arisen in the industry or the economy which might affect the company.
13. Scenarios

You are a partner in a medium sized AE. The following opportunities have arisen.

(a) A major audit client, Zirconium Industries Pte Ltd, is seeking loan finance from its bank to fund an expansion into a new factory. The expansion should result in an increase in capacity of 30%. Zirconium has conducted market research and is confident that they will be able to sell the added output. The financial director has recently telephoned you and mentioned that the bank are keen to obtain a reference from the AE, relating to Zirconium's ability to repay the loan and whether the business plan is reasonable. He said ‘they just need their forms filled, for their files. They know we can repay. We're one of their best clients.’ Your audit team is about to commence the audit for the year ended 31 December 20X8.

Required

Comment on the matters you would consider in relation to giving such a reference to the bank.

(7 marks)

(b) The finance director of Queenstown Trading Pte Ltd (QT), another audit client, telephoned you yesterday. The finance director recently attended a half-day course on the importance of corporate governance run by your AE. QT's long-term plans include the possibility of flotation on a stock exchange. The finance director has told the other directors the issues discussed at the course and they feel that it might be a good idea to engage the AE to undertake an assurance engagement to assess risk management and the internal control system at QT.

Required

Comment on the matters you would consider in relation to accepting and planning such an engagement.

(8 marks)

(Total = 15 marks)
13. Scenarios: Answer

(a) Zirconium Industries

An audit engagement partner would have to consider the following things before issuing a reference on behalf of a client:

(i) Is any additional work required to give such a reference?

(ii) If so, the need to contact the bank and discuss whether a separate engagement might be appropriate.

(iii) The inherent uncertainty of future income and expenditure and therefore the high risk which is associated with giving such an opinion.

(iv) The difficulty of issuing an opinion on current solvency. The auditors are about to commence the audit for the past year, meaning they will be reviewing information up to 15 months old.

(v) The fact that a duty of care to the bank is likely to arise if such a reference is given.

(vi) The need for disclaimers of liability, therefore, which will need to be reasonable in order to have legal force, perhaps the need for legal advice before such disclaimer is made.

(vii) Any need to negotiate a liability cap, although a disclaimer of liability should be sufficient/more appropriate.

(viii) Need for written clarification of the status of the reference, that is, explanation that there has been no engagement between the parties, that no fee has been paid, that it is given to the best of knowledge at the time.

(ix) The form of the reference. It is likely to be inappropriate to sign a bank's pre-printed document. The AE may have a standard reference document of its own, or may choose to compose each one according to the facts of the situation.

(b) Queenstown Trading

The directors of QT have expressed an interest in engaging the AE to undertake an assurance engagement in relation to their risk management and controls.

The following matters will be relevant:

Acceptance

Independence

The AE has to consider the issue of independence. It is vital that the provision of other services to the audit client does not impair their objectivity towards the audit. The provision of other services may create a self-review threat to independence.

Whether a threat to objectivity exists when providing any professional service will depend upon the particular circumstances of the engagement, and on the nature of the work that the Chartered Accountant in public practice is performing.

The amount that audit independence would be affected will depend on the exact nature of the service provided (see below) and the AE must take care not to assume management responsibility. However, an assignment testing the operation of controls could be complimentary to the audit.

Testing the operation of controls is a role often associated with internal audit. In Singapore, AEs are allowed to provide internal audit services to listed clients provided that these do not relate to a significant part of internal controls over financial reporting, financial accounting systems that generate information significant to accounting records or financial statements or amounts or disclosures material to the financial statements. QT is not listed yet, and it appears that the director wants this to be a one-time service, but if this became a regular service, the AE should bear in mind that it might not be permitted to continue to provide it, should the company achieve its listing aims.
Nature of the service

The AE would not be able to accept the engagement as it has been currently set out. An assurance engagement should exhibit certain elements, key of which are subject matter, suitable criteria and an engagement process. It is very difficult to give assurance on the effectiveness of risk management, as there are no recognised criteria by which to judge it. However, the AE could provide an assurance service checking that controls are designed according to management criteria and they operate according to management policy, for example. This would need discussing and agreeing in writing before the engagement could be accepted.

Planning

In terms of planning such an engagement, once the details of the engagement had been agreed, the following matters would be relevant:

(i) Is the AE sufficiently independent of the client to conduct the assurance service objectively? It may be that the fact that the company is an audit client would impair their objectivity towards this engagement.

(ii) Are all the elements of an assurance engagement present? This has been discussed above.

(iii) Has the AE and the parties agreed terms? In this case, the assurance service is likely to be carried out to benefit shareholders, so it may be necessary for a vote to be passed in general meeting to approve the service.

(iv) Are the criteria for assessing the subject matter suitable? In this case, management policy would be a suitable criterion for evaluating the operation of systems.

(v) The auditor must assess the materiality and risk relating to the engagement. Assessing materiality will involve thinking about qualitative factors in an engagement that is not about financial information, for example, what level or percentage of errors in implementing internal controls (ie honest mistakes) might be acceptable to users. These should be incorporated into a fee and into the detailed procedures planned for the engagement.

(vi) What form of report is required by the parties? There is no such thing as a standard report, so it is important for the parties to agree upon the format of the report that will be produced at the end of the engagement.
14. Prospective financial information (36 mins)

Fragrant Flowers Pte Ltd (FF) has a credit facility with Singapore National Bank (SNB) of $6 million. The facility is due to expire on 30 April 20X2. The overdraft in the recently audited statement of financial position at 31 December 20X1 is $5.5 million. The directors of FF have started negotiations with their bankers for a renewal of the facility and to increase the amount to $9 million. To support this request SNB has asked FF to provide a business plan for the coming 12 months consisting of a cash flow forecast or projection supported by a forecast statement of profit or loss and other comprehensive income and statement of financial position. The management of FF has produced a cash flow forecast or projection for the period 1 January 20X2 to 31 December 20X2 and, at the request of SNB, has asked the auditor to examine and report on it.

The audit manager, who has recently completed FF's audit, has been asked to make a preliminary examination of the cash flow forecast or projection and supporting material and has noted the following observations.

(1) The cash flows from sales are based on the assumption of an overall increase in sales of 24% compared to the previous financial year. Analysis shows that this is based on an increase in selling price of 5% and an increase in the volume of sales of 18%. Just over a quarter of all FF's sales are made to foreign customers.

(2) The cost of sales in the recently audited statement of profit or loss and other comprehensive income to 31 December 20X1 was 80% of sales revenue, giving a gross profit of 20%. In the forecast statement of profit or loss and other comprehensive income for the year to 31 December 20X2 the cost of sales has fallen to 72%, giving a gross profit of 28%. Manufacturing costs are made up of approximately one third each of materials, labour and production overheads.

(3) The trade receivables collection period used in the cash flow forecast or projection to 31 December 20X2 is 61 days. In the year to 31 December 20X1 this period averaged 93 days. Management has stated that it is its intention to inform all customers of a new standard 60 day credit period. In addition an early settlement discount of 1% will apply to customers who settle their account within 30 days of the statement.

Conversely the credit period for trade payables has been extended from an average of 45 days in the current year to 90 days in the forecast.

(4) The cash flow forecast or projection showed that the maximum credit required during the period would rise to nearly $9 million in November 20X2.

Required

(a) Describe the general matters an auditor should consider before accepting an engagement to report on forecast financial information. (5 marks)

(b) Detail the procedures that the auditor should undertake in relation to the cash flow forecast or projection of FF for the year to 31 December 20X2. (8 marks)

(c) The negotiations with SNB resulted in a renewal of FF's existing credit facility of $6 million, but the bank would not agree to increase it to $9 million. As a result of this FF issued a circular to its existing shareholders inviting them to subscribe for a new $3 million issue of debentures. The purpose of the circular was to show the intended use and the future benefits from the debenture issue. It was supported by the same forecast financial information, including the auditor's report, that had been provided to SNB. However, the directors of FF had removed all references to its original purpose and restricted distribution.

The trading results of the first half of the year to 31 December 20X2 showed that the forecast information was proving to be over optimistic and that FF was beginning to experience cash flow difficulties.
Required
Discuss the basis on which an auditor should form an opinion on forecast information, and consider whether the auditors of FF may be liable to:

(i) Singapore National Bank
(ii) The investors who subscribed for the new debentures

(7 marks)
(Total = 20 marks)

Note. You are to assume that the auditor’s report had expressed an unmodified opinion on the statement of cash flows.
14. Prospective financial information: Answer

(a) The factors that will affect the auditors' decision on whether to accept appointment are as follows.

(i) **Previous experience of client**

   The auditors should draw on their knowledge of the client as gained during the audit. In particular they will be interested in the willingness of the client to provide information, the integrity and knowledge of the directors, and the reliability of the forecasts prepared for financial accounting purposes, for example for assessment of going concern or deferred tax.

(ii) **How prepared**

   The auditors will need to consider how the forecast is being prepared, in particular:

   1. How the cash flow prediction was compiled, and the staff who compiled it.
   2. The extent to which the cash flow prediction is based on assumptions consistent with past events. The details given suggest that a more optimistic view is being taken than is warranted by the company's record in recent years.
   3. Whether the cash flow prediction represents management's best estimate of achievable results, or whether it represents hopeful targets or is based on certain hypothetical events taking place.
   4. How the cash flow prediction takes account of factors which may invalidate the assumptions made.
   5. The level of detail available supporting the cash flow prediction.

(iii) **Terms of report**

   The auditors will need to consider the exact terms within which they are reporting, as this could have a bearing on their liability. This is discussed further in (c) below.

(iv) **Users**

   The auditors should consider carefully how the report will be used, and who its users will be.

(b) A major concern of the reporting auditor will be the assumptions on which the report is based. The level of evidence required will depend on the terms of the auditors' report, but some evidence will be required on the major assumptions made in the cash flow prediction.

(i) **Sales**. It might be expected that the price increase would result in some lost sales, so extra sales will be needed from other customers to make up for the sales lost as well as achieving the planned increase. The auditor will need to focus on the plans to achieve that increase. Increases might be a result of a change in the sales mix or new products or customers; if these changes have already occurred, the auditors should consider what effect they have already had. Increased marketing and promotional activity may also be necessary, and this would need to occur rapidly in order to achieve the desired effect. This activity will probably be reflected in increased costs, and the auditors will need to check that these have been included in the cash flow prediction.

(ii) **Cost of sales**. The auditors will need to consider whether economies have been planned to improve margins, whether these economies are likely to be achieved, and whether there will be consequential other costs that need to be reflected in the plan. For example reduction in the labour force is likely to mean redundancy costs, investment in more up-to-date plant and equipment to mean capital investment costs.

(iii) **Trade receivables**. The auditors should consider whether the decrease in settlement period is likely to be achieved. They should consider whether emphasising new credit limits and prompt settlement discounts will help achieve the required target, and also the effectiveness of any other measures the company takes, for example tighter checks on new customers.
and more rigorous pursuit of slow payers. In particular the auditors will need to review the position of foreign customers, as they may be less flexible in reducing settlement periods. The auditors should also check that the consequences of the prompt settlement discount, a reduction in amounts received, have been reflected in the cash flow prediction. For foreign customers, the auditors should also check any exchange rate effects have been reflected in the cash flow prediction.

(iv) **Trade payables.** The auditors should check that the increase in payable days will not breach terms of business with suppliers, leading to possible supply problems or withdrawal of credit terms and demands for immediate cash payments. They should also check that the cash flow prediction reflects other possible consequences of the increase, for example a loss of early settlement discounts.

(v) **Maximum finance.** The auditors should check whether the estimated increase in finance is reasonable or whether other sources will be required, either because the $9 million is an under-estimate or because other existing sources of finance will need to be repaid. The auditors should check that the consequences of the increase, particularly an increased interest burden, have been reflected. They should consider also whether the cash flow prediction shows that the company will be able to make the repayments comfortably, or whether the cash flow prediction margins are tight.

The auditors should also check that the cash flow prediction is internally consistent, for example that increased sales correspond with increased purchases, and reflects all non-trading cash flows. Consistency with cash flow predictions made for other purposes, for example, management accounting budgets, should also be checked.

(c) **Liability** will depend partly on the following general factors.

**Extent of assurance**

In this assignment auditors are focusing on uncertain future events, as opposed to an audit, where the report is based on a verification of data relating to past events. Therefore the level of assurance that can be given on this type of report is lower.

The exact level of assurance will depend on the form of the opinion given. Reporting under SSAE 3400 *The Examination of Prospective Financial Information* would require the auditors to report whether the cash flow prediction has been properly compiled on the basis of the stated assumptions and is presented in accordance with the relevant financial reporting framework. The report would state that nothing has come to the auditors’ attention to suggest that the assumptions do not provide a reasonable basis for the prospective financial information. The auditors may go further, and make a positive report on the assumptions or less probably give a report on the achievability of the cash flow predictions. If the report gives more positive assurance, this may increase the expectations of the report’s users as to the assurance given.

**Other report issues**

Whatever the exact terms of their opinion, the auditors should mention other matters in their report that will clarify for users what the auditors have done and hence what they are offering:

(i) The auditors should state why and for whom the report is being prepared.

(ii) Reference should be made to the work done, and whether the work has been done in accordance with SSAE 3400.

(iii) The report should state that the directors are responsible for the assumptions made.

(iv) The auditors may be able to include specific disclaimers on the assumptions made and achievability of the cash flow predictions. Even if they do not, they should make a statement about the uncertainty of the cash flow prediction, and the possibility that the actual outcomes will differ from what is predicted.
Singapore National Bank

The auditors were on notice that the cash flow prediction was being prepared for the purposes of the bank, and thus the degree of the proximity that the law relating to professional liability requires has been established. If a claim arises, the courts will consider whether the cash flow prediction was properly prepared and based on reasonable assumptions that took account of the information that should have been known at the time of the cash flow prediction. If it was not, the court would then consider whether the auditors should have drawn the conclusion that they did or allowed themselves to provide some degree of implicit assurance on the cash flow prediction because of their association with it.

Certainly some of the assumptions made would appear to be doubtful and the bank may have a case against the auditors. However if the company fails to meet the cash flow prediction, it may well be difficult to assess how much this was due to factors that could have been predicted, and how much it was due to factors that could not have been cash flow prediction when the cash flow prediction was made.

The debenture holders

The auditors will probably not be liable to the debenture holders, as the auditors stated in their report that it was prepared solely for the bank. The fact that the directors omitted this statement makes no difference to the auditors' liability, although it may render the directors liable. In addition had the report been prepared for the purposes of obtaining debenture finance it would have been prepared on different assumptions.
15. Balestier Distributors (36 mins)

Your AE is the external auditor of Balestier Distributors Pte Ltd which has revenue of $25 million and a profit before tax of $1.7 million. The company operates from a head office at Balestier and has sales and inventory holding centres in different parts of the city. The directors have decided the company has reached a size when it needs an internal audit department. As is becoming increasingly common, the directors have asked your AE to provide this service to the company as well as being the external auditor of the company's annual financial statements.

In answering the question, you should consider:

(1) The effects of the ISCA's Code of Professional Conduct and Ethics in relation to providing an internal audit service to Balestier Distributors.

(2) The extent to which your AE can rely on the internal audit work when carrying out the external audit of Balestier Distributors.

(3) The arrangements over control of the work and reporting of the internal audit staff:

   (i) The extent to which the internal audit staff should be responsible to Balestier Distributors, and who should control their work.

   (ii) The extent to which the internal audit staff should be responsible to a manager or partner of the external AE, and whether the same manager and partner should be responsible for both the internal audit staff of Balestier Distributors and the external audit.

Required

In relation to your AE becoming internal auditors of Balestier Distributors:

(a) Describe the matters you should consider and the action you will take to ensure your AE remains independent as external auditor of the annual financial statements. (8 marks)

(b) Describe the advantages and disadvantages to Balestier Distributors of your AE providing an internal audit service. (7 marks)

(c) Describe the advantages and disadvantages to your AE of providing an internal audit service to Balestier Distributors. (5 marks)

Note. Balestier Distributors is not a public interest entity.

(Total = 20 marks)
15. Balestier Distributors: Answer

(a) The auditor should consider the following factors when assessing their independence.

(i) The level of recurring fee income from Balestier should not become significant, or a self-interest threat may emerge.

(ii) As external auditor, the AE will be reviewing the work of internal audit; if the same staff were acting as external and internal auditors, they would be judging their own work. This obvious threat to objectivity can be lessened by different staff carrying out the detailed work, and different partners and managers being in charge of providing both services.

(iii) Although it is unlikely that financial statements preparation would form part of the internal audit services, there would be a specific threat to independence if the external public accounting entity were asked to do that as part of internal audit work, so the AE should ensure it was specifically excluded by the agreement with Balestier.

(iv) Similarly there is a threat to independence if the internal auditors become involved in the management of the company, because as external auditor the AE is reporting on the stewardship of management. Part of the internal audit service could be making recommendations about the design of systems and controls, which is management's responsibility. The AE should thus ensure that the directors take responsibility for implementation of any recommendations, and their decisions are clearly recorded in board minutes.

(v) Internal audit staff may be particularly likely to breach other independence guidelines that are applicable to them as employees of the AE carrying out the external audit. They should be reminded that they should not own shares in the client, accept a loan from the client, or obtain goods or services on more favourable terms than are offered to Balestier's own staff.

(vi) If Balestier does fail to pay fees, there may be a greater danger of the amounts owing being similar to a loan because of their size and because they are amounts owed for a continuing service rather than an annual audit.

(vii) The engagement letter should set out clearly the respective responsibilities of the AE and Balestier. It should separately identify the work that the AE should carry out as external and internal auditors, and how fees will be calculated for each service. It should make clear to whom the AE's internal audit team will report.

(viii) The AE should consider as part of its annual review of independence whether it is still sufficiently independent to be able to continue to act as external auditor.

(b) The advantages for Balestier of having the external auditor provide internal audit services are as follows.

(i) The audit staff will be qualified or partly qualified accountants who are subject to professional standards and guidelines.

(ii) Training costs will be saved, as the AE, not Balestier will be responsible for staff training.

(iii) The AE may be able to provide a range of expertise which would not be available to Balestier without incurring considerable extra costs.

(iv) The efficiency of external audit would be enhanced, and hence its costs lowered, because internal auditors are using the same procedures to record and assess systems. Therefore the external auditor would not have to spend time checking whether appropriate work has been performed.
The disadvantages for Balestier of using the internal auditors are as follows.

(i) Balestier may want to use internal audit for a variety of tasks on the non-financial areas of its business, and the AE may not have staff with the expertise necessary in these areas.

(ii) As discussed in (a), the ISCA independence requirements place limitations on the work that the internal auditors can carry out as a result of their AE also acting as external auditor.

(iii) The AE may not be able to guarantee continuity of internal audit staff. There may be regular staff changes as staff leave or are involved in other work, and the learning curve for new staff may add to the costs of internal audit.

(iv) The AE may not be able to provide the staff that Balestier wants at the time Balestier needs them because of commitments to other clients.

(v) The costs of the AE's staff will be higher than if Balestier employed its own internal audit staff, because the AE will be charging Balestier a mark-up on the staff's time as well as their salaries.

(vi) There may be conflicts over the reporting arrangements for internal audit staff. Balestier would want to maintain control over their activities, but there has to be a mechanism for reporting to the AE as well, because the external AE is responsible for the staff's professional development and hence will need to assess how staff have performed.

(c) The advantages for the AE of carrying out both the internal and external audit are as follows.

(i) The AE will be able to gain greater assurance from their own staff's work as internal auditors than they are likely to be able to gain if the internal audit staff were employed by Balestier. The AE will know that its staff has the necessary levels of competence and independence. It will also not have to spend time assessing the methods used to record and evaluate controls.

(ii) The extent of the work done by internal audit is likely to go beyond that necessary to support an external audit opinion, so the AE will have more evidence available than it would aim to have if it was just carrying out an external audit.

(iii) Working on a variety of internal audit tasks will enhance the professional development of the audit staff concerned.

(iv) The internal audit work might be able to be carried out at times of the year when the amount of other work is low, and thus staff will be used more efficiently.

The disadvantages for the AE of carrying out both services are as follows.

(i) The AE may have problems exercising control over the internal audit staff, because of their responsibility to report to the client.

(ii) Problems over the internal audit work may jeopardise the AE's role as external auditor.

(iii) The potential problems discussed in (a) in guaranteeing independence may prove insurmountable.
16. Orchard Pte Ltd

Required

(a) Explain the auditor's responsibility in respect of fraud and error. (5 marks)

(b) Orchard Pte Ltd (Orchard), designs and manufactures high quality wooden furniture. The audit is nearing completion and you are in the process of reviewing the audit file in your capacity as audit manager.

Draft financial statements for the year ended 30 September 20X5 show a profit before tax of $100,000 and total assets of $4,562,500.

The following matters are brought to your attention.

(i) The inventories figure of $675,000 includes $80,000 which has been valued based on the directors' estimate. This is due to the loss of the inventory counting sheets for the Sherwood depot. The audit team were unable to find any other means of validating these inventories.

(ii) During the year Orchard made a loan to a director, Edwin Yan, for $5,000. This is not disclosed in the financial statements as the directors believe that the transaction is a personal issue.

(iii) Trade receivables that total $525,000 include $47,000 due from Teak Pte Ltd. This customer went into liquidation on 3 November 20X5. The audit senior has concluded that Orchard is unlikely to recover the debt based on information provided by the liquidator. The directors have refused to adjust the financial statements.

The audit senior has drafted the auditor's report, extracts of which are as follows:

'Modified opinion

The inventories balance includes an amount of $80,000 based on the directors' estimate. This is because the inventory counting sheets for the Sherwood depot were lost and we were unable to find any other suitable means of confirming the inventory value. Also, included in receivables is an amount of $47,000 due from a company which is in liquidation. We believe that this amount should have been fully provided against as it is unlikely that the company will receive any payment in respect of this amount.

Except for the financial effects of the matters referred to in the preceding paragraph, in our opinion, the financial statements give a true and fair view, in accordance with Generally Accepted Accounting Practice, of the state of the company's affairs as at 30 September 20X5 and of its profit for the year then ended.'

The audit senior has also attached a note for you explaining that he has made no reference to the director's loan on the basis that the amount involved is not material.

Required

Comment on the suitability of this report. Your answer should include an assessment of the materiality of each of the three outstanding issues. (10 marks)

(Total = 15 marks)
16. Orchard Pte Ltd: Answer

(a) Auditor's responsibility in respect of fraud and error

SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and the management of an entity. It is not the auditor's function to prevent fraud or error although the fact that an audit is carried out may act as a deterrent.

In respect of detection, SSA 240 states that the auditor should assess the risk of material misstatement due to fraud at both the financial statement and assertion level and determine overall responses to address the assessed risks. This might include changing the nature, timing and extent of audit procedures, eg more inspection, more work conducted during the year rather than at the year-end and larger sample sizes.

The approach to error under SSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* and SSA 330 *The Auditor's Procedures in Responses to Assessed Risks* is broadly similar to the approach outlined for fraud above.

In practical terms the likelihood of detecting errors will be much higher than that of detecting fraud as deliberate attempts are normally made to conceal fraud including collusion and falsification of records.

In either case an audit is subject to an unavoidable risk that some material misstatements will not be detected.

If the auditor identifies an instance of fraud or error, he should document his findings and report them to the appropriate level of management and possibly to those charged with governance of the entity depending on their significance.

The auditor also needs to consider the potential impact on the audit opinion. If the fraud or error has a material effect on the financial statements the auditor's report may need to be modified. The nature of the modification would depend on the specific circumstances.

The auditor may need to consider whether there is a legal duty to report the occurrence of fraud or material error to regulatory or enforcement authorities.

(b) Auditor's report

Inventories in Sherwood

An exact calculation of the required adjustment to inventories cannot be performed as it is not possible to tell the extent to which the directors' valuation is incorrect. However the inventories figure of $80,000 overall is material to both the profit and total assets figure.

The issue here is insufficient inappropriate audit evidence related to a matter which is material (assuming that the audit manager agrees that no other procedures can be performed). In the draft auditor's report this has not been dealt with correctly. It appears that it has been dealt with as a misstatement.

The explanation of the problem has been correctly dealt with in the explanatory paragraph itself. The opinion paragraph should have acknowledged this as follows:

'Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the validity of the inventories figure, in our opinion the financial statements…'

Director's loan

The audit senior has made no reference to the loan on the basis that $5,000 is not material to the financial statements. While this is true from a quantitative perspective, in this case the director's loan is material due to the sensitive nature of the balance. SFRS(I) 1-24 *Related Party Disclosures* requires disclosure of transactions with key management personnel.
If the directors of Orchard still refuse to provide the necessary information, the details of the loan should be included in the auditor’s report. In addition the opinion would be modified (qualified – ‘except for’) on the grounds of a material disagreement for non-compliance with legislation/SFRS(I).

Bad debt

If the debt in respect of Teak were recognised in profit or loss this would result in a reduction in profits of 47% and assets of 8.4%. On this basis it would have a material effect on the financial statements. While material, the matter is isolated to the receivables balance and does not affect the truth and fairness of the financial statements overall. The audit senior has modified the audit opinion on the grounds of material misstatement with the decision not to provide against the debt. This is the correct treatment and the report has been correctly drafted in respect of this issue.
17. HDN Associates

Required

(a) Assess the need for, and problems associated with, environmental reporting. (5 marks)

(b) You are a senior manager in HDN Associates, an AE in Singapore. You have been associated with the audit of PackageInc Pte Ltd, a manufacturer of packaging and bags, for several years. Many of PackageInc’s customers are major retail chains and these customers have been demanding greater environmental responsibility from their suppliers, in particular from PackageInc, in terms of the products they supply. The directors have responded with the following measures, the achievement of which they intend to report to customers on an annual basis.

(i) The directors have pledged to produce carrier bags with at least 50% recycled plastic material and to increase production of more environmentally friendly paper bags. (4 marks)

(ii) The directors have invested in a wind turbine which is fixed to the top of the factory roof and which they pledge will generate 50% of production electricity. (4 marks)

(iii) The directors have set up a system to canvass customer opinion monthly by including a satisfaction questionnaire with their monthly statement and pledge to ensure that at least 80% of customers are happy with PackageInc’s environmental profile on an ongoing basis. (2 marks)

The directors have asked the AE to provide verification of the report to customers.

Required

Identify and comment on any effects these measures will have on the audit of PackageInc and also any issues associated with providing the specific verification for each measure. (Total = 15 marks)
17. HDN Associates: Answer

(a) Although environmental reports are not a legal requirement, they are becoming increasingly common as more stakeholders demand environmental accountability from companies. Historically, companies whose activities have the greatest social and environmental impact have been the most active in developing this type of reporting, for example, companies within the oil and gas industry like Shell or BP.

A problem with environmental reporting is that there is no one set of guidelines that companies are required to follow. An increasing number of companies follow guidelines issued by the Global Reporting Initiative (GRI). The GRI aims to develop transparency, accountability, reporting and sustainable development. Its vision is that reporting on economic, environmental and social importance should become as routine and comparable as financial reporting. Otherwise companies use measures such as Environmental Impact Assessments, environmental surveys, environmental SWOT analysis and Environmental Quality Management (EQM).

Another problem is that information given in such reports can be highly subjective, prone to manipulation, and dependent on systems put in place at the client (that is, not capable of being verified to third party information) and it is therefore very difficult to give any level of assurance about such information. At best, Chartered Accountants are likely to be able to give negative assurance, and it is important to ensure that clients and users of the information understand the nature of this assurance and what it actually means.

(b) PackageInc

(i) Product changes

Impact on audit

The pledge will most likely result in a change in the revenue mix at PackageInc which will therefore affect gross margins.

In addition, it is likely to have an impact on the cost structure of the plastic bags, which will affect both inventory and cost of sales (which will therefore also impact on gross margins).

The auditor should be aware of these differences when carrying out analytical review on the statement of profit or loss and also on inventory in the statement of financial position.

In addition, changing the level of recycled material in the plastic bags and the amount of paper bags produced will change purchase patterns. More paper will have to be sourced and more recycled plastic will also have to be sourced, the latter possibly causing a change in supplier.

These matters will impact on payables in the statement of financial position which should also be noted when conducting analytical review. A potential change in major supplier may increase control risk and may affect controls testing planned.

Verification issues

The pledges relating to products as they stand are very imprecise. It is unclear whether the directors intend to make the increase in recycled plastic by 50% annually or by 50% as a one off exercise. It will be impossible for the auditors to give any assurance unless the pledges made are more precise.

Evidence relating to the pledges will be entirely from the company's production records which is not the preferred source of evidence because it is generally considered to be a weak source, capable of manipulation. This means that the auditor will only be able to give a very low level of assurance on these matters.
(ii) **Wind turbine**

*Impact on audit*

The wind turbine is an addition to non-current assets. The auditor will need to ensure that it is valued appropriately (at cost), and depreciated properly over an appropriate useful life.

The use of their own wind turbine should reduce the electricity cost in the statement of profit or loss, which the auditors should be aware of when carrying out analytical review. There may be some additional associated costs, however, such as maintenance and repairs to the wind turbine.

It is possible that the company may qualify for some government incentive or grant scheme for investing in wind power. If the company is not aware of this, the auditors should make them aware. Such a grant would need to be accounted for correctly in the financial statements.

*Verification issues*

Again, this pledge is imprecise and there is scope for it to be manipulated. In particular, it will be necessary for the directors to specify what counts as ‘production electricity’, for example, all power to plant, but not the production canteen, or all lighting in the factory but not in the offices.

It will also be important to ascertain if it is possible to break down the electricity costs of PackageInc in this way so that this claim can be verified. Even if it is possible to break down the costs, there is a risk again that the pledge is dependent on company information. If such information can be provided by the electricity supplier, then the auditors may be able to provide assurance about this pledge.

(iii) **Customer satisfaction survey**

*Impact on audit*

The customer satisfaction surveys might give the auditors insight into any problems with PackageInc’s products if a large number of dissatisfied customers were returning items for example, which might be relevant to inventory. It could also give information about possible liabilities due if the surveys indicated severely disgruntled customers who intended to take further action.

*Verification issues*

This pledge is specific but as the company controls to whom the questionnaires are sent and also controls the replies to those questionnaires it is obviously open to manipulation. As the evidence relating to this pledge is based in client systems and records, the evidence is again weak, and the auditor will only be able to give a low level of assurance if at all.
18. Singapore National Bank

Singapore National Bank Ltd is a listed bank, with 20 branches in Singapore and five branches in different countries in Asia. Singapore National Bank has both retail and corporate customers in Singapore and although it traditionally served its corporate customers only outside Singapore, in the last 12 months it has expanded operations and invested heavily in the retail banking market. All customers are served through local branches and the new online banking service, www.SNB.com. The online banking service has also been launched in the last 12 months after being planned and developed for the past three years. Although it has been successful overall, it has encountered some security problems.

In terms of its retail customers, Singapore National Bank targets young professionals and families. It offers the cheapest home and personal loans on the market and very competitive interest rates on credit cards. The bank is currently reviewing the sustainability of offering these products to the market. Services offered to corporate customers include banking, treasury and financial services products.

In order to finance further expansion, Singapore National Bank is considering issuing further shares or raising debentures. The bank's head office houses a well-resourced internal audit department. Internal controls are effective overall but the bank's name was recently mentioned in a high profile scandal last year which involved a corporate customer's involvement in money laundering.

This is the first year that your AE has carried out the Singapore National Bank audit and you are an audit manager.

Required

(a) What particular risks of material misstatement are associated with the bank's online facility and what IT controls would you expect to find in operation? (9 marks)

(b) Identify and explain other audit risks involved in the audit of Singapore National Bank and describe the audit procedures required to address those risks satisfactorily. (16 marks)

(Total = 25 marks)
18. Singapore National Bank: Answer

(a) The risks of material misstatement with regards to the online banking facility include:

- **Website development costs** – Those costs that satisfy the condition of SFRS(I) 1-38 *Intangible Assets* should be capitalised and amortised over the life of the website. All planning costs should have been treated like research costs and expensed through the statement of profit or loss in the year they were realised. All website development costs should have been capitalised and amortised over the useful life of the website (which the standard says should be ‘short’).

- **Domain name cost** – the cost of obtaining the domain name should be treated in the same way as permission to use a licence – capitalised and amortised.

The IT controls I would expect to find in operation are:

- **General controls**: These should focus on the prevention of access to the bank's records from unauthorised persons/hackers (via firewalls) and access controls, so as to ensure only those authorised have access to the website (through passwords, security checks, etc).

- **Application controls**: Input and output controls should be in operation here – reasonableness triggers should exist to ensure that customers' transactions are input correctly (such as limits on amounts to be transferred or paid out, queried by the system) and that they are prompted regularly to confirm that they wish to proceed. Items that appear outside the reasonable range should be checked on an exception basis.

(b) Other audit risks and the procedures required to address them are set out below:

- The bank is listed and intends to raise funds from further share offerings or loans – this is an inherent risk as it may lead to manipulating the financial statements for short term gain by directors to improve the chances of such funds emerging.

  **Procedure** – Take steps to identify areas of the financial statements which are more subjective or subject to management discretion (such as provisions, estimates, revaluations or the adoption of unsuitable accounting policies) and prioritise review as part of the audit.

- The bank has recently expanded operations to overseas countries which exposes it to specific business, market, regulatory and foreign exchange rate risks.

  **Procedure** – Review the performance and position of these overseas units against expectations. Discuss with management the issues encountered in the retail market in each territory and review procedures for hedging foreign exchange risk on transactions and balances such as overdrafts.

- The online banking facility has encountered some security problems in the past year, indicating increased risk of controls not being effective, so balances may be misstated or fraud may have occurred. Confidential client information may have been exposed, which gives rise to a loss of reputation.

  **Procedure** – Discuss the nature and extent of the security issues (including the root causes and the impact they had on the financial statements) and assess whether these issues have since been addressed or not by testing account balances most susceptible to material misstatement generated by the system.

- Home loans will most likely be secured on the properties bought by customers – however, if there is any doubt over these customers' ability to keep up with their repayments, the home loans may no longer be fully repayable, leading to potential misstatement of liabilities.

  **Procedure** – Discuss likely levels of default and asset security with management.
• Although the bank has a well-resourced internal audit department which may serve to reduce control risk and create efficiencies in the audit process, it is still an unknown quantity to our AE due to this being the first year of audit.

Procedure – Evaluate the quality of the outputs and the objectivity, credibility and professional competence displayed by the internal audit department and establish whether any reliance can be placed on their work.

• Money laundering issues related to a bank's customer may indicate a lack of effective controls or legal compliance in this area. It may also mean that the bank itself has been involved in money laundering. Both of these issues will affect our ability to deliver an effective opinion.

Procedure – Discuss with management the exact nature of the bank's involvement (if this has not already been done on client acceptance and avoiding any risk of tipping off) and ascertain whether the controls in this area have been improved.

Consider extent of risks from money laundering among the bank's customer accounts – extend scope of audit testing in those accounts assessed as having a significant risk of fraud and/or error.

• This is the first year of the audit of Singapore National Bank and so there is increased risk of misstatements not being identified by the auditor due to the following:
  – Overall lack of familiarity with the client
  – Opening balances may be misstated
  – Materiality levels may be inappropriate (performance materiality may be too high for certain assets and liabilities for example)

Procedure – Ensure that a thorough planning process takes place to gather full information on the client. On the assumption that Singapore National Bank was audited by another auditor before we were appointed, using SSA 510 Initial Audit Engagements – Opening Balances, it is recommended that we review their work to establish their competence and independence before reviewing the most recent set of financial statements and the auditor's report for any information relevant to opening balances.

We should also observe SSA 320 Materiality in Planning and Performing an Audit to ensure that the amounts we use for performance materiality are appropriate and that the criteria adopted for establishing non-financial materiality levels (including performance materiality on such issues as outstanding loans and related party transactions) are appropriate.
19. Plum Pte Ltd

(a) Auditors should accept some of the blame when a company on which they have expressed an unmodified audit opinion subsequently fails, and they should also do more to highlight going concern problems being faced by a company.

Required

Discuss this statement. (8 marks)

(b) You are the manager responsible for the audit of Plum Pte Ltd (‘Plum’), and you are planning the final audit of the financial statements for the year ending 30 June 20X0. Plum is a supplier of components used in the manufacture of vehicle engines. Due to a downturn in the economy, and in the automotive industry particularly, the company has suffered a decline in sales and profitability over the last two years, mainly due to the loss of several key customer contracts. Many of Plum’s non-current assets are impaired in value, and a significant number of receivables balances have been written off in the last six months.

In response to the deteriorating market conditions, the management of Plum decided to restructure the business. The main manufacturing facility will be reduced in size by two-thirds, and investment will be made in new technology to make the remaining operations more efficient, and to enable the manufacture of a wider variety of components for use in different types of engines and machinery. In order to fund this restructuring, the management of Plum approached the company’s bank with a request for a significant loan. You are aware that without the loan, Plum is unlikely to be able to restructure successfully, which will raise significant doubt over its ability to continue as a going concern.

Your AE has been asked to advise on the necessary forecasts and projections that the bank will need to see in order to make a decision regarding the finance requested. Management has also requested that your AE attend a meeting with the bank at which the forecasts will be discussed.

Required

(i) Identify and explain the matters that should be considered, and the principal audit procedures to be performed, in respect of the additional funding being sought. (6 marks)

(ii) Comment on the ethical and other implications of the request for your AE to provide advice on the forecasts and projections, and to attend the meeting with the bank. (6 marks)

(Total = 20 marks)
19. Plum Pte Ltd: Answer

(a) The concept of an expectation gap between auditors and the public is a key lens through which assertions such as this one can be viewed. The first part of the statement would appear to assert that the auditor is in some way responsible for the failure of a company. This is not the case: those charged with governance are responsible for risk assessment and risk management and safeguarding the company's assets. It is not the role of the auditor to become involved with the entity's risk management processes – indeed, this could be deemed to constitute a management role, which would compromise the auditor's independence.

However, it is true that the auditor should gain an understanding of the client's business; this is a crucial requirement of SSAs. Amongst other things, it is necessary for an auditor to audit management's assessment of the appropriateness of the going concern basis of accounting, for which a good understanding of the business risks faced by the client is necessary. The auditor must judge whether the going concern basis of accounting used is appropriate. However, this is never a matter of cut-and-dried logic: it is a judgment, based on an assessment of risk. It is in the nature of risk for there to be uncertainties, and it is in the nature of judgment to contain elements of doubt.

It is therefore to be expected that there will be cases where the auditor has judged the going concern basis of accounting to be appropriate, and yet the company fails within the year. The question is not whether the assumption was proved correct by subsequent events, but whether the auditor's assessment was reasonable and in line with auditing standards.

There is more scope for discussion on the question of whether auditors should do more to highlight problems. This may be the responsibility of management; it would be possible for regulators and setters of accounting standards to require increased disclosure on going concern. For example, financial statements could be required to provide more narrative detail regarding the risks faced by an entity.

Revisions to auditor's reports since 2015 have tried to improve auditor reporting on going concern. Auditors must now disclose the presence of material uncertainties over going concern that they believe have been adequately disclosed by management by way of a 'Material Uncertainty related to Going Concern' paragraph in the auditor's report. (If the auditors believe management's disclosures to be inadequate then the auditor's report will be modified). The revised auditor's report also contains new descriptions of the auditor's and management's responsibilities in relation to going concern.

In conclusion, it is unfair to require auditors to accept the blame for company failures which are the proper responsibility of management, although it may be argued that even more could be done by auditors to highlight going concern problems where they exist.

(b) (i) The central issue here is going concern; there are a number of indications that Plum may not be a going concern. For instance, declining sales and profitability over two years; the loss of key customers; the impairment of assets; debts going bad. Most significant of all is the question of whether the loan will be obtained.

If Plum does not obtain the loan, then the financial statements must contain disclosures regarding the material uncertainty over going concern. The auditor's report should contain a 'Material Uncertainty related to Going Concern' section discussing the uncertainty and referring to the note. If the financial statements do not contain these disclosures, then the auditor's opinion would need to be either qualified or adverse.
Procedures in respect of the loan include the following:

- Obtain and review the forecasts and projections prepared by management and consider if the assumptions used are in line with business understanding.
- Obtain a written representation confirming that the assumptions used in the forecasts and projections are considered achievable in light of the economic recession and state of the automotive industry.
- Obtain and review the terms of the loan that has been requested to see if Plum can make the repayments required.
- Consider the sufficiency of the loan requested to cover the costs of the intended restructuring.
- Review the repayment history of any current loans and overdrafts with the bank, to form an opinion as to whether Plum has any history of defaulting on payments. (Any previous defaults or breach of loan conditions makes it less likely that the new loan would be advanced).
- Discuss the situation with management and those charged with governance, to ascertain if any alternative providers of finance have been considered, and if not, if any alternative strategies for the company have been discussed.
- Obtain a written representation from management stating management’s opinion as to whether the necessary finance is likely to be obtained.

(ii) Ethical

These forecasts are crucial for the assessment of whether the company is a going concern. There is a self-review threat if the auditor is both advising on the preparation of the forecasts, and auditing them as part of its work on going concern.

Where cash flow is important for the assessment of going concern, particular consideration should be given not only to what the forecasts say, but to their reliability. This exacerbates the potential impact of the self-review threat.

There is potentially an advocacy and management threat, as the auditor is advising on a matter significant to the company’s operational existence, and promoting the company’s position to the potential provider of finance.

The auditor must consider whether safeguards can be put in place to reduce these threats to an acceptable level. For instance, a separate team could help prepare the forecasts, and management could be asked to provide representations to the effect that they alone are responsible for the forecasts.

If the AE decides that the threat is still not reduced to an acceptable level, then either, or both, of the services should not be provided.

Other

A further issue is that if the auditor does attend the meeting with the bank, it must be careful not to create the impression that it is responsible for the forecasts, or is in any way guaranteeing the future existence of the company. In legal terms, attending the meeting and promoting the interests of the client could create legal ‘proximity’, which increases the risk of legal action against the auditor in the event of Plum defaulting on the loan.
Section Two
1. Kranji

Singh & Wu has provided audit services to Kranji Industries Pte Ltd (Kranji) for 20 years. The audit manager has been involved with the audit for ten years: the first two as audit assistant, then with increasing seniority until she became the audit manager for Kranji two years ago. The chief financial officer (CFO) of Kranji, James Ho, has been employed by Kranji for the 20 years that Singh & Wu has audited it. He started as an accounts assistant, and has increased in seniority in the company over time, until five years ago, he was promoted to CFO.

Over the course of the audit manager's business association with the CFO, they have become friendly to the point that they now play golf together occasionally in charity events, and the CFO has recommended the audit manager and Singh & Wu to several business associates.

The CFO recently requested a meeting with the audit manager to discuss some additional services Kranji is considering obtaining from Singh & Wu.

Kranji has decided to outsource its payroll function. The CFO is aware Singh & Wu offers payroll services, and has intimated that Singh & Wu would be Kranji's first choice to provide this payroll service, assuming the price was right.

The CFO is also aware from conversations held during the last audit that the audit team has serious concerns about the abilities of the financial controller who reports to him, and that several weaknesses in internal control were discovered at the previous audit, due to mistakes made by the financial controller. After continuing problems with the financial controller's job performance, the CFO has decided that Kranji should terminate her employment. However, the CFO is quite friendly with the financial controller, and has asked if the audit manager would attend a joint meeting with her to help explain why she is no longer required by the company.

The CFO has also asked if Singh & Wu might be involved in the recruitment process for a new financial controller. He casually asked whether the audit manager was still happy at Singh & Wu and whether she might want to take up the position. However, the audit manager was aware that despite the casualness of the remark, it was a serious offer. The audit manager was able to confirm that she is happy in her current employment, while keeping the conversation light.

The final item discussed at length during the meeting was the implications of recent changes to accounting standards on Kranji. On the way out from the meeting, the CFO offered the audit manager several boxes of chocolates to take back to Singh & Wu's offices. The chocolates were left over from a promotional trade fair where Kranji had taken a stand.

**Required**

(a) With reference to an appropriate ethical Code, comment on the ethical issues in relation to:

(i) The 20-year association between Singh & Wu and Kranji; and

(ii) The 10-year association between the audit manager and Kranji.

(b) Recommend appropriate safeguards to mitigate any threats identified in part (a) above.

(c) With reference to an appropriate ethical Code, comment on the ethical issues in relation to the audit manager's friendship with the CFO and recommend an appropriate safeguard to mitigate any threat identified.

(d) With reference to an appropriate ethical Code, comment on the ethical issues in relation to the request for Singh & Wu to provide payroll services to Kranji and recommend an appropriate safeguard to mitigate any threat identified.

(e) With reference to an appropriate ethical Code, comment on the ethical issues faced by Singh & Wu in relation to the request by Kranji to meet with the financial controller.
(f) With reference to an appropriate ethical Code, comment on the ethical issues faced by Singh & Wu in relation to the request to be involved in the recruitment of a new financial controller by Kranji. (3 marks)

(g) With reference to an appropriate ethical Code, comment on the ethical issues in relation to the discussion on changes to accounting standards. (3 marks)

(h) With reference to an appropriate ethical Code, comment on the ethical issues in relation to the audit manager accepting the chocolates from the CFO. (3 marks)

(Total = 25 marks)
1. Kranji: Answer

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Tutorial notes

Candidates may refer to the ISCA Code (EP 100) or the ACRA Code in ethical questions. Exact paragraph numbers are not required in the answers to questions, merely the principles of the Code which will be the same regardless of which Code is quoted. In the model answer below, the ACRA Code has been quoted, but marks would still have been awarded had the ISCA Code been referred to.

The key themes arising in this question are the issues of familiarity and management responsibility. There are a number of issues for Candidates to consider in the context of the Fundamental Principles of the ACRA/ISCA Code, principally the issues of integrity and objectivity, or, as in their practical outworking, independence.

Candidates need to be able to explain why a matter is a threat to independence rather than simply identifying the threat. They must be able to apply the principles of the Code to various scenarios.

Marking guide

(a)(i) Long association increases the familiarity threat. The long association is not prohibited by law or ethical guidance.

SSA 210 Agreeing the Terms of Audit Engagements.

Para A1 – Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied.

Note. para number is not required; the principle is required.

Singh & Wu must confirm that it is independent of Kranji prior to each audit and must put in place safeguards to objectivity.

3 marks

(a)(ii) Long association increases the familiarity threat.

ACRA Code of Professional Conduct and Ethics for Professional Accountants and Accounting Entities.

Para 290.148 – Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time.

Note. para number is not required; the principle is required.

The severity of the threats depends on factors such as:

- Length of service
- Nature of the role undertaken
- Role of the individual on the team
- Nature of the engagement
- Whether the client's management team has changed
- Whether the nature and complexity of Kranji's accounting and reporting issues has changed
  - Threat is reduced by the different roles performed by the audit manager.
  - Threat is increased by the audit manager's increasing seniority.

3 marks
| (b) | Rotating the audit manager | 1 mark |
|     | Rotating other staff associated with the assignment |
|     | Having a professional accountant who was not a member of the audit team review the work of the audit manager |
|     | Regular internal or external quality review |

| (c) | Familiarity threat to independence. (ACRA Code 290.130) |
|     | Significance depends on the nature of the relationship/roles of individuals involved |
|     | The relationship is a friendly, respectful business association and is not a threat to the audit manager's objectivity. |
|     | If the relationship developed further, the audit manager's objectivity could be threatened. |
|     | Safeguard: rotate the audit manager from this client. |

| (d) | Size of the combined fee income from the two services can result in a self-interest/intimidation threat. (ACRA Code 290.218) |
|     | Safeguards: external quality review/reduce dependency/third party consultation |
|     | Creation of a self-review threat. |
|     | Reduction of the self-review threat if there is a separate payroll department reporting to a different partner. |
|     | Whether Singh & Wu would be taking on management responsibility for the payroll. |
|     | Safeguard: Singh & Wu has to determine the terms of service. |
|     | Safeguard: Singh & Wu must ensure Kranji maintains management responsibility. |
|     | Safeguard: The service provided by Singh & Wu must be of a routine/mechanical nature. |
|     | Intimidation threat associated with the CFO. |

| (e) | Threat of management responsibility. |
|     | No safeguards can reduce the threat to an appropriate level when management responsibility is assumed as the threat is so significant. |
|     | What constitutes a management threat is an audit judgment. |
|     | No ethical barrier to the request as the auditor has not made the decision to terminate employment. |
|     | Possible legal, moral and ethical arguments against the request. |
|     | The appropriate legal process should be followed, and this is unlikely if the auditor helps terminate the financial controller's employment. |
|     | It might appear that the auditor has made the decision. |
|     | Decline the request. |

| (f) | Threat of management responsibility. |
|     | Self-interest, familiarity & intimidation threats (ACRA Code 290.211) |
|     | Significance dependent on the nature of assistance and role being recruited for. |
|     | Preferable to decline the request. |
|     | Possibly participate in a minor way. |
|     | Report the casual offer to the audit engagement partner so there is no appearance of impropriety. |
(g) Discussion about accounting standards application is a normal part of the audit process and does not generally create a threat (ACRA Code 290.166). Threat of management responsibility if Singh & Wu takes responsibility for the preparation of financial statements (ACRA Code 290.160). Management and self-review threats may arise where auditors tell Kranji management how to apply accounting standards. Kranji must make the final decision about how to implement an accounting standard. Kranji must make the final decision about accounting policies.

3 marks

(h) Accepting gifts can create a self-interest or familiarity threat. Can only be accepted if their value is trivial and inconsequential ISCA Code 290.227) Chocolates are of little value and were already offered for free to others so can be accepted.

3 marks

Answer points

(a) (i) There has been a long association between Singh & Wu and the client (20 years).

There is nothing in law or ethical guidance to prevent Singh & Wu and Kranji having such a long relationship, but it does increase the threat to independence of familiarity, which means there is a risk that objectivity will be lost.

Singh & Wu must confirm that it is independent of Kranji prior to each audit (SSA 210 Agreeing the Terms of Audit Engagements Para A1) and must put in place safeguards to objectivity.

(ii) There has been a long association between the audit manager and the CFO (10 years).

The ACRA Code notes that ‘Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time’ (ACRA Code 290.148).

The severity of the threats depends on factors such as length of service and the nature of the role undertaken. The fact that the CFO has performed different roles over the course of his relationship reduces the threat, although his increasing seniority tends to increase the threat.

(b) Safeguards to mitigate the familiarity threats identified in (a) are as follows.

- Rotating the audit manager
- Rotating other staff associated with the assignment
- Having a professional accountant who was not a member of the audit team review the work of the audit manager
- Regular internal or external quality review

(c) The audit manager and the CFO now have a relationship that consists of playing golf together at charity events and the CFO recommending Singh & Wu to other business contacts. Clearly this has been caused by a degree of familiarity over the course of their audit relationship. Section 290.130 of the ACRA Code explains that the significance of the threat depends upon the nature of the relationship between the audit manager and the CFO and the positions held by each party. Although both individuals are in senior roles, the relationship described appears to be no more than a friendly, respectful business association and, as such, does not itself constitute a threat to the audit manager's objectivity. However, it is a factor that the engagement partner should bear in mind when assigning staff to Kranji because, if the relationship developed further, the audit manager's objectivity could be threatened, and it might be appropriate to give the audit manager a break from this client.
(d) Singh & Wu provides payroll services and so it is an obvious potential service provider for the company.

Factors to consider in whether this will detrimentally impact audit independence are:

- The combined fee income from the two services. Providing additional payroll services could raise the total fee level from Kranji to a high proportion of the total fees of Singh & Wu which may result in fee dependence. Singh & Wu will not want to lose a client that generates a large proportion of its revenue and this can create a self-interest threat to independence. Alternatively an intimidation threat may occur where Singh & Wu feel pressured to issue a unmodified audit opinion or perform a low quality audit rather than risk losing a lucrative client. The ACRA Code 290.217 suggests safeguards to reduce this threat are external quality control reviews, consulting a third party on any key judgments or taking steps to reduce dependency on Kranji, for example by taking on other client work.

- Whether a self-review threat would be created (as Singh & Wu would be auditing payroll processed by itself). This threat would be reduced if there was a completely separate payroll department reporting to a different partner which there is likely to be if Singh & Wu routinely offers this service.

- Whether Singh & Wu would be taking on management responsibility for the payroll, as this would be a significant threat to audit independence. Singh & Wu would have to determine the terms of the service and ensure that Kranji maintains management responsibility and that the service provided by Singh & Wu was of a routine/mechanical nature.

- Whether there is any intimidation threat associated with the CFO implying Singh & Wu would be given the work ‘if the price is right’. This seems unlikely, as it is normal business practice to want to pay an appropriate amount for a business service. However, Singh & Wu should exercise judgment about whether it is being coerced into lower fees generally, to a point where it is not able to provide a quality service for the fees.

(e) In relation to employment issues, the main threat to consider is that of management responsibility. The ACRA Code 290.161 states that ‘if a firm were to assume a management responsibility for an audit client, the threats created would be so significant that no safeguards could reduce the threats to an acceptable level’. What constitutes a management threat is an audit judgment, but the Code gives examples, such as 'making significant decisions regarding acquisitions, deployment and control of human, financial, physical and intangible resources' (290.160).

In this scenario, the audit team has noted failings on the part of the financial controller, but this has been confirmed by management conclusions subsequent to the audit, and management has taken the decision to terminate her appointment. The CFO has asked the audit manager to attend and assist in the termination meeting. In principle, there is no ethical barrier to this taking place (as the auditor has not made the decisions and would simply be performing the mechanics of explaining the termination). However, there might be legal, moral and ethical arguments against the auditor conducting that meeting. The appropriate legal process should be followed, and this is unlikely to be the case if the auditor does it. In addition, it might appear that the auditor had made the decision, which is a threat to independence. Therefore Singh & Wu should decline this request.

(f) Section 290.211 of the ACRA Code states that the provision of recruiting services to an audit client can create a self-interest, familiarity or intimidation threat. The significance of the threat depends on the nature of the assistance and the required role of the person being recruited. Recommending a client for the financial controller position at Kranji increases the significance of this threat, as the financial controller will have significant influence over Kranji's financial statements and accounting records.

In addition, Singh & Wu must not appear to take management decisions. Singh & Wu might be best advised to decline this opportunity, or to only participate in a minor way as allowed by the 290.211 of the ACRA Code, such as reviewing the professional qualifications of a number of candidates.
In relation to the casual offer to the audit manager, the audit manager should report this to the audit engagement partner simply so that the partner is aware that the offer has been made and turned down, and so there is no appearance of impropriety.

(g) Section 290.166 of the ACRA Code explains that audit necessitates dialogue between the AE and management which may involve discussion on the application of accounting standards. The ACRA Code goes on to state that these activities are considered to be a normal part of the audit process and do not, generally, create threats to independence. The discussion between Singh & Wu and Kranji falls into this category.

This discussion may also give rise to a management responsibility threat. A key management responsibility is ‘taking responsibility for the preparation and fair presentation of the financial statements…’ (290.160). There is a management threat and a self-review threat if auditors in effect tell management how to apply accounting standards. Obviously auditors are well placed to advise clients on the impact of new standards on the financial statements, but care must be taken to ensure that management make the final decisions about how to implement an accounting standard and what accounting policies the client uses.

(h) Section 290.227 of the ACRA Code states that accepting gifts from an audit client may create a self-interest or familiarity threat. This threat is so significant that unless the value of the gift is trivial and inconsequential, no safeguard can reduce the threat to an acceptable level.

The chocolates offered as a gift to the audit manager were available for free to others as a marketing incentive at a trade fair. They are unlikely to be of any significant monetary value and the gift can be accepted by the audit manager.
2. Agarwal & Joshi

Agarwal & Joshi is an accounting entity (AE) with 6 offices in South-East Asia and 24 partners. You are the quality control partner of Agarwal & Joshi.

Lemon

An audit client, Lemon Pte Ltd (Lemon), is a manufacturer and retailer of artificial limbs, supplying custom-made artificial arms and legs to hospitals throughout the region. Lemon has been an audit client for the five years since its incorporation. One of the audit assistants has approached you and would like to have a confidential discussion about the audit of Lemon.

During this discussion you find out that the audit assistant joined straight from university and Lemon was his second audit assignment. The audit assistant informed you that his previous assignment commenced with an audit planning meeting; however, there was no planning meeting for Lemon. The audit assistant also told you that the audit manager was often busy with a larger client and the audit senior assumed responsibility.

You discover that the audit assistant audited property, plant and equipment and inventory. As the audit senior was busy, the audit assistant attended the inventory count alone but wasn't familiar with the inventory so relied on the help of Lemon's staff to find certain items. The audit assistant did not understand the stage of completion of the work in progress and relied on Lemon's staff for clarification and guidance.

You also discover that, due to time constraints on the inventory count, the audit senior advised the audit assistant to reduce his sample size. There were a few items that the audit assistant could not find and when he called the audit senior, he was told to replace them with something he could find.

Kal

Another audit client is Kal Pte Ltd (‘Kal’), a company which operates coffee shops throughout Singapore. Kal has been a client of your AE for the past three years and has plans for further expansion. Last year Kal reported a profit before tax of $1,500,000.

This morning you attended a meeting with the audit partner responsible for Kal. It has just come to the audit partner's attention that the finance manager who was responsible for counting and banking all of Kal's receipts has been carrying out a teeming and lading fraud and has defrauded Kal of $120,000. This finance manager was also responsible for preparing the bank reconciliation statement.

When the audit partner reviewed the working papers from last year, he discovered a file note that states:

‘At the year end there were $60,000 cash receipts entered in the cash book that have not yet been shown in the bank statements. These have been shown as outstanding lodgements in the bank reconciliation statement and were shown on the bank statements 7 days after year end. No further procedures will be performed as this amount is immaterial.’

Last month, Kal performed an investigation into banking delays and discovered the teeming and lading fraud of $120,000 in total over two years. Kal has spoken to its lawyers who believe that Agarwal & Joshi should have spotted the fraud. Kal now plans to sue Agarwal & Joshi for negligence.

Required

(a) Identify and explain five quality control concerns arising from the audit of Lemon. (10 marks)

(b) Recommend three actions that Agarwal & Joshi should take given the quality control concerns raised in (a) above. (3 marks)

(c) Comment on whether Agarwal & Joshi may be negligent with regards to the fraud at Kal on the basis of information given. (7 marks)

(d) Assess whether it would make a difference if Agarwal & Joshi had written a letter to Kal’s management following last year’s audit explaining that the late banking of cash receipts identified during the audit is a control deficiency that increases the risk of fraud. (5 marks)

(Total = 25 marks)
2. Agarwal & Joshi: Answer

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Tutorial notes

This question tests Candidates’ understanding of quality control and auditor liability where fraud has occurred at an audit client.

Candidates should be aware that strong quality control procedures ensure an efficient and effective audit. Candidates need to state the requirements of the auditing standards and explain whether these have been followed when assessing quality control or potential negligence claims.

Marking Guide

(a) No audit planning meeting
    Audit manager unavailable
    Inexperienced staff assigned to risky area (inventory count)
    Lack of time assigned
    Changing sample sizes and sample items

(b) Independent review
    Review of manager’s workload
    Additional staff training

(c) Outstanding lodgements of $60,000 are 4% of PBT and below materiality.
    Outstanding lodgements should have been reported to management as this is a deficiency in internal control.
    $60,000 has been defrauded in current year (120,000 – 60,000) and this could have been avoided.
    Kal’s coffee shop business is likely to have significant cash transactions and daily banking should be an internal control to prevent misappropriation.
    Late banking should have raised suspicions.
    Agarwal & Joshi have not exercised professional scepticism.
    Agarwal & Joshi have not reporting the deficiency in internal control to management.
    Agarwal & Joshi have not performed further audit procedures.
    Agarwal & Joshi are likely to be found negligent in a court of law.
    Kal management are likely to be found contributory negligent due to a lack of segregation of duties and ineffective internal controls.

(d) Further audit work was still not performed.
    Reporting to management is a good defence against negligence and adds to the defence that management were also negligent.
    Management took a year to react to the letter which indicates a weak control environment at Kal
    Failure of management to remedy a deficiency in internal control.
    Conclusion: Likelihood of Agarwal & Joshi being found guilty is decreased.
Answer points

(a) **Audit planning meeting**

There was no audit planning meeting to identify the audit strategy and delegate responsibilities to the audit team (SSA 300 Planning an Audit of Financial Statements).

All audits should commence with an audit planning meeting that is led by the audit partner (and manager). During this meeting all members of the audit team should gain an understanding of the client's business, and should be made aware of all risks facing the client and all risks facing the auditor (SSA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment). Audit work should also be delegated to the audit team, taking into consideration their level of experience (SSA 330 The Auditor's Responses to Assessed Risks).

The audit partner has not fulfilled the requirement of SSA 220 Quality Control for an Audit of Financial Statements Para. 15 which states that 'The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards...' since the requirements of the SSAs have not been met.

**Audit manager not available**

The audit of Lemon was not properly supervised by the audit manager as he was tied up with another client. There appears to have been no involvement by the audit engagement partner.

The audit manager should have been more focused on the audit of Lemon. He should have visited the audit team at Lemon's premises to ensure that all members of the team understood their role, and to answer any queries. The audit manager should also have been available to take calls from the audit team when issues arose (SSA 220 Quality Control for an Audit of Financial Statements).

**Inventory count**

This was only the audit assistant's second audit so he should not have attended the inventory count alone. It also appears that the audit assistant did not understand the purpose of the inventory count.

Work in progress is a complex area that should have been audited by a more experienced member of the audit team.

The audit senior should have attended the inventory count with the audit assistant and should have used it to provide on the job training. As the audit assistant was not familiar with the inventory and did not understand what he was counting, it would have been more appropriate to have the audit senior with him (AGS 4 Existence and Valuation of Inventories in the Context of Historical Cost).

**Insufficient time**

The audit assistant did not have enough time to complete his audit work on the inventory count. This indicates poor planning or insufficient budgeting. As Lemon is an existing client, the audit manager would be aware of the time required to conduct the inventory count and should have allocated more time and more resources to the count (SSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements).

**Changing sample sizes and changing items**

The audit plan should not be changed by an audit assistant or audit senior. Sample items should not be swapped for easier to find items. Sample sizes should not be reduced (SSA 500 Audit Evidence). This is a serious matter, as it questions the integrity of the individual as well as the audit process.
The audit manager should have been informed of the time constraints and would then have had the opportunity to allocate more time or resources to the inventory count, or to speak to the client about the additional time required.

The items that could not be found should have been noted on the inventory count sheets as they may not exist and inventory could be overstated.

(b) The audit of Lemon was not properly planned, staffed and supervised, and there is a risk that Agarwal & Joshi will issue an inappropriate audit opinion.

The audit file should be reviewed by an independent person before the auditor's report is issued.

A review of the manager's workload should be performed to understand why he was not available. The partners may need to reconsider their allocation of audit work.

Agarwal & Joshi may need to provide additional staff training to ensure that all staff are aware of the need to follow the audit plan, the mechanics of attending inventory counts and the need to have review and supervision procedures in accordance with the auditing standards.

(c) At the year end, the outstanding lodgements in the bank reconciliation statement amounted to $60,000. Assuming that all of this was part of the teeming and lading fraud, then this amounts to 4% of profit before tax, which is likely to be below materiality (assuming a 5% materiality level).

Although the outstanding lodgements are below the materiality level, they should still have been reported to management verbally or in writing as there is a deficiency in internal control and a risk of fraud if cash is being banked late. (SSA 265.10b, SSA 265.A25)

A further $60,000 had been defrauded in the current accounting year. If Agarwal & Joshi had reported the outstanding lodgements to management and the control tightened, then this could have potentially avoided Kal being defrauded out of the further $60,000 this year.

Agarwal & Joshi's suspicions should have been raised by the late banking and it should have looked for a teeming and lading fraud at last year's audit. Note that taking 7 days to bank cash may not indicate a delay in all businesses and industries so this judgment would have to be made by reference to this particular business. Kal operates coffee shops so is likely to have significant cash transactions daily, meaning that its internal control system should include frequent bankings so that unbanked cash is not put at risk of misappropriation. By understanding Kal's business, Agarwal & Joshi should have deduced that 7 days constituted a delay in banking.

Agarwal & Joshi appear not to have exercised professional scepticism in the light of the above factors, and failed to take steps that an auditor might be expected to take to meet the requirements of auditing standards. For example, SSA 315.31 requires an auditor to revise the risk assessment and modify the further planned audit procedures if new information is obtained which is inconsistent with the audit evidence on which the original risk assessment was based. Agarwal & Joshi has not revised the risk assessment or performed further audit procedures following the discovery of the deficiency in internal control.

On this basis, a court is likely to determine that Agarwal & Joshi was negligent in not reporting a deficiency to management and also in not performing any further audit work.

However, it is likely that management of Kal is contributory negligent as there was a clear lack of segregation of duties and an ineffective system of internal controls, both of which are management's responsibility.

(d) If Aggarwal and Joshi had reported on the deficiency in internal control in the letter to management then it is less likely that a court would find the AE to be negligent.

Agarwal & Joshi could be criticised for not having reported the delay verbally to management as soon as they noticed it, as this would have allowed management to investigate it immediately. This is a relatively minor criticism, so unlikely in itself to be the basis for finding Agarwal & Joshi negligent.
Whether Agarwal & Joshi should also have become suspicious of a teeming and lading fraud and performed further work on the basis of the immaterial outstanding lodgements (SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) would also have to be considered in the context of the materiality and the reporting to those charged with governance undertaken by the auditor.

The fact that Agarwal & Joshi reported on the deficiency and explained the risk of fraud to Kal should be a good defence against a charge of negligence, and certainly adds to the defence that those charged with governance were also negligent.

It should be asked why it took management almost a year to act on the management letter concerns and investigate the delay. This points to a deficiency in the control environment at Kal. SSA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* Para A24 explains that 'the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency'.

In conclusion, if Aggarwal and Joshi had written a letter to Kal's management following last year's audit explaining that the late banking of cash receipts identified during the audit is a control deficiency that increases the risk of fraud, this would make a difference in the likelihood of the AE being found negligent.
3. DLA Associates

You are a partner in the accounting entity DLA Associates (DLAA). The AE has been formed by the merger of DL Co and A Associates (AA), two medium-sized accounting entities solely based in Singapore. DLAA is an independent AE with no affiliations to other AEs. It has also recruited a new partner, Husna Binte Yaakob, from a competitor.

You have been appointed as quality control partner for DLAA, having served in that role for DL Co. You have just attended a partners’ meeting and discovered the following:

Your new colleague, Husna Binte Yaakob, has recently secured the audit of Singapore Construction Company Ltd (SCCL), a listed company. SCCL is the first listed company DLAA has had as a client and is seen as a major coup for DLAA. The AE from which Husna moved specialised in auditing construction companies and you are aware that no one at DL Co had any relevant industry expertise, as DL Co had no construction clients. DLAA deliberately tendered at a low price to counterbalance any perceived problems due to it being a new entity and owing to a desire to obtain market share in the larger companies’ market. The audit fee for SCCL is anticipated to be approximately 15.2% of the total fee income of DLAA.

Husna outlined her plans to obtain more business for DLAA at the meeting. She is aware that SCCL are hoping to expand to Malaysia through purchasing a local building company there and has already discussed the possibility of carrying out due diligence work for them with the CEO of SCCL. She is also hopeful that DLAA would be invited to audit any new subsidiary and carry out the resultant group audit.

Husna has also been approached by another construction company, SingBuild Ltd (SingBuild). SingBuild has decided to put its audit out to tender and she has been asked to submit a tender on behalf of DLAA. SingBuild are major competitors of SCCL.

You are aware that the audit committee at SCCL are interested in DLAA’s quality processes, as you were asked to meet with key members of the committee during the tender process to discuss the culture of quality control in DLAA. However, having reviewed the files relating to SCCL, you are concerned that the new partner is sacrificing quality for quantity of work. You note that she requested professional clearance from the former auditors of SCCL and has not yet received a reply. She does not appear to have followed this up.

Required

(a) (i) Assess five matters DLA Associates should have considered when accepting SCCL as an audit client.

(ii) With the matters considered, state whether DLA Associates should accept SCCL as an audit client.

(b) Comment on three matters Husna Binte Yaakob should consider in determining whether DLA Associates could carry out the potential due diligence and group audit work for SCCL.

(c) Comment on three matters Husna Binte Yaakob should consider in determining whether DLA Associates could carry out the tender for SingBuild.

(Total = 25 marks)
3. DLA Associates: Answer

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Tutorial notes

This question tests Candidates’ understanding of audit and assurance appointment issues.

Candidates should consider whether any ethical threats are created by taking on new clients and make sure that these are fully explained, not just identified. Make sure that safeguards are detailed where these can help reduce threats to an acceptable level. Remember to consider the practical elements of accepting a new client such as resourcing and locations. If the question asks for a decision, ensure that you conclude on whether an engagement can be accepted.

Marking guide

(a)(i) Award up to 2 marks per matter identified and explained up to a maximum of five matters.

Any five from the following:

Lack of experience in the construction industry

There is a threat to compliance with the fundamental principles of professional competence and due care.

DL Co has no experience in the construction sector but AA might have.

Lack of experience in an industry does not necessarily mean an AE cannot audit a company competently.

Partner has industry experience.

SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment requires DLAA to obtain an understanding SCCL’s industry which reduces the threat.

Using an auditor’s expert can act as a safeguard.

Lack of experience of listed companies

SCCL is DLAA’s first listed client and the AE lacks experience of the rules and regulations for listed companies.

A self-interest threat to competence and due care may be created.
**AE fee income levels**

Ethics Pronouncement 100 – *Code of Professional Conduct and Ethics*

Para 290.217 – *When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing the client creates a self-interest or intimidation threat.*

*The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.*

Examples of such safeguards include:

(i) Reducing the dependency on the client;

(ii) External quality control reviews; or

(iii) Consulting a third party, such as a professional regulatory body or a professional accountant on key audit judgments.

**Note.** Para number is not required: the principle is required.

Fees from SCCL exceed 15% and the client is a public interest entity.

**Partner fee income levels**

The audit fee from SCCL is 100% of the audit partner's fee income which creates a self-interest threat.

Safeguards must be applied to reduce the threat such as:

- Second partner review of the audit partner's work
- Other clients allocated to the audit partner

**Proposed fee level**

Low fees are not a problem if DLAA can carry out a quality audit.

Accepting the engagement as a loss leader to gain entry into the listed company market can give rise to a self-interest threat.

**Professional clearance**

Professional clearance from previous auditors is required but has not been given but this could be an administrative oversight.

**Resourcing and timing**

DLAA must consider timing and whether staff of the appropriate levels are available.

Deadlines, quality and auditing standards must all be met.

Threat to compliance with the fundamental principles of professional behaviour, professional competence and due care.

**Location**

Location must be practical and cost effective.

(a)(ii) **Lack of experience in the construction industry**

The audit partner is likely to have experience of the construction industry and should provide supervision and direction.

Will not prevent acceptance.

**Lack of experience in listed companies**

There has to be a first listed client when breaking into the listed client market.

Will not prevent acceptance.
**AE fee income levels**
Only the first year so will not impact acceptance this year.
Extra provisions will apply in future years.

**Partner fee income levels**
Situation must be monitored by DLAA and is likely to reduce as more clients are obtained.
Will not prevent acceptance.

**Professional clearance**
DLAA must contact the previous auditors by registered post stating they assume there are no reasons not to accept the engagement.
The engagement can still be accepted if this procedure is completed.

**Resourcing and timing**
As long as DLAA have enough staff of the appropriate levels available, the engagement can be accepted.

**Location**
Will not currently prevent acceptance.
Since the company has plans to expand abroad, this could be an issue in future years.

Conclusion: The audit can be accepted if safeguards are in place.

(b) **Fees (maximum 2 marks)**
The audit fee is already 15.2% of total fees for DLAA for the year creating a self-interest threat if this trend continues next year.
DLAA should be taking steps to reduce fee dependence and taking on the extra work will increase the threat.
DLAA is aiming to grow its client base and this may only be a temporary issue so the matter should be appraised when the work is offered, rather than now.

**Due diligence (maximum 2 marks)**
Offering due diligence services to SCCL creates a self-review risk where DLAA could be auditing figures from the due diligence in the following years audit if the sale goes through.
Using separate teams for the audit and due diligence work is a safeguard.
Also, discussion of the threat with the audit committee prior to acceptance.

**Group audit (maximum 2 marks)**
DLAA may not have experience of auditing international groups or Malaysian GAAP creating a threat to the fundamental principles of due care and competence.
DLAA has no offices in Malaysia and it may not be practical to send staff abroad to carry out the audit of any Malaysian subsidiary.
Using component auditors may be a more practical solution.
(c) Award up to 2 marks per matter identified and explained up to a maximum of three issues.  

**Conflict of interest**

A conflict of interest arises as DLAA would be auditing two competing construction companies.

Ethics Pronouncement 100 – *Code of Professional Conduct and Ethics*

Para 220.11 – *In addition, it is generally necessary to disclose the nature of the conflict of interest and the related safeguards, if any, to clients affected by the conflict and, when safeguards are required to reduce the threat to an acceptable level, to obtain their consent to the professional accountant in public practice performing the professional services.*

**Note.** Para number is not required: the principle is required.

Before tendering for the audit of SingBuild, DLAA should obtain consent from both clients.

DLAA should allocate separate teams and separate engagement partners to SingBuild and SCCL.

**Resources**

Staff with knowledge and experience of the construction industry could be required to work on the audits SingBuild and SCCL.

If few DLAA staff have the relevant knowledge and experience and they are required to work on both clients at the same time, there may not be enough resource to adequately staff the two audit teams.

**Fee level**

DLAA may quote a low fee for the SingBuild audit to win more business.

Low fees could result in the AE cutting corners to be cost-effective and the audit quality being inadequate.

**Restraint of trade**

The new audit partner may be subject to a restraint of trade and DLAA must ensure this is upheld when any tenders are made.

If broken, DLAA's reputation could be adversely affected or the AE may face a legal case.

**Competence**

DLAA may not have enough competent staff to audit both SingBuild and SCCL.

DLAA could consider hiring more staff with relevant experience and knowledge.

Also consider using an external valuer.

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**Maximum 6 marks**

**Answer points**

(a) (i) **Lack of experience in construction industry**

There is a question over whether DLAA has the professional competence to audit SCCL due to its lack of experience in the construction industry. It is a fundamental principle of accountancy ethics that Chartered Accountants work with professional competence and due care.

One of the merged AEs has no experience in the construction industry. This concern may be unfounded, as the lack of experience only relates to the 'DL' part of the entity, and 'AA' may have experience in the industry.
However, unless there is a very particular specialisation relating to an industry, there is no reason to assume that because an AE has no experience of a sector that they will not be able to audit a company competently. In addition, the audit partner does have experience of the industry and so will be able to direct the audit properly and help the audit team to understand industry specific issues. The AE will have to obtain a suitable understanding of any new client, and there is no reason why they will not be able to do so in relation to this one.

DLAA will need to consider if they require the services of an auditor’s expert prior to accepting the audit of SCCL and factor this in to the cost and timing of the audit. For example, an expert might be required to provide evidence on the valuation of land or assessing the stage of completion of a construction project. Using an expert acts as a safeguard to eliminate or reduce the risk from a lack of experience in the construction industry.

Lack of experience of listed companies

Similar considerations might be had in relation to the fact that this is DLAA’s first listed client and so DLAA lacks experience of listed companies. A listed client will be subject to rules and regulations over and above the requirements for a non-listed company, of which DLAA may not have first-hand experience. A self-interest threat to professional competence and due care could therefore be created if DLAA accepts the audit of SCCL.

AE fee income levels

There are ethical considerations relating to the fee level. EP 100 states that when the total fees from an audit client represent a large proportion of the total fees of the AE, the dependence on that client and concern about losing that client create a self-interest or intimidation threat (EP 100 s290.217). In this situation Husna Binte Yaakob must evaluate the significance of the threat and apply the following safeguards if necessary:

- Reducing the dependence on the client
- Engagement quality control reviews
- Consulting a third party, such as a professional regulatory body or a Chartered Accountant, on key audit judgments

Given the impetus of the AE for growth, the second of these safeguards is definitely being implemented as Husna Binte Yaakob herself and other partners seek new audit clients for the merged AE.

As SCCL is a listed company EP 100 provisions which apply to clients which are public interest entities are also relevant. EP 100 states that where the audit client is a public interest entity and for two consecutive years, the total fees from the client and its related entities represent more than 15% of the total fees received by the AE, the AE must disclose this fact to those charged with governance and discuss whether a pre-issuance review or post-issuance review will be performed.

Partner fee income levels

There is also a potential ethical problem in relation to the audit engagement partner, Husna Binte Yaakob, for whom this audit fee currently represents 100% of her fee income for the AE. ISCA guidance suggests that safeguards need to be applied where there is a self-interest threat to independence for the engagement partner by such a situation (EP 100 s290.218). It might be necessary to perform second partner reviews of Husna Binte Yaakob’s audit files until she has built up her client base a little. Also, DLAA might allocate her other clients of the AE to alleviate this situation, for example if any partner/client relationships are becoming too familiar and DLAA needs to rotate partners.
Proposed audit fee level

DLAA has deliberately tendered at a low price to counterbalance some perceived weaknesses in the tender. This situation could give rise to a self-interest threat. This is not necessarily an ethical problem unless it is not possible to carry out the audit in a quality manner at the price that has been stated and the AE therefore does not perform a thorough audit. However, it is a business reality that sometimes AEs may accept a service as a loss leader for reasons of business strategy (in this case, to break into the listed company market).

Professional clearance

AEs are required to obtain professional clearance from the previous auditors of a new client. In this instance, it appears that Husna Binte Yaakob has requested professional clearance from the previous auditors, but they have not replied.

If the previous auditors were denied permission to reply to the prospective auditors, they should have informed the prospective auditors of that fact, so it does not imply that the previous auditors have been gagged. It may just be an administrative oversight by the previous auditors.

Resourcing and timing

Prior to acceptance, DLAA will need to consider if they have time and resources to perform the audit of SCCL so that all quality and auditing standards are adhered to. Assigning too few staff could result in work being rushed or late and misstatements might be missed if the staff assigned to the audit are not experienced enough.

DLAA will have other audit clients where the timing of audit work could clash with the reporting deadlines of SCCL. DLAA will need to consider if they have enough staff of the correct skill levels available when the SCCL audit work needs to be performed so that this and other audits are not adversely impacted. This ensures the AE complies with the fundamental principles and professional behaviour, professional competence and due care.

Location of audit work

DLAA will need to consider the location of the audit work before accepting the audit of SCCL and whether it is practical and cost-effective for DLAA staff to attend. Currently SCCL seems to be only based in Singapore which will not be an issue for DLAA. However, the company does have plans to expand to Malaysia. This may be a consideration for the acceptance of audits in future years as DLAA staff may not have experience of Malaysian local accounting rules and regulations and could require further training.

(ii) DLAA will need to consider all the matters above in deciding whether it is appropriate to accept the audit of SCCL.

Lack of experience in construction industry

This will not prevent DLAA from accepting the audit of SCCL. As detailed in (i), this is mitigated by the fact that Husna Binte Yaakob is likely to have experience of the construction industry and staff from A Associates might also. In addition, experts can be used as an additional safeguard.

As it is probable that Husna Binte Yaakob has the relevant experience, it is important for her to provide adequate supervision.

Lack of experience of listed companies

Assuming that the engagement team members are mindful of the relevant requirements and apply proper professional competence and due care, this should not be a problem. It should not be forgotten that the AE has merged in order to break into this market, and in order to build up a group of listed clients, there has to be a first listed client.
AE fee income levels

Whilst the fees relating to SCCL exceed the 15% benchmark, this is currently only the first year and will not impact whether DLAA can accept the audit. This issue will need to be monitored however, in future years.

Partner fee income levels

DLAA should monitor this situation, as it is in a period of attempted growth for the AE and for Husna Binte Yaakob's own client base, so this problem may reduce as more new clients are obtained.

Proposed audit fee level

As long as DLAA adhere to quality control practices and can illustrate that they are providing a quality service, this is not a reason not to accept the engagement.

Professional clearance

It is not necessary to assume that a failure to reply implies a reason not to accept the client. However, DLAA should now contact the previous auditors by registered post stating that they are assuming that there are no reasons for them not to accept the engagement so that they have fulfilled all their requirements in this regard.

Resourcing and timing

As long as DLAA have enough staff of the appropriate levels available, the engagement can be accepted.

Location of audit work

This is not currently an issue that would prevent DLAA accepting the audit as all the audit work would be in Singapore. Since the company has plans to expand abroad, this could be an issue in future years.

Conclusion

In conclusion, DLAA can accept the audit of SCCL so long as the safeguards detailed are applied.

(b) Whether it will be appropriate for DLAA to carry out the additional work for SCCL depends on a range of factors. The nature of the other services and their impact on audit independence must be considered, as must the issues relating to total fees from the client.

Fees

The audit fee for SCCL is projected to be 15.2% of total fees for the AE this year. This is already at a level where there may be a significant self-interest threat to the AE and DLAA should be considering the application of safeguards to the engagement to ensure that independence is not threatened. One of these safeguards is to take steps to reduce DLAA's dependence on the client. Taking on additional work for that client is the complete opposite of this safeguard and will obviously push up the fee income level and intensify the threat of lack of independence. It is unclear how much extra fee would be generated, but we could reasonably assume that taking on another company audit and a group audit could double the current fees. However, this must be balanced by the context of an AE seeking to grow and that the EP 100 provisions for public interest entities apply where the fee levels exceed 15% for two consecutive years. Depending on the rapidity of the growth, and the number of different clients being taken on by DLAA, this might be a temporary problem which would not exist when the work was actually offered in the future (as, at the moment, it is all theoretical). It should therefore be appraised at that time, rather than now.
Due diligence

Offering a service to the client other than audit could impact on the independence of the audit. Husna should consider the nature of the service being considered. Given that it would be due diligence in relation to a company that SCCL would be looking to buy, there might be significant self-review risk. If SCCL bought the company, it would be recorded as an investment in SCCL’s financial statements next year, and the value of the company would be tied up with the figures that DLAA had reviewed in its due diligence. There may have been risks and uncertainties relating to the accuracy of these figures that the due diligence process should have highlighted.

DLAA could put safeguards in place to reduce the threat to independence, for example, ensure that the due diligence was carried out by a completely separate engagement team. This might be sufficient to protect the independence of the audit.

As the client is listed, the threat to independence of accepting the due diligence engagement could be discussed with the audit committee also.

Group audit

It is not clear from the scenario whether DLAA has any experience auditing international groups. As it is an AE based solely in Singapore, there might be practical considerations against auditing a company based in Malaysia, as DLAA only has its Singapore office. This would depend on how easy it was to audit the company in Malaysia and whether the AE had the expertise in Malaysian GAAP to do so. It might be more realistic to consider taking on the group audit and relying on the work of component auditors for the statutory audit of the Malaysian company than to undertake the audit of that company itself.

(c) Conflict of interest

In terms of tendering for the audit of SingBuild, the main consideration that Husna should have is that this would represent a conflict of interest for DLAA, which also audits SingBuild’s major competitor, SCCL.

When considering whether to accept a client or when there is a change in a client’s circumstances, AEs should take reasonable steps to ascertain whether there is a conflict of interest or if there is likely to be one in the future. Disclosure is the most important and powerful safeguard, which would usually include:

- Notifying the client of the interest/activities that may cause a conflict of interest and obtaining their consent to act in the circumstances
- Notifying all known relevant parties that the Chartered Accountant is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent so to act
- Notifying the client that the Chartered Accountant does not act exclusively for any one client in the provision of proposed services, and obtaining their consent so to act (EP 100 s220.11)

Thus before tendering for the audit of SingBuild, it would be wise to inform SCCL that the AE intended to and obtaining their consent for DLAA to do so and, as part of the tender, informing SingBuild that DLAA does not act exclusively for any one client and might have clients who are in competition with the company.

There are advantages, and it is not uncommon for auditors to carry out the audit of more than one company in the same industry. It would be important to ensure that different engagement partners were allocated to each of the two clients.

Resources

If DLAA were to obtain both of these audits this could put a strain on its resources as any staff with relevant experience could be required to work on both audits. This could result in the quality of either audit not meeting the required standards. Misstatements in the financial statements could
be missed where staff do not have enough time and DLAA runs the risk of issuing an inappropriate audit opinion opening it up to potential litigation claims.

**Fee level**

DLAA may be tempted to quote a low price for the audit of SingBuild, in order to win the client and grow that area of the business. This would then mean that DLAA may need to cut corners in the performance of the audit work in order for the engagement to be cost-effective. Again, this could result in misstatements being missed in the audit of financial statements.

**Restraint of trade**

It is possible that Husna Binte Yaakob is subject to a restraint of trade in relation to clients of her previous AE. DLAA should ensure that any tender by them including Husna Binte Yaakob does not breach any legal restrictions relating to their having poached the new partner from another AE, as this would be unprofessional of the AE and could adversely affect its reputation if the other AE enforced any such legal rights.

**Competition**

DLAA should consider how it could improve the knowledge and skills of its audit staff so as to be able to audit these two construction companies. The firm may wish to hire some staff with relevant experience to help with training and knowledge dissemination. The AE should also consider whether the services of an external valuer are required.
4. Singh & Goh Ltd

You are an audit manager with Mistry & Tam, a large accounting entity, and are currently planning the audit of Singh & Goh Ltd (‘S&G’), a supplier of fast moving consumer goods which is listed on the SGX. S&G is a holding company for a number of subsidiary corporations.

You have reviewed the prior year audit file and familiarised yourself with the client. S&G operates with three divisions; foods, home and healthful living. It owns a number of brands in each division, all of which are ‘household names’. The company has a stable accounting department and a qualified Chief Financial Officer (CFO) who is very experienced in accounting and has been employed by S&G for many years. The prior year audit files show audit work has found no material misstatements in previous years.

The following developments have taken place during the year about to be audited:

1. S&G carries all its buildings at valuation. The CFO has informed you that S&G bought a new building at the end of the year which the CFO has currently accounted for at cost.

2. S&G purchased a brand from a competitor for an amount you anticipate will be material. It is an established brand. Since the purchase, the competitor has released a new brand on the market which is in direct competition with the old brand. The competitor's new brand focuses on issues which are important to the market at present, such as eco-friendliness, and it has taken significant market share from the old brand. S&G's marketing department is having to invest significantly more effort in the purchased brand than S&G had anticipated.

3. S&G expanded into the health beverage market during the year by purchasing 100% of the share capital of Baxter Pte Ltd. The CFO anticipates that beverages will contribute 12% of revenue for the group for the year, increasing to 25% in the following year. This is an area in which the company anticipates growth and the CFO is monitoring the financial results closely to ensure that appropriate resources are directed to it. Health beverage operations are currently being overseen by the president of the healthful living division, but day to day operational management and reporting is being carried out by the staff at Baxter Pte Ltd.

S&G draft FS are as follows:

<table>
<thead>
<tr>
<th>Draft key financial statement figures (for the year ended 31 December 20X2)</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>770.7</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>8.6</td>
</tr>
<tr>
<td>Total assets</td>
<td>10.5</td>
</tr>
</tbody>
</table>

**Required**

(a) Recommend an appropriate materiality benchmark for the purposes of planning the audit of S&G and the appropriate percentage to be applied to this benchmark. (6 marks)

(b) Comment on whether the valuation of the new building has an impact on the materiality calculation for planning purposes. (3 marks)

(c) Explain why there is a significant risk of material misstatement for the purchased brand figure at S&G. (9 marks)

(d) Explain why there is significant risk of material misstatement from including Baxter in the consolidated financial statements of S&G for the year ended 31 December 20X2. (7 marks)

(Total = 25 marks)
4. Singh & Goh Ltd: Answer

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<table>
<thead>
<tr>
<th>Title</th>
<th>Learning outcome</th>
<th>Textbook chapter</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q4 Singh and Goh</td>
<td>Define materiality and performance materiality and demonstrate how it should be applied in accordance with professional auditing standards. Identify and explain material and significant audit risks (broken into risks of material misstatement and detection risks) for a given assignment.</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7</td>
<td>3</td>
</tr>
</tbody>
</table>

Tutorial notes

This question tests Candidates' ability to calculate materiality using benchmarks and to explain the risk of material misstatement identified in planning an audit.

When asked to explain a risk of material misstatement refer to the financial reporting standards where appropriate and explain how these might be followed incorrectly resulting in a misstatement. Be sure to describe whether the risk will result in an over or understatement of profits or assets where applicable. In some cases, the risk could result in either over or understatement. Always consider factors that may reduce the risk of material misstatement such as a strong internal audit team or experienced CFO.

Marking guide

(a) **Benchmarks**

- Revenue 0.5 – 1%
- Profit 5 – 10%
- Total assets 1 – 2%

Materiality is revised as the audit progresses.

Profit is the most appropriate benchmark for S&G which is equity financed.

Range is $430,000 – $860,000 for profit.

Choosing the exact percentage to apply involves judgment.

The experienced CFO and lack of misstatements in previous years indicate a high percentage is appropriate.

However S&G has been subject to change over the past year and so a lower percentage is more appropriate.

Any known issues in the draft financial statements need to be dealt with so that performance materiality is appropriately set.

6 marks

(b) The property should have been revalued at the end of the accounting period in line with S&G's accounting policy but this has not occurred.

This could result in the property being over or understated.

The building has been purchased recently and so the cost and fair value are likely to be similar.

In monetary terms, the issue is unlikely to impact the financial statements and so has no impact on materiality for planning.

3 marks
(c) **Initial recognition**  
9 marks

Risk of incorrectly accounting for the brand is mitigated by the fact there is an experienced CFO.

The purchased brand is an identifiable, non-current monetary asset and should be accounted for under SFRS(I) 1-38 *Intangible Assets*.

There is a risk that the brand is expensed and not capitalised on initial recognition resulting in assets and profits being understated.

There is a risk that costs are incorrectly capitalised resulting in an overstatement of assets and profits.

**Amortisation**  
SFRS(I) 1-38 *Intangible Assets*

*Para 97 –* The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.

**Note.** Para number is not required: the principle is required.

Determining the useful life of the brand involved management judgment and could be subject to bias resulting in a misstatement.

**Subsequent measurement**  
SFRS(I) 1-38 *Para 72 –* An entity shall choose either the cost model... or the revaluation model... as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.

**Note.** Para number is not required: the principle is required.

**Revaluation model**

S&G already owns other brands and the new brand may not be accounted for using the same model resulting in a misstatement.

Subjectivity in determining the fair value of the brand at the period end increases the risk of misstatement.

The success of the competitor's new brand may mean that the recently purchased brand is overstated and needs to be impaired.

(d) There is risk that the newly purchased subsidiary will not be accounted for correctly in the consolidated financial statements.  
7 marks

There is a risk that the identifiable net assets and net liabilities are not measured at fair value at the date of acquisition and consequently goodwill will not be calculated correctly.

The risk is mitigated by the experience of the CFO and the fact S&G owns other subsidiaries.

The previous management of Baxter are still carrying out operations and reporting which increases control risk if group-wide controls are not operating yet.

If the operations and reporting of Baxter are not integrated with S&G the risk of a material misstatement in the consolidated financial statements is increased.

Beverages revenue is expected to be 10% of total revenue in future years which is over the 10% threshold in SFRS(I) 8 *Operating Segments* requiring segmental reporting.

There is a risk that the requisite segmental reporting is not carried out or that the disclosures are incorrect.
Answer points

(a) Materiality is often calculated on the basis of draft figures using the following commonly used benchmarks:

<table>
<thead>
<tr>
<th></th>
<th>Lower limit</th>
<th>Upper limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td>0.5 – 1%</td>
</tr>
<tr>
<td>Profit</td>
<td></td>
<td>5 – 10%</td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
<td>1 – 2%</td>
</tr>
</tbody>
</table>

Inherent in a calculation based on draft figures is the understanding that materiality may be revised, and that work done may be re-appraised, as more accurate figures become available.

S&G is equity financed by shareholders who receive dividends based on profit. This means that the users of the financial statements will be interested in the profit figure and this is the most appropriate benchmark to use. (Note that the users of financial statements will also be interested in the factors that impact on profit, for instance, revenue and asset valuations.)

Based on the information the auditor has received, the auditor might perform the following ranges in which to determine materiality:

<table>
<thead>
<tr>
<th></th>
<th>Lower limit</th>
<th>Upper limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>430,000</td>
<td>860,000</td>
</tr>
</tbody>
</table>

Determining which percentage to apply to the benchmark involves judgment. The lower limit of materiality will be more appropriate where risk is deemed to be higher and vice versa.

S&G has a stable accounting department with an experienced CFO and material misstatements have not been identified in prior years audits. This indicates using the upper limit of materiality could be appropriate. However, there have been significant changes in the nature of S&G’s business in the current year as the company has branched into a new market and purchased a new brand. This suggests using the upper limit may not be appropriate and applying a more conservative percentage may be more suitable. Thus the lower limit of the profit benchmark will be the most appropriate materiality figure for planning purposes.

Whether it is appropriate to commence audit fieldwork using this figure as a materiality level depends on factors such as the monetary value of any known issues in the draft figures. If amendment of these issues would have a substantial impact on the monetary value of the materiality calculated then it would be better for the auditor to deal with these issues in advance of the fieldwork, so that the materiality set is appropriate and audit work can be planned efficiently.

Currently, there are no known issues at S&G which would impact the materiality calculation in this way.

(b) The new property has been purchased very recently, and therefore in the absence of any information about any particular circumstances associated with its purchase, the cost is likely to be very similar to the current fair value, as it is likely to be very close to the current market value.

So although technically, all properties should be held at valuation, in monetary terms this issue is likely to make little or no difference to the financial statements. Hence it does not affect the calculation of the materiality for planning.

(c) There is a risk that S&G does not account correctly for the purchased brand and it is materially misstated. Misstatements may occur during initial recognition of the brand, amortisation, valuation or impairment.

Initial recognition

The risk of error in initial recognition is likely to be relatively low given the experience and ability of the CFO. The purchased brand is an identifiable, non-monetary asset and as such should be capitalised under SFRS(I) 1-38 Intangible Assets. There is a risk that it will be expensed, in which
case assets and profits would be understated. There is also a risk that incorrect costs (such as advertising costs) are capitalised, which could result in overstatement of assets and profits.

**Amortisation**

The intangible asset should be amortised over its useful life. The risk of material misstatement is significant here as this will involve management judgment in determining the useful life of the brand. This estimation and the values that result could be affected by management bias. There is a risk that management assess the useful life as too long, resulting in an understatement of amortisation each year and overstatement of profits. The intangible assets could also be overstated in the statement of financial position.

**Revaluation**

The asset may be carried at cost or valuation, and if the valuation model is used all assets in the same class should be valued with the same model. As S&G has other brand assets, the financial statements would be misstated if this asset was not valued using the same model as other purchased brands owned by S&G.

If the brand is to be carried at valuation (which is possible, given that the fact that this brand has been purchased implies a market in brands), there is further risk of misstatement due to the possible subjectivity associated with determining the brand's fair value at the year end. This may result in over or understatement in the financial statements.

**Impairment**

Regardless of the valuation model used, there is evidence of a negative change in the market of the purchased brand, which is the launch of a new product by the competitor. The success of this product in obtaining market share from the brand, and the fact that the marketing department are doing more work than was anticipated to support the brand could be seen as external and internal impairment indicators. SFRS(I) 1-36 Impairment of Assets requires management to perform an impairment review if there are indicators that an asset is impaired, so that it can be written down to an appropriate value in the financial statements. There is a risk that management have not performed an impairment review or that any review performed is incorrect and based on unrealistic assumptions.

The subjectivity associated with making judgments for the impairment review increases the risk of material misstatement associated with this asset, and further increases the chances of the valuation of the asset being subject to management bias.

(d) S&G purchased 100% of the share capital of Baxter Pte Ltd (Baxter) during the year. There is a risk that this transaction will be accounted for incorrectly. This should be a relatively low risk of errors due to the quality and experience of the CFO and the fact that S&G already owns a number of subsidiary corporations.

However, the auditor should still be alert to risks associated with accounting for the fair values relating to the purchase and the calculation of goodwill under SFRS(I) 3 Business Combinations (for example, SFRS(I) 3.37 states that the consideration transferred in a business combination is measured at fair value). Wherever, judgment is allowed, there is a risk that management bias may influence the figures.

There is possible increased risk associated with the purchase due to the fact that although beverages are being overseen by the president of the healthful living division, the operations and reporting of Baxter is being largely left as it is at the moment. There is a risk then that group-wide controls are not functioning properly yet and that there could be initial problems of integration in reporting and operations which could lead to material misstatement in the consolidated financial statements.

There is also the issue of how S&G account for beverages within their segmental reporting. It seems possible that beverages will represent a reportable segment. The CFO is closely monitoring the results of the segment in order to support operating decisions relating to it, and it is expected
to represent 12% of revenue for this year and more in future years. These criteria appear to make it a reportable segment per the requirements of SFRS(I) 8 *Operating Segments*, and there is a risk that the appropriate disclosures are not made or are misstated, for example, included within healthful living, due to the fact that it appears to currently fall under the operational control of the healthful living division.

Since Baxter is 100% owned by S&G, the consolidation process is unlikely to be complex and this does create a significant risk of misstatement. There is a risk that intercompany balances and transactions between Baxter, S&G or other group companies have not been identified or eliminated which could lead to overstatement in the statement of financial position and the statement of profit or loss. There is also a risk that figures from the financial statements of Baxter may not be transferred correctly to the consolidation schedule resulting in misstatements in the group financial statements.
5. Premier Games

Krish Deol is an audit manager for Johal & Chang Co, a small accounting entity. Krish is in the midst of planning the audit of Premier Games Ltd (Premier Games) for the year ended 31 December 20X5. Johal & Chang Co has been the auditor of the company for a number of years. A few years ago the company listed on the Singapore Exchange. The CEO and founder of Premier Games is Simon Chan. The company's functional currency is the Singapore Dollar.

Premier Games develops games for a worldwide market to be played on consoles, computers, mobile phones and other hand-held devices. Games can take up to three years to develop and developers are either employed by the company or the company outsources development to third party development studios. The treatment of development costs varies – some costs are written off straightaway whereas others are capitalised and amortised over the useful life of the game to which it relates.

The success of games depends very much on the ratings they get, and the majority of sales are in the first few weeks after launch. If a new game does well in the first year of launch, a new version of it will subsequently be produced each year, usually in September to coincide with the Christmas market. During the financial year, three new games were successfully completed and launched with excellent sales in the first few weeks. No new games were launched in the previous financial period.

The majority of sales made by Premier Games relate to games played on consoles and computers. These games are produced as disks which are compatible with the type of console or computer being used. The console games that Premier Games produces are played on consoles produced by three large console manufacturers. Premier Games has to pay the console producers royalties on each of their games based on the number of units that they build of each game. Royalty fees are a significant outlay for the company. If Premier Games requests console producers to build units that they cannot sell, they must still pay them the royalty fee. Lead times for production are around a month, so decisions on production volumes must be made at least a month before launch. The console producers also provide Premier Games with a proportion of marketing costs if the company puts their logo on advertising campaigns.

The main customers of Premier Games are large supermarkets and toy stores as well as specialist gaming stores. Games for mobile phones and other hand held devices are purchased from online retailers with all online sales being made in US$.

Sometimes, games do not perform to expectations. In this case, the excess inventory is either sold off cheaply to big customers such as supermarkets or it is destroyed. A write down is calculated for inventory obsolescence, and this is based on the prior year sales figures. During the financial year, some games did not perform very well when their new versions were launched and had to be sold in stores at a big discount. Some excess inventory was scrapped altogether.

The company has a large marketing budget as the success of games depends on having high impact advertising campaigns that run leading up to, and after, the launch of games. Digital and TV advertising is costly.

As the company is driven by sales and meeting targets, key staff are given targets to meet. Staff are therefore hugely incentivised to meet their targets as the company will pay out bonuses when targets are met. Staff are generally under a lot of pressure and there is a culture of blame within the company.

Premier Games is subject to regulations relating to health and safety. In addition, games have to be age-rated appropriately and there are regulations and legislation that deal with this.

The audit manager has been told by the Finance Director of Premier Games, Wilfred Hui, that the company is likely to be involved in a management buy-out by the senior management in the next few months.

The audit manager has been sent the draft financial statements for the year, prepared by the finance director. An extract of the draft statement of profit or loss is shown on the following page.
Premier Games Draft Financial Statements for the Year Ended 31 December 20X5 (extract SGD)

Statement of Profit or Loss (extract)

<table>
<thead>
<tr>
<th></th>
<th>Draft 20X5</th>
<th>Audited 20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3,875</td>
<td>4,105</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(1,375)</td>
<td>(1,345)</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(899)</td>
<td>(779)</td>
</tr>
<tr>
<td>Administration costs</td>
<td>(698)</td>
<td>(589)</td>
</tr>
<tr>
<td>Other expenses (includes research, development and inventory impairment)</td>
<td>(169)</td>
<td>(142)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>734</td>
<td>1,250</td>
</tr>
</tbody>
</table>

Required

(a) With reference to the draft statement of profit or loss and prior year figures, use analytical procedures to identify three audit risks in the audit of Premier Games for the year ending 31 December 20X5.  

(b) Identify two other audit risks in the audit of Premier Games for the year ending 31 December 20X5.  

(c) Identify six business risks that may affect Premier Games.  

(d) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the treatment of development costs at Premier Games.  

(e) Describe two audit procedures to be performed on the development costs. For each procedure, explain the purpose of the procedure.  

(Total = 25 marks)
5. Premier Games: Answer

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<table>
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<tr>
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<th>Textbook chapter</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q5 Premier Games</td>
<td>Discuss and apply the use of analytical procedures in the planning of an assignment.</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Identify and explain material and significant audit risks (broken into risks of material misstatement and detection risks) for a given assignment.</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Identify and explain the importance of understanding the entity and its environment, including internal controls in risk assessment.</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Apply and evaluate audit procedures for all transactions in the extant syllabus for the FR module.</td>
<td>9</td>
<td>3</td>
</tr>
</tbody>
</table>

Tutorial notes

The question tests Candidates' knowledge of audit and business risks in addition to the audit of development costs.

When using analytical procedures in part (a) of the question, Candidates should ensure that a list of figures is not just presented – some valid commentary is required. Candidates should link the results of their analytical procedures to the discussion of audit risks which are pertinent to the audit of Premier Games.

Some Candidates struggle with the distinction between business risk and audit risk. Remember business risk affects the objectives of the company, whereas audit risk pertains to the financial statements.

Marking guide

(a) Award up to two marks per audit risk identified and explained up to a maximum of three risks. 6 marks

Revenue

Revenue has fallen by 5.6%.
Revenue was expected to increase following the launch of the new games.
Risk that revenue is understated (completeness assertion).
Targets linked to bonuses increase the risk of overstatement of revenue.

Cost of sales

Cost of sales has increased by 2.2%.
Cost of sales was expected to fall given the fall in revenue.
Also points to a possible misstatement in revenue

Distribution costs and administrative expenses

Distribution costs have increased by 15.4%.
Administrative expenses have increased by 18.5%.
These costs would have been expected to increase due to the three new games such large rises are unusual given the fall in cost of sales.
There is a risk that cost of sales has been allocated incorrectly to distribution and administrative costs and these are overstated.

**Other expenses**

Other expenses have increased by 19%.

Not entirely unreasonable as it includes ‘one-off’ expenses.

Inventory write-down is judgmental and may not be accurate.

Development costs may have been expensed when they should have been capitalised.

Costs may have been allocated incorrectly between cost of sales, administrative costs, distribution costs and other expenses.

(b) Award up to 1.5 marks per audit risk identified and explained up to a maximum of two risks.  

**Development costs**

Development costs can only be capitalised if they meet the criteria in SFRS(I) 1-38 *Intangible Assets*.

There is a risk that development costs have been incorrectly capitalised when they should have been expensed or vice versa, resulting in profit and assets being over or understated.

**Foreign currency**

Foreign currency revenues result from games being sold online in USD and this must be accounted for in line with SFRS(I) 1-21 *The Effects of Changes in Foreign Exchange Rates*.

There is a risk that the standard has not been followed correctly or that incorrect rates have been used, resulting in revenue and profits being over or understated.

**Management bias**

Management may be tempted to show low results in order to negotiate a lower price for the company.

This will impact the entire financial statements and professional scepticism will need to be applied to the audit.

**Inventory write down**

Slow moving inventories need to be written down in line with SFRS(I) 1-2 *Inventories* which requires inventory to be measured at the lower of cost and net realisable value.

Any inventory write down involves judgment and may be manipulated by management, so inventory and profits could be over or understated.

(c) Award up to 1.5 marks per business risk identified and explained up to a maximum of six risks. Choose any six from the following.

- Singapore Exchange rules and regulations are breached
- Foreign exchange rate risk
- Piracy
- Third party developers default on agreements, share confidential information or do not perform work up to standard
- Poor games ratings
- Lack of copyright
- Royalties must be paid to console manufacturers regardless of how many games are sold

3 marks

9 marks
- Reliance on three console providers
- Technological advances
- Bugs
- Blame culture at Premier Games
- Health and safety regulations or age rating legislation is breached

### (d) SFRS(I) 1-38 Intangible Assets

**Para 54** – No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

**Para 57** – An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

**Note.** Para number is not required, the principle is required.

If these criteria have not been met Premier Games must expense the development costs.

There is a risk that development costs have been incorrectly capitalised resulting in an overstatement of profits and assets.

### (e) Award up to two marks per audit procedure explained, up to a maximum of two procedures. Choose any two from the following.

Perform analytical procedures on development costs, comparing the level of costs capitalised or expensed in the previous year to the current year.

**Purpose:**

To assess the reasonableness of the amounts in the financial statements and spot any anomalies.

Obtain a detailed breakdown of development costs incurred during the year and calculate development costs incurred on each new and existing game.

**Purpose:**

To assess the reasonableness of development costs per game and identify any games where the development cost seems unusually high or low. This may indicate over or under capitalisation of development costs.

Inspect the ledger accounts for evidence of development expenditure.

**Purpose:**

To ensure that all development projects are clearly defined and that all expenditure is correctly classified.
For a sample of games, inspect supporting documents (for example, invoices and timesheets from developers).

**Purpose:**
To ensure costs recorded are complete and accurate.
Discuss with developers how technical feasibility is assessed and make a judgment on whether this appears to be reasonable.

**Purpose:**
To ensure that development costs capitalised meet the criteria of SFRS(I) 1-38.
Review budgeted revenues and costs by examining results to date, production forecasts, advance orders and discuss findings with management of Premier Games.

**Purpose:**
To consider the completeness and existence of capitalised development costs, where actual costs to date are much higher or lower than budgeted.

For new games being developed during the year, inspect research data relating to those games and discuss feasibility with relevant management. Specialists within the industry may need to be utilised.

**Purpose:**
To assess the likelihood of the games being launched successfully.
Review future cash flow forecasts.

**Purpose:**
To ensure adequate resources available to complete development of new and existing games.
Review costs that have previously been capitalised.

**Purpose:**
To ensure that the criteria laid out in SFRS(I) 1-38 are still relevant.
Where costs are capitalised, review accounting records to ensure that amortisation commences with production of games and is charged on a systematic basis.

**Purpose:**
To ensure the accuracy of amortisation.
Assess whether the period of amortisation appears reasonable by reference to the accounting policies in place at competitors.

**Purpose:**
To ensure the accuracy of amortisation.

For any games whose development was abandoned during the year, review the accounting records and draft financial statements to confirm that costs relating to the development of these games has been written off to the statement of profit or loss.

**Purpose:**
To ensure that development costs have not been overstated and the completeness of research costs in the financial statements.
Inspect draft financial statements to assess the reasonableness of disclosures made in respect of development costs and of any sensitivity analysis performed to establish the impact on reported profit if projections are found to be wrong. The audit manager should review the accounting policy disclosure to ensure it is adequate.

**Purpose:**
To ensure the presentation of financial statements is in line with reporting standards.
For capitalised employee costs review contracts and timesheets.
Answer points

(a) Revenue

Revenue for the year has gone down from $4,105k in the previous year to $3,875k in the year ended 31 December 20X5. This is a fall of 5.6% which is significant. We would have expected the revenue to have increased given the successful launch of three new games during the year. As sales from new games fall away after the first few weeks, the highest revenue from these games would already have been reflected in the financial statements being audited. The assertion of completeness is therefore a risk. This is an area that the audit manager needs to discuss further with management. There may be a valid reason to explain the fall but, given what the audit manager has been told, it doesn't seem that likely.

Staff at Premier Games are given targets to meet which are linked to bonuses so there is a real incentive to meet them and achieve the required results. There is a big risk that management may have overstated revenue for the year in order to get their bonuses but the fact that revenue has fallen for the year doesn't support this.

Cost of sales

Cost of sales has increased from $1,345k to $1,375k – an increase of 2.2%, which is unusual as it does not follow the percentage fall in revenue. We would have expected cost of sales to fall in line with revenue. If revenue has been understated, then cost of sales may be correct. An analysis of the costs included needs to be obtained and a discussion with management to try to explain the reasons for the increase.

Distribution costs and administrative expenses

Distribution costs and administrative expenses have, on the other hand, both increased compared to the prior year, by 15.4% and 18.5% respectively. We would expect these costs to increase to coincide with the new games being launched as there will be big outlays for marketing and advertising so these may be reasonable. It may be that some costs have been wrongly allocated within the categories of cost of sales, distribution costs, administrative and other expenses.

Other expenses

Other expenses have increased by 19%. The percentage is greater than the fall in revenue or increase in cost of sales. However, this is not entirely unreasonable given that one-off expenses such as the inventory write-down are included within this category.

The inventory write-down is a judgmental amount calculated by management using previous sales. There is a risk related to the accuracy of this figure in that, if management have over- or underestimated this amount it will result in under or over-stated profits. The increase in other expenses may be a result of management's overestimation of this amount. Management may be incentivised to show lower profits in order to reduce the price of the company for the planned management buy-out.

Other expenses will include research and development costs for games which Premier Games hope to release in future years. There is a risk that the increase in other expenses is due to development costs being expensed when they should have been capitalised and subsequently amortised. The increase in other expenses is unlikely to be a result of research and development costs relating to
the three new games released in the year as games take years to develop, meaning it is unlikely all research costs are in the year of release.

Alternatively, there is a risk that some costs have been incorrectly allocated between cost of sales, distribution costs, administrative and other expenses.

(b) Development costs

The issue of whether development costs incurred are written off or capitalised is also an issue as it will have an impact on the profit figure for the year. As development costs are likely to be material, it is important that a breakdown of costs is obtained to assess whether costs have been treated correctly.

Foreign currency

The company sells games online in US$ so there is a risk of incorrect translation of foreign currency which may result in misstatement in the financial statements which are in Singapore Dollars. Year-end exchange rates must be verified to reliable external sources and transactions checked to ensure they have been accounted for correctly in line with SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates.

Management bias

The senior management of the company are attempting a management buy-out imminently and there may be a real incentive here for them to show results are as low as possible in order to negotiate and pay a lower price for the company. This may go some way to explaining the results in the draft statement of profit or loss and this is another area where the audit manager needs to be wary and ensure he approaches the audit with a high level of professional scepticism and use his professional judgment.

Inventory write down

Premier Games writes down inventory each year based on the previous year’s sales figures. SFRS(I) 1-2 Inventories requires inventory to be written down to the lower of cost and net realisable value. This involves an element of judgment and there is a risk that inventory has not been written down correctly in line with the standard, either in error or as a result of management bias. The senior management are attempting a management buy-out and have an incentive to value the inventory as low as possible in order to pay a lower price for the company. There is a risk that inventory has been understated in the financial statements.

(c) Breach of rules and regulations

Premier Games is listed on the Singapore Exchange. As a listed company, it will have to adhere to various rules and regulations imposed by the exchange, which opens it up to the risk of fines and penalties if these rules are breached.

Another business risk the company faces is compliance with health and safety regulations and legislation relating to age ratings. The company is exposed to the risk of litigation and potentially fines for breaching health and safety and other legislation.

Foreign exchange

The company operates in a worldwide market and sells games online in US$. This exposes it to foreign exchange risk ie exposure to unanticipated changes in the exchange rate between two currencies.

Piracy

The company operates in an industry where piracy of games is inherent. Piracy is a problem in certain countries but the fact that games can be easily copied means that revenue and profit are lost as a result of this.
Use of third parties

Premier Games often uses third party developers to build games. There is a risk that these third party developers default on agreements made with the company to complete projects as agreed or they do not complete the work to the relevant standard expected. There is also a risk that confidential information is shared with external entities such as competitors.

Poor games ratings

The success of games depends very much on ratings. A poor rating will lead to a loss in sales and the possibility of excess inventory which will have to be destroyed – a further cost to the company. These costs impact profit and share price and possible future investment in the company by potential investors. Related to this is the negative image that the gaming industry has for more adult-oriented games with violent content. A real-life shooting incident can lead to negative publicity for companies such as Premier Games, with a knock-on effect on sales of particular games.

Copyright

The gaming industry is highly competitive. It may not be possible to use copyright rules to protect ideas and innovations which leaves the company exposed to the copying of games and ideas.

Royalties

The company has to pay a significant cost in the form of royalties to console manufacturers. If sales are vastly different to the number of units produced, the royalty still has to be paid, leading to a loss in profit and an impact on the share price of the company.

Overreliance on three console producers

Premier Games is heavily reliant on the three console producers it uses. If there are problems with consoles or customers stop buying a particular console, this can have a negative impact on sales of games produced by the company.

Technological advances

Premier Games is open to the risk of technological advances. For example, IT advances may mean that its games cannot be played on some new and innovative devices (eg tablets) which results in a loss of market share and costs having to be invested in designing games that can be played on all types of device.

Bugs

Games created to be played on electronic devices such as computers and mobile phones are open to the risk of bugs which can lead to further costs to rectify them or negative publicity where bugs are discovered after launch.

Culture

Managers within Premier Games are driven by sales and targets, which has led to a culture of blame within the organisation. This can result in demotivated staff and loss of key personnel to competitors.

Premier Games must account for development costs in accordance with SFRS(I) 1-38 Intangible Assets. The standard defines an intangible asset as an identifiable non-monetary asset without physical substance. It may be held for use in the production and supply of goods or services, or for rental to others, or for administrative purposes. The asset must be controlled by the entity as a result of events in the past, and something from which the entity expects future economic benefits to flow.

SFRS(I) 1-38 defines research as ‘original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding’. Research costs must be written off to the statement of profit or loss in the year they are incurred. SFRS(I) 1-38 defines
development as ‘the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use’.

Where Premier Games incurs development costs, they can only be capitalised in special circumstances, when all of the following criteria are met:

- Completion of the asset will be technically feasible.
- The business intends to complete the asset and use or sell it.
- The business will be able to use or sell the asset.
- The business can demonstrate how future economic benefits will be generated, either by demonstrating a market exists or the internal usefulness of the asset.
- Adequate technical, financial and other resources will be available to complete the development and use or sell the intangible asset.
- Expenditure attributable to the development of the asset can be measured reliably. General overhead expenditure, costs of inefficiencies and operating losses, and expenditure on training staff to operate the asset should not be capitalised.

If these criteria are not met, the development costs should be expensed in the statement of profit or loss in the year they are incurred.

The key audit issue in the audit of Premier Games is whether the development costs incurred in developing new games meet the criteria laid out in SFRS(I) 1-38. Incorrect treatment of these costs is likely to have a material effect on the financial statements of the company. If development costs are incorrectly capitalised, the profit figure for the company may be materially overstated which has a knock-on effect on the share price of the company. The audit manager has been told that development costs are sometimes written off and sometimes capitalised.

The auditors will need to perform substantive audit procedures in order to conclude whether development costs have been correctly treated. These substantive procedures will be designed to assess whether the SFRS(I) 1-38 criteria have been met for capitalised development costs.

### (e) Analytical procedures

Perform analytical procedures on development costs, comparing the level of costs capitalised or expensed in the previous year to the current year to assess the reasonableness of the amounts in the financial statements.

Review budgeted revenues and costs by examining results to date, production forecasts, advance orders and discuss findings with management of Premier Games. This is to consider the completeness and existence of capitalised development costs, where actual costs to date are much higher or lower than budgeted.

### Reasonableness testing

Obtain a detailed breakdown of development costs incurred during the year and calculate development costs incurred on each new and existing game. This is to assess the reasonableness of development costs per game and identify any games where the development cost seems unusually high or low. This may indicate over or under capitalisation of development costs.

### Classification, presentation and disclosures

Inspect the ledger accounts to ensure that all development projects are clearly defined and that all expenditure is correctly classified.

Inspect draft financial statements to assess the reasonableness of disclosures made in respect of development costs and of any sensitivity analysis performed to establish the impact on reported profit if projections are found to be wrong. The audit manager should review the accounting policy
disclosure to ensure it is adequate. This ensures the presentation of financial statements is in line with reporting standards.

Agreeing to supporting evidence

For a sample of games, inspect supporting documents (invoices and timesheets from developers etc) to ensure costs recorded are complete and accurate.

For capitalised employee costs review contracts and time sheets to ensure that only time charged to development is capitalised.

SFRS(I) 1-38 capitalisation criteria

Discuss with developers how technical feasibility is assessed and make a judgment on whether this appears to be reasonable to ensure that development costs capitalised meet the criteria of SFRS(I) 1-38.

Where costs have previously been capitalised, review to ensure that the criteria laid out in SFRS(I) 1-38 are still relevant.

For new games being developed during the year, inspect research data relating to those games to assess the likelihood of the games being launched successfully and discuss feasibility with relevant management. Specialists within the industry may need to be utilised.

Review future cash flow forecasts to ensure adequate resources available to complete development of new and existing games.

Amortisation

Where costs are capitalised, review accounting records to ensure that amortisation commences with production of games and is charged on a systematic basis to ensure the accuracy of amortisation.

Assess whether the period of amortisation appears reasonable by reference to the accounting policies in place at competitors to ensure the accuracy of amortisation.

Abandoned games

For any games whose development was abandoned during the year, review the accounting records and draft financial statements to confirm that costs relating to the development of these games has been written off to the statement of profit or loss. This is to ensure that development costs have not been overstated and the completeness of research costs in the financial statements.

Disallowed costs

Examine development costs capitalised for launched games to ensure disallowed costs, such as marketing costs, have not been capitalised.
6. Hair Today

You are the audit assistant working on the audit of Hair Today Pte Ltd (Hair Today) a chain of hairdressing salons, for the year ended 31 December 20X5. Vanessa Woo is the Managing Director and creative artistic director of Hair Today.

During the audit, you find out that in September 20X5, there was an incident at one of the salons where a junior colourist accidentally mixed the wrong colour for a customer, resulting in the customer having blonde hair instead of dark brown. The customer was understandably very upset and a senior member of the team tried to reverse the mistake with the result that clumps of the customer's hair started to fall out. The customer started legal proceedings against Hair Today in October 20X5. The managing director says she had no choice but to terminate the junior colourist's employment, who then also started legal proceedings against Hair Today for unfair dismissal at around the same time. No adjustments have been made to the draft financial statements for these claims.

During the financial year, the company decided to expand by opening a further three salons. In order to finance the expansion, it had to borrow $500,000. $300,000 of this was borrowed from the company's bank. The remaining $200,000 was borrowed from Woo Investments Pte Ltd, a company owned by Henry Woo, the managing director's brother. When questioned about the borrowing from Woo Investments, the managing director said that as the loan was informal with no agreement to repay or any interest, it hadn’t really been reflected in the financial statements of Hair Today.

Required

(a) Describe four audit procedures to be performed in relation to the legal proceedings against the company. For each procedure, explain the purpose of the procedure. (8 marks)

(b) Describe three audit procedures to be performed in relation to the bank loan and explain the purpose of each. (6 marks)

(c) Describe four audit procedures to be performed in relation to the loan from Woo Investments Pte Ltd. For each procedure, explain the purpose of the procedure. (8 marks)

(d) Assess the impact of the discovery of the borrowing from Woo Investments on the rest of the audit of Hair Today. (3 mark)

(Total = 25 marks)
6. Hair Today: Answer

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<td>Q6 Hair Today</td>
<td>Apply and evaluate audit procedures for all transactions in the extant syllabus for the FR module.</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Identify and describe audit procedures to obtain sufficient audit evidence from identified sources eg inquiries, inspection, observation and re-performance.</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Explain the specific audit risks and procedures concerning related parties and related party transactions including significant transactions outside normal business.</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Recognise circumstances that may indicate the existence of unidentified related parties and select appropriate audit procedures.</td>
<td>8</td>
<td>3</td>
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</table>

Tutorial notes

This question tests Candidates' knowledge and application skills in the audit of provisions, bank loans and related parties. Candidates must ensure they do not simply state an audit procedure in this type of question. Always remember to explain why an audit procedure is performed.

Marking guide

(a) Award up to two marks per audit procedure explained up to a maximum of four procedures.

Inspect any correspondence from lawyers regarding each of the claims.

*Purpose:*

To confirm the amount of each claim and whether there is any possibility of either of the claims being successful.

Request a letter of inquiry prepared by Vanessa Woo to the managing director be sent to the company's legal advisers to request them to communicate directly with the auditor about each case. When permission has been granted, discuss the cases with the lawyers acting for Hair Today.

*Purpose:*

To assess the probability of each claim being successful and whether a reliable estimate can be made of the amount of the claim.

Review the company's legal fee expense accounts.

*Purpose:*

To determine whether any payments in relation to either case have been made after the year-end. This checks the completeness and accuracy of the provisions balance in the financial statements.

8 marks
Obtain a general representation from the managing director that all provisions and contingencies have been disclosed to the auditors. Specific representations in relation to the claims will also be sought.

**Purpose:**
To fulfil the requirement in SSA 501 Para 12.

Enquire with the managing director and legal advisers regarding any other possible claims against the company by disgruntled customers or employees.

**Purpose:**
To assess the completeness of provisions.

Review any internal documents concerning the cases.

**Purpose:**
To assess whether a provision should be recognised as per the criteria in SFRS(I) 1-37.

Review any disclosures in the financial statements.

**Purpose:**
To ensure these fulfil the requirements of SFRS(I) 1-37

<table>
<thead>
<tr>
<th>(b)</th>
<th>Award up to two marks per audit procedure explained up to a maximum of three procedures.</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Obtain the loan agreement to verify the amount borrowed from the bank, the term of the loan and the rate of interest on the loan.</td>
</tr>
<tr>
<td></td>
<td>Review the draft financial statements to ensure the amount payable within one year and more than one year are correctly stated as well as the disclosure of the loan in the notes to the financial statements.</td>
</tr>
<tr>
<td></td>
<td>Prepare a bank confirmation letter for the bank to confirm the amounts outstanding as at the year-end and to determine whether there are any other loans outstanding.</td>
</tr>
<tr>
<td></td>
<td>Review minutes of Board meetings to obtain evidence of Board discussion and approval of the bank borrowing.</td>
</tr>
<tr>
<td></td>
<td>Review correspondence with the bank to obtain evidence regarding the bank borrowing.</td>
</tr>
<tr>
<td></td>
<td>Review any bank covenants and any financial ratios detailed in the covenants for Hair Today, to ensure they have not been breached.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(c)</th>
<th>Award up to two marks per audit procedure explained up to a maximum of four procedures.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Discuss the informal loan from Woo Investments with the managing director to ascertain when the loan was made, amount and arrangements for repayment.</td>
</tr>
<tr>
<td></td>
<td>To understand the business rationale of the transaction and to obtain the amount and terms of the loan.</td>
</tr>
<tr>
<td></td>
<td>Enquire of management whether any other such loans were made to Hair Today.</td>
</tr>
<tr>
<td></td>
<td>To identify any other related party transactions of which the auditors are unaware (completeness of related party disclosures).</td>
</tr>
</tbody>
</table>
Review the disclosures in the draft financial statements.

*Purpose:*

To assess whether adequate disclosure has been made in line with SFRS(I) 1-24 Related Party Disclosures.

Obtain written representations from the managing director regarding the identity of the entity's related parties and all the related party relationships and transactions of which she is aware, and that she has appropriately accounted for and disclosed such relationships and transactions in accordance with the financial reporting framework.

*Purpose:*

To fulfil the requirement of SSA 550 Related Parties Para 26.

Inspect internal minutes of Board meetings.

*Purpose:*

To obtain evidence of the amount of the loan made by Woo Investments and when it was made, including any repayment arrangements, interest payments etc. In addition, to look for evidence of any other related parties of which the auditor may be unaware.

Inspect Hair Today's bank statements and accounting records.

*Purpose:*

To ascertain when the loan was made and to provide evidence of the amount loaned and whether it has been reflected in the ledger.

Establish through inquiries with management and physical inspection whether the proposed expansion of the company has taken place or is in the process of occurring.

*Purpose:*

To ensure the business rationale for the transaction is in line with management's explanations and if not, consider if there is a risk of this being a fraudulent transaction, for example money laundering. If fraud is suspected, consider the implications on the rest of the audit.

Write to Henry Woo of Woo Investments to obtain confirmation of the amount loaned to Hair Today and when the amount is repayable and on what terms, together with any other loans that may have been made to the company. The confirmation could be an 'open' confirmation request and should ask Henry Woo to state the balance etc rather than ask him to confirm particular amounts.

*Purpose:*

This confirms the amount and terms of the loan agrees to the information provided by management.

(d) A loan has been purposely excluded from the financial statements and this may not be an isolated occurrence.

The seniority of the staff involved in excluding the loan increases its significance.

Auditors cannot place as much reliance on evidence and representations from Vanessa Woo, the managing director.

Auditors will need to revisit the risk assessment.

Auditors will need to assess the impact on the nature, timing and extent of procedures.
Answer points

(a) There are two ongoing litigation claims taking place. One claim is from a former customer against the company and the other is from a former employee for unfair dismissal. In both cases, the auditor must inspect any correspondence from lawyers regarding each of the claims as this will give an insight into how far the claims have gone and whether there is any possibility of either of the claims being successful. It will also confirm the amount of each claim.

The auditor should request that a letter of inquiry is prepared by the managing director to be sent to the company's legal advisers to request them to communicate directly with the auditor about each case. When permission has been granted, the auditor should discuss the cases with the lawyers acting for Hair Today to assess the probability of each claim being successful and whether a reliable estimate can be made of the amount of the claim.

A review of the company's legal fee expense account can provide evidence as to whether any payments in relation to each case have been made after the year-end. This checks the completeness and accuracy of the provisions balance in the financial statements.

The auditor should obtain a general representation from the managing director that all provisions and contingencies have been disclosed to the auditors. Specific representations in relation to the claims will also be sought. This is to fulfil the requirement in SSA 501 Audit Evidence – Specific Considerations for Selected Items Para 12 which states that the auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

The auditor should have a discussion with the managing director and legal advisers regarding any other possible claims against the company by disgruntled customers or employees to assess the completeness of provisions.

The auditor should review any internal documents (for example minutes from meetings) concerning the cases to assess whether a provision should be recognised as per the criteria in SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets (Hair Today has a present obligation as a result of a past event, the probability of a payment being made and whether a reliable estimate can be made of that payment).

Review any disclosures in the financial statements to ensure these fulfil the requirements of SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets.

(b) Loan agreement

Obtain the loan agreement to verify the amount borrowed from the bank, the term of the loan and the rate of interest on the loan.

Review any bank covenants and calculate any financial ratios detailed in the covenants for Hair Today, to ensure they have not been breached.

Disclosure and presentation

Review the draft financial statements to ensure the amount payable within one year and more than one year are correctly stated as well as the disclosure of the loan in the notes to the financial statements.

Bank confirmation/correspondence

Prepare a bank confirmation letter for the bank to confirm the amounts outstanding as at the year-end and to determine whether there are any other loans outstanding.

Review correspondence with the bank to obtain evidence regarding the bank borrowing.

Board meetings

Review minutes of Board meetings to obtain evidence of Board discussion and approval of the bank borrowing.
(c) Discuss the informal loan from Woo Investments with the managing director to ascertain when the loan was made, amount and arrangements for repayment. This is to understand the business rationale of the transaction and to obtain the amount and terms of the loan.

Enquire of management whether any other such loans were made to Hair Today to identify any other related party transactions of which the auditors are unaware. This procedure checks for completeness of related party disclosures.

Review the draft financial statements to assess whether adequate disclosure has been made in line with SFRS(I) 1-24 Related Party Disclosures.

Obtain written representations from the managing director regarding the identity of the entity's related parties and all the related party relationships and transactions of which she is aware, and that she has appropriately accounted for and disclosed such relationships and transactions in accordance with the financial reporting framework to fulfil the requirement of SSA 550 Related Parties Para 26.

Inspect internal minutes of Board meetings to obtain evidence of the amount of the loan made by Woo Investments and when it was made, including any repayment arrangements, interest payments etc. In addition, this procedure enables the auditor to look for evidence of any other related parties of which the auditor may be unaware.

Inspect the company's bank statements and accounting records to ascertain when the loan was made, to provide evidence of the amount loaned and whether it has been reflected in the ledger.

Establish through inquiries with management and physical inspection whether the proposed expansion of the company has taken place or is in the process of occurring. This is to ensure the business rationale for the transaction is in line with management's explanations and if not, consider if there is a risk of this being a fraudulent transaction, for example money laundering. If fraud is suspected, consider the implications on the rest of the audit.

Write to Henry Woo of Woo Investments to obtain confirmation of the amount loaned to Hair Today and when the amount is repayable and on what terms, together with any other loans that may have been made to the company. The confirmation could be an 'open' confirmation request and should ask Henry Woo to state the balance etc rather than ask him to confirm particular amounts. This confirms the amount and terms of the loan agrees to the information provided by management.

(d) The loan from Woo Investments is a related party transaction which has purposely been excluded from the financial statements of Hair Today by the managing director. This is concerning as it could indicate there is other information which the managing director has purposely excluded. The fact that it is a senior member of staff at Hair Today who chose to exclude the loan from the financial statements increases the significance of this action.

The auditors may not be able to place as much reliance on management representations during the audit of Hair Today, particularly those from the managing director Vanessa Woo. The reliability of any other evidence previously provided by Vanessa Woo may also be called into question.

The auditors will need to reevaluate the risk assessment for Hair Today and assess the impact on the nature, extent and timing of audit procedures. For example, alternative evidence may need to be collected where previously evidence was obtained directly from Vanessa Woo.
7. Merlion

Your accounting entity is the newly appointed auditor of Merlion Developments Limited (Merlion), a property development company. Merlion buys land from the government and private sellers on which to construct commercial and residential property for sale.

During the year ended 30 September 20X5 the following events occurred:

(a) Merlion began developing a site in Sungei Buloh in May 20X5 on which it intends to build a condominium development. Planning permission, which was received in October 20X4, required that ten rare plants within the area be preserved and that the surrounding area be restored to its original state following construction. Merlion provided $2.8 million for the estimated cost of site restoration, including $400,000 for the relocation of the plants. In September 20X5 the plants were accidentally destroyed as part of the site clearance works, and Merlion paid a fine of $150,000 to Sembawang Town Council in November 20X5.

(b) Merlion owns two properties in Sengkang which it was unable to sell at a good price in 20X3 and which it subsequently rented out. One property is an office block, with offices being leased out annually, which is currently fully let. The other is a retail building. Leases are available for let in the retail building on a monthly or annual basis, and many of the shops are currently vacant. The buildings are held as property, plant and equipment on the statement of financial position. On 30 September 20X5 the office block was valued at an open market value that was $1.6 million in excess of its carrying amount. The revaluation excess was credited to a revaluation reserve.

Your accounting entity is also carrying out the audit of Singapore Quarries Ltd (SQ).

Earlier in the year, SQ bought a quarry in Tanzania for 357m shillings. SG has a bank account in Tanzania. It pays local employees and suppliers in shillings but invoices customers in Singapore dollars. It makes transfers to its Tanzania bank account when required for payment. Tanzania has a history of high inflation.

Required

(a) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the appropriateness of the provision for restoring the site in Sungei Buloh. (4 marks)

(b) Recommend the journal entry adjustment(s) to be made to the provision for restoring the site in Sungei Buloh. (2 marks)

(c) In relation to the provision for restoring the site in Sungei Buloh, describe the audit evidence you would expect to see when reviewing the files of Merlion. (5 marks)

(d) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the appropriateness of the valuation of the properties in Sengkang. (5 marks)

(e) In relation to the valuation of the properties in Sengkang, describe the audit evidence you would expect to see when reviewing the files of Merlion. (5 marks)

(f) Describe two audit procedures to be performed on the quarry in Tanzania to confirm valuation. (2 marks)

(g) Describe two audit procedures to be performed on the quarry in Tanzania to confirm existence. (2 marks)

(Total = 25 marks)
7. Merlion: Answer

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<tr>
<td>Q7 Merlion</td>
<td>Identify and describe audit procedures to obtain sufficient audit evidence from identified sources eg inquiries, inspection, observation and re-performance. Identify and evaluate the audit evidence expected to be available to support the assertions about classes of transactions, account balances, and presentation and disclosure. Apply and evaluate audit procedures for all transactions in the extant syllabus for the Financial Reporting module.</td>
<td>8, 8, 9 and 10</td>
<td>3, 3, 3</td>
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Tutorial notes

This question tests Candidates’ knowledge of auditing provisions, investment property and non-current assets. Candidates will need a solid understanding of the relevant financial reporting standards to score well in this question. Consider whether management have applied the financial reporting standards correctly or whether they have applied the correct standard at all.

When asked to suggest audit procedures for a scenario, make sure these are tailored for the situation described.

Marking guide

(a) SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets.

Para 14 – A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

Note. para number is not required, the principle is required.

Merlion did not have a present obligation to replant the plants at year-end but did have an obligation to pay the Council fine.

The auditor needs to consider if the matter may be fully settled by payment of fines or if there may be further obligations.

The provision for relocation of rare plants is overstated by $250,000 ($400,000 – $150,000) and may be overstated.

The provision for restoring the surrounding area may be overstated by the amount by which $2.4m ($2.8m – $400,000) exceeds the potential fine payable.

4 marks
### (b)
Award up to one mark per journal entry up to a maximum of two journals.

<table>
<thead>
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<th>Debit</th>
<th>Credit</th>
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<tr>
<td>DR Provision (SOFP)</td>
<td>250,000</td>
</tr>
<tr>
<td>CR Statement of profit or loss</td>
<td>250,000</td>
</tr>
</tbody>
</table>

To correct overstatement of provision

If any further obligations arise before the financial statements are signed:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR Statement of profit or loss</td>
<td></td>
</tr>
<tr>
<td>CR Provision (SOFP)</td>
<td></td>
</tr>
</tbody>
</table>

To provide for obligations relating to restoration of the Sungei Boleh site

If Merion can avoid the costs of restoring the surrounding area:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR Provision (SOFP)</td>
<td></td>
</tr>
<tr>
<td>CR Statement of profit or loss</td>
<td></td>
</tr>
</tbody>
</table>

To correct overstatement of provision for cost of restoring the surrounding area

The amounts of the last two journal entries would be confirmed through audit work.

**2 marks**

### (c)
Award up to one mark per piece of audit evidence up to a maximum of five pieces.

- Correspondence with Sembawang Town Council, setting out the planning conditions and the penalties for non-compliance.
- A payment of $150,000 shown in the cash book and bank statement in November 20X5.
- A letter from Sembawang stating that the $150K settlement is full and final.
- A breakdown of the calculation of the remaining $2.4 million provision, which should be the present value of the expected future cost. The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money.
- Physical inspection of the development site.
- Quotations or contracts relating to the restoration work.
- Written representations from management that no further liabilities in respect of this will accrue.

**5 marks**

### (d)
*SFRS(I) 1-40 Investment Property*

*Para 7 – Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.*

**Note.** para number is not required, the principle is required.

The property in Sengkang is held for the purpose of generating rental income and is not owner occupied. Therefore, it should be accounted for using SFRS(I) 1-40, not SFRS(I) 1-16.

SFRS(I) 1-40 requires properties to be initially recognised at cost. Subsequent measurement can be using the cost or fair value model.

*SFRS(I) 1-40 Para 33 – After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value…*

The office block has been revalued so therefore the retail building must also be revalued.

Revaluation surpluses and deficits on investment properties are taken directly to the statement of profit or loss, and affect profit for the year.

Since some of the retail units are empty, it may be that the value of the retail building has fallen below its carrying value, which would decrease reported profit for the year.

**5 marks**
Profits could be overstated and there may be an element of management bias. If the cost model is used, the office block revaluation gain will be credited to other comprehensive income under the heading revaluation surplus and no adjustment is required.

Comparatives for 20X4 will need to be restated and disclosure made as per SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors for the prior period error.

<table>
<thead>
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<th>(e)</th>
<th>Award up to one mark per piece of audit evidence up to a maximum of five pieces.</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Physical inspection of the two properties, in order to note their condition and location.</td>
</tr>
<tr>
<td></td>
<td>Rental contracts for the occupied units, to confirm that they are rented out to third parties and not owner-occupied.</td>
</tr>
<tr>
<td></td>
<td>A copy of the valuer's report, with details of bases used and assumptions made.</td>
</tr>
<tr>
<td></td>
<td>Details of the valuer's qualifications, experience and independence.</td>
</tr>
<tr>
<td></td>
<td>Notes of discussions with management regarding the reason for the revaluation of only the office block.</td>
</tr>
<tr>
<td></td>
<td>A copy of the impairment review, if any, of the retail building.</td>
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</table>

<table>
<thead>
<tr>
<th>(f)</th>
<th>Award up to one mark per audit procedure up to a maximum of two procedures.</th>
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<tbody>
<tr>
<td></td>
<td>Verify the value of the quarry to the purchase contract.</td>
</tr>
<tr>
<td></td>
<td>Confirm that the value of the quarry is translated to Singapore dollars at the exchange rate at the date of purchase, as it is a non-monetary asset.</td>
</tr>
<tr>
<td></td>
<td>Inquire of the directors what useful life the quarry is being depreciated over, if it is being depreciated.</td>
</tr>
<tr>
<td></td>
<td>Corroborate whether that useful life appears reasonable by considering past practice, any business plans relating to the quarry, the size of the quarry.</td>
</tr>
<tr>
<td></td>
<td>Recalculate the depreciation charge.</td>
</tr>
<tr>
<td></td>
<td>Confirm the exchange rate between dollars and shillings at the year-end date and ensure that the value the bank account has been translated accurately at the year-end date as it is a monetary asset.</td>
</tr>
<tr>
<td></td>
<td>Review inflation rates in Tanzania (by referring to published indices) to ensure that there is no instance of hyperinflation, which might affect accounting treatment.</td>
</tr>
<tr>
<td></td>
<td>Observe a copy of the impairment review, if one exists, for the quarry, and consider the reasonableness of assumptions used.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(g)</th>
<th>Obtain evidence that the quarry exists. Whether it is cost efficient to send a member of staff to Tanzania will have to be determined. It is possible that the existence of the quarry could be established by reviewing documents and even possibly, Google Earth.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Examine a title deed for the quarry to confirm it is registered as existing land.</td>
</tr>
</tbody>
</table>

Answer points

(a) The estimated restoration cost of the Sungei Buloh site should be included within the cost of developing the site to the extent that it meets the requirements to be recognised as a provision under SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets. A provision should not be recognised unless it meets the requirements of SFRS(I) 1-37 para 14.

- There must be a present obligation as a result of a past event.
- Its settlement must be likely to result in an outflow of economic benefits.
- It must be capable of reliable measurement.
The provision for restoration costs of the Sungei Buloh site can be broken into two parts. These are a provision for the cost of relocating the rare plants and a provision for restoring the rest of the surrounding area to its original state.

In this case, Merlion did not have an obligation at the year-end to relocate the rare plants (indeed, that may not be possible) but only had the obligation to pay the fine to Sembawang Town Council. Note that the replanting cost was likely to be tax deductible but a fine is not.

The auditor should consider whether the matter is fully settled by payment of the fines or whether there may be further obligations in addition to the fine. In either case the provision is overstated.

The provision for relocating the rare plants is overstated by $250,000 ($400,000 – $150,000). If further obligations relating to the relocation of the rare plants arise after the end of the reporting period but before the financial statements are signed, the provision will need to be adjusted by the amount of the obligation.

Given that Merlion managed to avoid the requirement to replant the plants by paying the fine, it may be that Merlion can also avoid the costs of restoring the surrounding area by paying a smaller fine, in which case there is no obligation in this instance either. If this is the case, the provision for restoring the surrounding area may be overstated by the amount by which $2.4m ($2.8m – $400,000) exceeds the potential fine payable.

(b) The journal entries would be as follows.

DR Provision (SOFP)            250,000
CR Statement of profit or loss 250,000

To correct overstatement of provision for relocating rare plants

If any further obligations arise before the financial statements are signed:

DR Statement of profit or loss
CR Provision (SOFP)

To provide for obligations relating to restoration of the Sungei Boleh site

If Merion can avoid the costs of restoring the surrounding area:

DR Provision (SOFP)
CR Statement of profit or loss

To correct overstatement of provision for cost of restoring the surrounding area

The amounts of the last two journal entries would be confirmed through audit work.

(c) I would expect the following evidence to be available:

- Correspondence with Sembawang Town Council, setting out the planning conditions and the penalties for non-compliance.
- A payment of $150,000 shown in the cash book and bank statement in November 20X5.
- A letter from Sembawang Town Council stating that the $150K settlement is full and final.
- A breakdown of the calculation of the remaining $2.4 million provision, which should be the present value of the expected future cost. The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money.
- Physical inspection of the development site.
- Quotations or contracts relating to the restoration work.
- Written representations from management that no further liabilities in respect of this will accrue.
The properties in Sengkang are not owner-occupied but are held for the purpose of generating rental income. They are therefore within the scope of SFRS(I) 1-40 Investment Property and not SFRS(I) 1-16 Property, Plant and Equipment.

SFRS(I) 1-40.30 explains that after initial recognition at cost, a company can apply the cost model or the fair value model to its investment property, but must apply the same model to all of its investment property. Merlion must choose which model to apply in correcting the treatment of the buildings in its financial statements.

**Fair value model**

If the fair value model is chosen, the retail building should be revalued as well as the office block since the model must be applied to all investment property. Revaluation surpluses and deficits are taken directly to the statement of profit or loss, and affect profit for the year.

The revaluation of the office block resulted in a revaluation surplus, which will increase reported profit for the year. Since some of the retail units are empty, it may be that the value of the retail building has fallen below its carrying value, and the SFRS(I) 1-40 fair value revaluation would decrease reported profit for the year. Merlion may be attempting to manipulate its financial statements to show more favourable results by revaluing the office block but not the retail building.

**Cost model**

If Merlion opts to follow the cost model which is permitted under SFRS(I) 1-40, the office block revaluation gain will be credited to other comprehensive income under the heading revaluation surplus. Merlion has already done this for the office block and so no adjustment would be required.

Note that SFRS(I) 1-40.79(e) requires Merlion to disclose the fair value of the office block, even if the cost model is used.

**Prior period error**

The office blocks will have been classified incorrectly in the prior year ending 30 September 20X4, resulting in a prior period error in the financial statements. SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors requires this prior period error to be corrected by restating the comparatives in the 20X5 financial statements and disclosing the nature, amount, circumstances surrounding the error and a description of how it has been corrected (SFRS(I) 1-8 Paras 42 and 49).

(e) I would expect the following evidence to be available:

- Physical inspection of the two properties, in order to note their condition and location.
- Rental contracts for the occupied units, to confirm that they are rented out to third parties and not owner-occupied.
- A copy of the valuer's report, with details of bases used and assumptions made.
- Details of the valuer's qualifications, experience and independence.
- Notes of discussions with management regarding the reason for the revaluation of only the office block.
- A copy of the impairment review, if any, of the retail building.

(f) Any procedures from the following could be performed:

- Verify the value of the quarry to the purchase contract.
- Confirm that the value of the quarry is translated to Singapore dollars at the exchange rate at the date of purchase, as it is a non-monetary asset.
• Inquire of the directors what useful life the quarry is being depreciated over, if it is being depreciated.
• Corroborate whether that useful life appears reasonable by considering past practice, any business plans relating to the quarry, the size of the quarry.
• Recalculate the depreciation charge.
• Confirm the exchange rate between dollars and shillings at the year-end date and ensure that the value the bank account has been translated accurately at the year-end date as it is a monetary asset.
• Review inflation rates in Tanzania (by referring to published indices) to ensure that there is no instance of hyperinflation, which might affect accounting treatment.
• Observe a copy of the impairment review, if one exists, for the quarry, and consider the reasonableness of assumptions used.

(g) Any procedures from the following could be performed:
• Obtain evidence that the quarry exists. Whether it is cost efficient to send a member of staff to Tanzania will have to be determined. It is possible that the existence of the quarry could be established by reviewing documents and even possibly, Google Earth.
• Examine a title deed for the quarry to confirm it is registered as existing land.
8. Sunnyside

You are involved in planning the audits of three separate clients.

Client 1
Singapore Shop Pte Ltd (SS) is a retailer with a number of retail premises across Singapore. The non-current assets of SS are high value, as the retailer owns a number of shop units. The company has recently expanded its operations to Malaysia, where it now owns two retail units. Since the purchase of its most recent properties, the Board of SS has decided that it wants to carry land and buildings at fair value in the financial statements. The CFO has therefore revalued all the properties owned by SS and they are now carried in the draft statement of financial position at their fair value.

Client 2
Singapore Oil Company Ltd (SOC) is a petrochemical company. Three weeks before the reporting date there was a major oil spill due to a split in their pipeline which was repaired two weeks later. The resulting environmental damage is substantial and it is anticipated that the clean-up operation will take months. SOC has created a valid expectation in the eyes of the public that it will finance the clean-up operation, as a result of announcements it made during the spill period. The CFO has informed you that she therefore intends to include a provision for clean-up costs in the financial statements.

Client 3
Sunnyside Pte Ltd (Sunnyside) is an importer of household goods mainly from India and China. It sells the goods through its retail stores. Once it has imported the goods into Singapore, they are stored at one of the company's four huge warehouses, although some inventory may be held at a 'holding area' at a port prior to release to the company.

Required
(a) Conclude whether the accounting entity should use the work of an auditor's expert in the audit of Singapore Shop Pte Ltd. Justify your answer. (5 marks)
(b) Conclude whether the accounting entity should use the work of an auditor's expert in the audit of Singapore Oil Company Ltd. Justify your answer. (9 marks)
(c) Explain why there is a significant risk of material misstatement for the year-end inventory figure at Sunnyside. (3 marks)
(d) Describe four audit procedures to be performed in relation to the year-end inventory figure at Sunnyside. For each procedure, explain the purpose of the procedure. (8 marks)

(Total = 25 marks)
8. Sunnyside: Answer

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<table>
<thead>
<tr>
<th>Title</th>
<th>Learning outcome</th>
<th>Textbook chapter</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q8 Sunnyside</td>
<td>Identify and explain the circumstances in which an auditor is likely to need an</td>
<td>8</td>
<td>3</td>
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<td>expert opinion to obtain sufficient, appropriate evidence on a matter. Evaluate</td>
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<td>the work required to be done when there is the use of an expert including:</td>
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<td>• Evaluating the relevance, completeness and accuracy of the source data</td>
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<td>significant to that expert's work provided by management;</td>
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<td>• Evaluation of the expert's competence, capabilities and objectivity for the</td>
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<td>auditor's purposes;</td>
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<td></td>
<td>• Adequacy of the expert's work; and</td>
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<td>• The auditor's duty to form a concurring opinion with the expert.</td>
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<td></td>
<td>Identify and describe audit procedures to obtain sufficient audit evidence from</td>
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<td></td>
<td>identified sources eg inquiries, inspection, observation and re-performance.</td>
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<tr>
<td></td>
<td>Apply and evaluate audit procedures for all transactions in the extant syllabus</td>
<td>9</td>
<td>3</td>
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<td>for the Financial Reporting module.</td>
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</table>

Tutorial notes

This question tests Candidates' knowledge of auditor's experts and the audit of inventory.

In determining if an expert is required, think about the extent of an auditor's skills and expertise, but also think about whether appropriate audit evidence may be available through other means.

In the last two requirements, Candidates should consider the practical issues of auditing inventory at a company such as Sunnyside. They should recognise the risk to completeness of inventory given that some of it may be held at a third party location at the year-end. When audit procedures are required, always remember to explain the purpose of the procedure.
### Marking guide

#### (a)
SS may need an auditor's expert to value the retail premises using SFRS(I) 13 *Fair Value Measurement*.

The auditors must follow SSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

The auditors must consider:
- If there is an active market for the properties.
- If there is any reason to assume that the cost price of the new properties is substantially different from their market value at the end of the year?
- If the new properties are comparable with the older properties for the purposes of determining whether valuation is reasonable?
- Are the properties in any way specialised, so as to make them not comparable with other retail properties on the market in Singapore and Malaysia at the current time?

An active market is likely and the retail premises are not specialised. The cost of the new properties is likely to give fair evidence of their valuation.

**Conclusion:** an auditor's expert is not required.

5 marks

#### (b)
A provision needs to be included in the financial statements of SOC and the auditors will need to determine if the amount included as a provision is fairly stated.

This involves ensuring all potential costs have been included in the provision, making judgments about whether these are costs or contingent liabilities and assessing the reliability of estimates.

Oil spills are rare and no two are alike in terms of damage and clean-up.

Some procedures such as physically verifying the oil spill could be carried out by the auditor to gather evidence.

However other issues such as fishing damage and marine biology are beyond the scope of the auditor's knowledge.

If SOC engage their own expert, the auditors may be able to rely on this management's expert.

Factors impacting whether the auditor can reply on management's expert include:
- The expert's relationship with SOC.
- The auditor's feel that they still have insufficient knowledge and understanding to understand the management's expert's report or to corroborate things within it.

If the auditors cannot rely on SOC's expert, then they must use an auditor's expert.

9 marks

#### (c)
Inventory in port holding areas at the end of the reporting period is excluded from the inventory count resulting in an understatement of inventory.

Incorrect exchange rates used on the date of transactions could result in an over or understatement of the inventory balance.

Inventory may be recorded in the incorrect reporting period due to cut-off issues, resulting in an over or understatement of the inventory balance.

Obsolete/damaged inventory may not have been written down to the lower of cost and net realisable value resulting in overstatement of inventory.

3 marks
(d) Award up to 2 marks per audit procedure explained up to a maximum of four procedures.

Evaluate management's instructions and procedures for recording and controlling the inventory count.

**Purpose:**

Allows the auditors to make an initial assessment of the reliability of Sunnyside's inventory count.

Attend the year-end inventory count and observe the performance of inventory count procedures are in line with management's instructions.

**Purpose:**

Helps ensure that the inventory tests carried out by management are complete and accurate.

Attend the year-end inventory counts and inspect the inventory for any signs of damage.

**Purpose:**

This identifies any inventory which needs to be written down to the lower of cost and net realisable value.

Attend the year-end inventory counts and carry out test counts. Test counts should be performed from floor to list and from list to floor.

**Purpose:**

To gain evidence of the completeness and existence of the inventory as recorded on Sunnyside's count sheets.

For a sample of goods, agree the cost back to a specific invoice or agree that cost using FIFO or weighted average has been correctly calculated.

**Purpose:**

This provides evidence that the valuation of inventory is accurate.

Check that the cost of goods purchased from overseas suppliers has been translated into Singapore dollars using the correct exchange rate on the date of the transaction.

**Purpose:**

This test provides evidence that the valuation of inventory is accurate.

Arrange to get third party confirmation of the quantities and condition of any inventory held at port locations in line with the requirements of SSA 505 External Confirmations.

**Purpose:**

This test provides evidence of the existence and completeness of inventory.

Review the terms of the purchase contract with the foreign suppliers to establish at what point the company should recognise the inventories.

**Purpose:**

This aids the auditor when assessing that the cut-off of inventory is reasonable.
Answer points

(a) The issue at SS is valuation of properties. The requirements of SFRS(I) 13 Fair Value Measurement must be accounted for properly, ensuring that the most appropriate premise is used, that is, that it is measured at its highest and best use. It is important to assess whether the auditors will require expert help in determining whether the fair valuation of properties is appropriate to meet the requirements of SSA 540 Auditing Accounting Estimates, Including Fair Value Estimates, and Related Disclosures.

In considering this, the following questions are relevant:

- Is there an active market for the shopping mall which can be used to determine whether the valuation is reasonable (by comparison with other similar properties on the market)?
- In the case of the new properties, is there any reason to assume that the recent cost price is substantially different from the market value (fair value) at the end of the year?
- Are the new properties comparable with the older properties for the purposes of determining whether valuation is reasonable?
- Are the properties in any way specialised, so as to make them not comparable with other retail properties on the market in Singapore and Malaysia at the current time?

There is likely to be an active market which the auditors can use for analytical procedures. In this case there is no reason to assume that the retail premises are particularly specialised in a way that would seriously affect their comparability.

The new properties’ cost value is likely to give fair evidence of valuation this year unless there has been a known change in the market since purchase (for example, a property slump).

In conclusion, it is likely that the auditors can obtain sufficient evidence about the fair value of the properties without engaging the services of an auditor’s expert.

(b) At SOC a more difficult situation exists. An oil spill which the company was responsible for has occurred, and it appears that it will be necessary to include a provision for clean-up costs in the financial statements.

The auditors will have to determine whether the provision for clean-up costs is fairly stated. This will involve determining whether all potential costs have been included and whether each cost has been fairly stated. It will involve making judgments about whether costs are actually liabilities or whether they are only contingent liabilities, and looking at the reliability of estimates relating to costs as well.

Although this is clearly not the only example of an oil spill that has ever occurred, each spill will be unique in how it has affected its environment, the extent of the damage, and what specific animals, birds and items have been damaged and require repair or clean up.

The auditor will be able to gather some audit evidence relating to the clean-up costs. For example, the following procedures could be carried out:

- Physically verify the extent of the oil spill to determine the geographical location that the clean-up costs should relate to.
- Review insurance documents to identify what cover the company has that will off-set the provision requirement.
- Review publicly available information about other oil spills, including published papers about the costs of environmental clean-up around the globe, to give the auditor information to use for analytical purposes and to understand the issues arising from such spills.

However, issues of marine biology, environmental impact, building and fishing damage are outside of the scope of general business knowledge and are likely to be beyond the scope of the auditors’
knowledge. Also, as noted earlier, each oil spill is unique in how it affects their specific environment. Such knowledge may well be outside of the scope of the company as well, if no such disaster has occurred within the company previously.

Whether the auditor needs to obtain the help of some sort of environmental specialist or disaster consultant, in order to determine whether the CFO's provision in the financial statements is fairly stated, may depend on how the CFO goes about calculating it.

If the CFO uses the services of such a consultant or expert (whether internal or external to the company) then this may reduce the need of the auditors to engage their own expert, as it may be that they determine they can rely to an extent on the work of the management's expert, and that they can review the assumptions and costs given in the management's expert's report. As noted above, there is some publicly available information on other oil spills that they might be able to use in comparison as analytical evidence and the auditor can carry out other complementary procedures to provide evidence about the management's expert's report.

However, if the auditors have reason to feel that they cannot rely on the work of the management's expert (eg because he is insufficiently objective due to his relationship with SOC), and/or they feel that they still have insufficient knowledge and understanding to understand the management's expert's report or to corroborate things within it, then it still may be appropriate to use the work of an auditor's expert to provide audit evidence concerning whether the provision for clean-up costs is appropriate.

(c) As Sunnyside is an importer of household items, inventory is likely to be material on the statement of financial position.

The other relevant issue is that once goods come in from overseas, they are held at the port in a holding area prior to being released to the company. There is a risk that some of the inventory is held in the holding area at the year-end and is not included in the year-end inventory figure. This is a risk of understatement of inventory.

Inventory may be purchased from suppliers abroad using foreign currency and will be subject to the requirements of SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates. Inventory is a non-monetary item and is translated using the exchange rate at the date of the transaction. There is a risk that the incorrect exchange rates were used to translate the inventory at the date of the transaction, resulting in an over or understatement of inventory.

Inventory is at risk of being recorded in the incorrect reporting period due to cut-off issues. Inventory from the foreign suppliers needs to be recognised at the correct point in time and it needs to be established if this is when the goods are shipped from the supplier or when they are received at the port or the company's warehouses. Recognising the inventory too early or too late could result in inventories being over or understated.

Household goods sold by Sunnyside may be at risk of obsolescence where newer better products are brought to the market. Inventory should be held at the lower of cost and net realisable value (NRV) as per SFRS(I) 1-2 Inventories. There is a risk that inventory at Sunnyside is overstated where obsolete household goods have not been written down to the lower of cost and NRV. Similarly, there is a risk that damaged inventory has not been written down which will also result in an overstatement of inventory.

(d) Evaluate management's instructions and procedures for recording and controlling the inventory count. This allows the auditors to make an initial assessment of the reliability of Sunnyside's inventory count.

Attend the year-end inventory count and observe the performance of inventory count procedures are in line with management's instructions. This helps ensure that the inventory tests carried out by management are complete and accurate. This is particularly important at Sunnyside where logistics may mean that the auditors cannot attend all test counts.
Attend the year-end inventory counts and inspect the inventory for any signs of damage. This identifies any inventory needing to be written down to the lower of cost and net realisable value.

Attend the year-end inventory counts and carry out test counts. Test counts should be performed from floor to list and from list to floor to gain evidence of the completeness and existence of the inventory as recorded on Sunnyside's count sheets.

For a sample of goods, agree the cost back to a specific invoice or agree that cost using FIFO or weighted average has been correctly calculated. This provides evidence that the valuation of inventory is accurate.

Check that the cost of goods purchased from overseas suppliers has been translated into Singapore dollars using the correct exchange rate on the date of the transaction. This test provides evidence that the valuation of inventory is accurate.

Arrange to get third party confirmation of the quantities and condition of any inventory held at port locations in line with the requirements of SSA 505 External Confirmations. This test provides evidence of the existence and completeness of inventory.

Review the terms of the purchase contract with the foreign suppliers to establish at what point the company should recognise the inventories. This aids the auditor when assessing that the cut-off of inventory is reasonable.
9. Luxury Attire

Your accounting entity is currently working on the audit of Luxury Attire Ltd (Luxury Attire) for the year ended 31 December 20X4.

Luxury Attire is a company that listed on the Singapore Stock Exchange in January 20X4. The company specialises in women's clothing, focussing on the age range 30–50. The emphasis is on quality fabrics with cutting edge designs and although not a traditional designer brand, the clothing appeals to many women both inside and outside this age range.

The clothing range focusses on smart and casual day wear, with accessories of handbags, jewellery and shoes. The clothes are sold through 15 boutique-style small stores with an emphasis on customer service.

The company operates from a small head office building which is owned outright. It also leases a large premises next to its head office where its designers work and some of the clothes are manufactured and stored for retail. All the shop premises are leased. The company has also decided in the financial year to outsource some of its manufacturing to a third party clothes manufacturer in India where some of the clothes and shoes are made as the materials and labour costs are a lot cheaper.

As well as the stores, the company operates a website through which customers can browse the collection and make purchases online. The website was set up at the start of this financial year and has been a great success so far, despite a few glitches at the beginning with customer orders going ‘missing’.

The audit manager recently met with the Finance Director of Luxury Attire, who told her that the website gives customers the option to ‘click and collect’ – ie customers can collect their purchases from their nearest chosen store at no cost, which means that as well as not having to pay for postage, they don't have to wait around at home for a courier to deliver the goods meaning they can collect them from the store at their own convenience. In addition, they can try the clothes on at the store and get a refund straightaway if the items are not suitable, rather than having to post them back to the company and incur postage and packaging costs.

Generally the refund policy of the company is to offer a full refund on purchases returned within 14 days of sale or to offer a credit note on purchases returned between 14 days and 28 days. No refunds or credit notes are offered on purchases returned after 28 days or on sale items.

Like most clothing retailers, it is normal practice for the company to have a sale at the end of each season. Towards the end of December, after the Christmas holiday, the company holds its annual winter sale which includes reductions on autumn/winter lines that haven't been selling well, as well as inventory left over from the previous spring/summer season. Sale items can be purchased through the stores and the website.

At the recent meeting with the Finance Director, the audit manager was told that there had been some customer complaints relating to lines of clothing that turned out to have been manufactured in India. The complaints seem to focus on shoddy workmanship and poor quality fabric.

The audit manager has obtained from the Finance Director the draft financial statements for the year as well as the audited financial statements for the previous financial year for comparison. An extract of these is shown below. She has asked the audit assistant to carry out some preliminary analysis on these figures to help with audit planning for the year ended 31 December 20X4.

**Luxury Attire Draft Financial Statements for the Year Ended 31 December 20X4**

<table>
<thead>
<tr>
<th>STATEMENT OF PROFIT OR LOSS</th>
<th>Draft 20X4</th>
<th>Audited 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3,490</td>
<td>2,257</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(888)</td>
<td>(756)</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(367)</td>
<td>(256)</td>
</tr>
<tr>
<td>Administration costs</td>
<td>(690)</td>
<td>(589)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(25)</td>
<td>(25)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>1,520</td>
<td>631</td>
</tr>
</tbody>
</table>
STATEMENT OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th></th>
<th>2021</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,245</td>
<td>1,356</td>
</tr>
<tr>
<td>Inventory</td>
<td>645</td>
<td>367</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,890</td>
<td>1,723</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>850</td>
<td>850</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>890</td>
<td>723</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>1,890</td>
<td>1,723</td>
</tr>
</tbody>
</table>

Required

(a) Using analytical procedures on the draft statement of profit or loss, identify and explain four risks of material misstatement at Luxury Attire. (12 marks)

(b) Using analytical procedures on the draft statement of financial position, identify and explain three risks of material misstatement at Luxury Attire. (9 marks)

(c) State four examples of how analytical procedures could be used as substantive procedures in the audit of Luxury Attire. (4 marks)

(Total = 25 marks)
9. Luxury Attire: Answer

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<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q9 Luxury Attire</td>
<td>Discuss and apply the use of analytical procedures in the planning of an assignment.</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Identify and explain material and significant audit risks (broken into risks of material misstatement and detection risks) for a given assignment.</td>
<td>7</td>
<td>3</td>
</tr>
</tbody>
</table>

Tutorial notes

In this question, Candidates are assessed on their ability to perform analytical procedures at the planning stage of an audit and also as substantive procedures.

In the first two requirements, Candidates should first decide which figures stand out when comparing the draft financial statements to the prior year figure. They should ensure that a list of figures is not just presented – some valid commentary is required. They should question whether some figures in the draft financial statements could be materially misstated, whether the integrity of the directors is in question, whether there has been any window dressing etc. Given the time, Candidates should limit themselves to key ratios, not calculate every ratio they know.

In the third requirement, Candidates should focus on the most obvious places where analytical procedures could be applied as substantive procedures such as depreciation, finance costs, revenue, wages etc.

Marking guide

(a) Award up to three marks per risk of material misstatement identified and explained up to a maximum of four risks of material misstatement. 12 marks

Revenue

Increase of 55% from 20X3 to 20X4 seems high.
Increase may be legitimate and due to the new website or higher selling prices.
However it may be due to incorrect cut-off resulting in an misstatement of revenue.
Fraud is always a risk in revenue recognition.
There is a risk that the increase is due to management fraudulently inflating revenue figures to impress shareholders from the recent listing.
The large increase could be due to errors arising from weak controls associated with the new website.
Increased returns due to poor quality inventory and 'click and collect' may mean revenue is overstated.

Cost of sales

Cost of sales has increased by 17% from 20X3 to 20X4 and seems low considering revenue has increased by 55%.
Cost of sales may legitimately be lower due to manufacturing being moved to India where manufacturing costs are cheaper.
However cost of sales could be understated as a result of incorrect cut-off or overstated closing inventory.
**Distribution costs**

Significant increase of 43% from 20X3 to 20X4.

Movement of manufacturing to India would result in increased distribution costs and the increase could be legitimate.

However, costs may have been allocated incorrectly between cost of sales and distribution costs resulting in an overstatement of distribution costs.

**Administrative costs**

Increase of 17% from 20X3 to 20X4 is lower than expected.

An increase was to be expected given the new website and movement of manufacturing to India so this may be legitimate.

There is a possibility that costs have been misallocated between administrative costs, distribution costs and cost of sales resulting in an understatement of administrative costs.

**Other calculations**

Net profit margin has grown from 28% in 20X3 to 43% in 20X4 which is unusual. This may indicate overstated revenues or understated costs.

(b) Award up to three marks per risk of material misstatement identified and explained up to a maximum of three risks of material misstatement.  

**Non-current assets**

Decrease of 8.2% from 20X3 to 20X4.

This could be legitimate and due to a disposal during the year.

Costs from the new website may have been expensed when they should have been capitalised resulting in an understatement of intangible assets.

The associated amortisation will be understated.

**Inventory**

Significant increase of 76% from 20X3 to 20X4.

More inventories might be being held for the new website. However, there is a risk that inventory is overstated and includes slow moving products which need to be written down to net realisable value.

**Current liabilities**

Increase of 23% from 20X3 to 20X4.

This may be legitimate and the result of the company negotiating better credit terms with suppliers.

However, it may indicate the company is struggling to pay its debts on time which is a cause for concern.

The current ratio is 0.73 in 20X4 and was 0.51 in 20X3 which indicates the company may be having liquidity problems. There may be a risk the Luxury Attire is not a going concern.

(c) Award up to one mark per procedure up to a maximum of four procedures.  

Proof in total for depreciation charges.

Predictive tests using 20X3’s audited figures and applying any expected changes (e.g. rental increases) in 20X4 to compute the expected lease payments in 20X4.

Calculation of an expected wages cost and then comparing this to the actual cost in the ledger.

Calculation of expected finance charges by applying the interest rate to the loan balance outstanding.

Reasonableness of tax in the statement of profit or loss by applying tax rates to any profit before tax figure.
Answer points

(a) Revenue has increased by 55% compared to the prior year. This seems very high and could be overstated. However, we are told that the company launched its website during the year and this has proven very successful. This could have contributed to some of the increase, along with higher selling prices. The increase may legitimately be caused by an increase in sales prices in the year and the new revenue stream from the website and revenue.

There is a risk of misstatement of revenue as a result of incorrect cut-off being applied. The basis of revenue recognition from website sales needs to be clarified. For example, is the performance obligation satisfied when the goods are despatched to the customer for ‘click and collect’ or when the customer collects the goods from the store? There is a risk that revenue is misstated if revenue is recognised too early or too late for ‘click and collect’ sales.

SSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
Para 26 explains there is a presumption that fraud is a risk in revenue recognition. A large increase in revenue of 55% could be due to management fraudulently inflating the revenue figure. Management may be attempting to present the financial statements as better than they really are in order to impress and attract shareholders following the recent Stock Exchange listing.

The new website has encountered some problems which may indicate that controls in place may be poor or lacking. This may cast doubt over the existence of revenue and led to an overstatement in the financial statements.

There have been complaints from customers about some of the items that were made in India. This may lead to an increased level of returns and therefore to a risk of revenue being misstated. This is also exacerbated by the website sales – as purchasing on a website is very easy and convenient, customers may purchase a lot of items only to return them when received if they do not fit correctly or look as they appeared on the website. Both these factors may have contributed to the increase in revenue of 55%.

Cost of sales has risen by only 17% compared to the prior year. Given that revenue has increased by 55%, we might expect to see a comparable increase in cost of sales but the increase is not as pronounced as for revenue. This could be due to some of the manufacturing taking place in India where costs are lower but there may also be a risk of incorrect cut-off being applied to make the results appear better than they actually are. Closing inventory may also be overstated which would result in a lower cost of sales figure. The company's post-Christmas sale would have been happening at the year end and hence some items of inventory may be carried at an amount higher than carrying value.

Distribution costs have increased significantly, by 43% which appears strange. There may be an issue with incorrect classification of costs between cost of sales and distribution costs especially as the increase in cost of sales is not as marked. The company has outsourced some of its production to India and this would result in increased distribution costs.

Administration costs have increased by 17% compared to the prior year. Again there may be issues of misclassification of costs between cost of sales, distribution costs and administration costs. Due to the launch of the new website and the outsourcing to India, we would perhaps expect a more marked increase in administration costs in the year.

Net profit margin has grown from 28% in 20X3 to 43% in 20X4 which is unusual. This may indicate overstated revenues or understated costs.

(b) Non-current assets have fallen from $1,356,000 to $1,245,000 – a drop of 8.2%. There may be a valid reason for the decrease such as the disposal of assets in the year.

There are no intangible assets on the statement of financial position. SFRS(I) 1-38 Intangible Assets allows the capitalisation of a website arising from development to be capitalised if it meets the criteria given in SFRS(I) 1-38 Intangible Assets Para 21 and 57. The website costs do not appear to have been capitalised. Intangible assets may be understated and costs overstated in the
statement of profit or loss. (It could be that the costs do not meet the recognition criteria in which case they have been correctly treated.)

If the website is not capitalised then there will be no amortisation associated with the missing intangible asset. Amortisation will be understated in the statement of profit or loss.

The main area of concern on the statement of financial position is the increase in inventory from $367,000 to $645,000 – an increase of 76%. This could indicate an overstatement in inventory. However, there may be a legitimate reason for this rise. The company has launched its website during the year and so has produced more inventory which is still held at the year end. It may also be because it is holding existing lines of inventory at the year-end which did not sell well earlier in the year.

The current liabilities figure is also a cause for concern. It has increased by 23% compared to the prior year. As the company has to purchase fabrics and leather for its products, it may be that it has taken advantage of any credit periods offered by its suppliers. We also do not know how the arrangements with the Indian manufacturer are managed and this may also have contributed to the increase.

The current ratio is 0.73 in 20X4 and was 0.51 in 20X3 which indicates the company may be having liquidity problems. There may be a risk the Luxury Attire is not a going concern.

(c) SSA 520 Analytical Procedures discusses how analytical procedures can be used as substantive audit procedures during the fieldwork stage. If an entity’s controls are assessed as being reliable, then the auditor might use substantive analytical procedures alongside tests of controls to undertake audit testing.

A ‘proof in total’ analytical procedure could be used to test the depreciation charge for the year on the head office building owned by the company. It could also be extended to any leased premises that are held on the statement of financial position.

The rental payments on any leased premises could also be tested using a predictive test based on the prior year audited figure and applying any rental increases (vouched to the rental agreements) and factoring in any changes in premises during the current financial year.

An expected value for the wages cost could be derived by taking the prior year figure and applying any salary increases and factoring in new staff joining during the year and existing staff who may have left during the year. This would be useful for auditing the wages cost for the Singapore shop staff and head office staff. It is not clear from the information how the outsourcing in India is managed in terms of paying the staff there and substantive analytical procedures are unlikely to extend to this part of the business.

It should be possible to audit the finance costs for any bank borrowing by applying the interest rate to the amount of the loan per the loan agreement.

Similarly, the auditors can assess the reasonableness of tax in the statement of profit or loss by applying tax rates to any profit before tax figure.
10. Lee Toh Lighting Group

You are the key audit partner of Lee Toh Lighting Group Ltd (‘Lee Toh’), a company which manufactures and sells light bulbs in Asia and Europe. The company has one factory alongside its corporate headquarters in Jurong, two factories in mainland China, and one factory in France. Your accounting entity has been responsible for the audit of Lee Toh for the past seven years.

Revenues at Lee Toh are split more or less equally between the Asian and European markets. All sales in Asia are made to wholesalers who have networks of sales staff selling to individual businesses across the region. European sales are managed by a subsidiary corporation based in France. These sales are all made directly to customers via the Lee Toh website. The French subsidiary corporation manages the European sales area of the website and organises the distribution of these products from its factory and warehouse in Paris.

A few months ago, you attended an audit planning meeting for the year ending 31 December 20X3 with the group finance director at Lee Toh. At this meeting, you discussed an article found in a trade magazine relating to the phasing out of incandescent light bulbs in Europe. The article explained how a new European Energy Directive would mean that incandescent bulbs would be banned in Europe from June 20X4. The article went on to describe how incandescent bulbs have been falling in popularity in Asia due to their lack of energy efficiency and were expected to be phased out in Singapore in the next 12 months.

Part of the Paris factory is used for the manufacture of incandescent bulbs and at year end was anticipated to contain machinery at a cost of $750k and accumulated depreciation of $500k. At the planning meeting, the group finance director explained that production of incandescent bulbs at the Paris factory would cease on 10 January 20X4 and Lee Toh has made plans to close this part of the factory down.

Lee Toh rented an office in China from January 20X3 under a four year lease. The terms of the lease state that the premises are rent-free for the first twelve months. Lee Toh is adopting SFRS(I) 16 Leases for the first time in 20X3.

Revenue in the draft financial statements of Lee Toh is $10m for the year ending 31 December 20X3 and the company has recorded total assets of $12m at 31 December 20X3.

Required

(a) Explain why there is a risk of material misstatement for the machinery used to manufacture incandescent bulbs at Lee Toh for the year ending 31 December 20X3. You do not need to consider any requirements in relation to SFRS(I) 1-37 or SFRS(I) 5. (3 marks)

(b) Describe three audit procedures to be performed on the machinery and explain the purpose of each procedure. (6 marks)

(c) Explain why there is a risk of material misstatement for the incandescent bulbs within the inventory of the French subsidiary corporation of Lee Toh for the year ending 31 December 20X3. You do not need to consider any requirements in relation to SFRS(I) 1-37 or SFRS(I) 5. (2 marks)

(d) Describe four audit procedures to be performed on the inventory of incandescent bulbs in the French subsidiary corporation and explain the purpose of each procedure. (8 marks)

(e) Describe three audit procedures to be performed on the lease and explain the purpose of each procedure. (6 marks)

(Total = 25 marks)
10. Lee Toh Lighting Group: Answer

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<th>Learning outcome</th>
<th>Textbook chapter</th>
<th>Cognitive level</th>
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</thead>
<tbody>
<tr>
<td>Q10 Lee Toh Lighting Group</td>
<td>Apply and evaluate audit procedures for all transactions in the extant syllabus for the Financial Reporting module.</td>
<td>9 and 10</td>
<td>3</td>
</tr>
</tbody>
</table>

Tutorial notes

The question tests Candidates' knowledge of impairment of non-current assets and inventory and the audit of leases. Candidates need a good understanding of these areas of financial reporting in order to assess risks of material misstatement and suggest relevant audit procedures.

When asked to discuss the risks of material misstatement, Candidates should always assess materiality where appropriate. Remember to state whether there is a risk of over or understatement in the financial statements and to explain why this is.

For audit procedures, Candidates need to ensure they explain why a procedure might be performed. Simply stating a procedure is not adequate.

Marking guide

(a) The machinery is 2% of total assets and 2.5% of revenue in the draft financial statements.
The machinery is material.
The machinery may need to be impaired as the bulbs it produces will be illegal in Europe and falling out of favour elsewhere.
If the carrying amount of the machinery is greater than its recoverable value (higher of value in use and fair value less costs of disposal) the machinery will be overstated and will require adjustment.
Depreciation will also be impacted if the machine is written down. 3 marks

(b) Award up to two marks per procedure explained up to a maximum of three procedures.
Obtain a copy of management's impairment review and reperform all calculations.
Purpose:
To ensure there are no mathematical errors in the impairment review.
Discuss with management any assumptions made in their impairment review, for example when estimating value in use or fair value.
Purpose:
To assess the reasonableness of assumptions made by management and whether they are in line with the auditor's expectations.
Recalculate depreciation on the basis of any impaired amount.
Purpose:
To assess the accuracy of the depreciation figure. 6 marks
(c) The inventory may contain a substantial number of incandescent bulbs which will soon be obsolete. These bulbs may need to be written down to the lower of cost and net realisable value as per SFRS(I) 1-2 *Inventories* or inventory will be overstated in the financial statements of Lee Toh. Any impairment of inventory will also result in a reduction of profit for the year ending 31 December 20X3.  

**2 marks**

(d) Award up to two marks per procedure explained up to a maximum of four procedures.

Obtain an inventory listing for the French subsidiary corporation of Lee Toh. Identify any incandescent bulbs within the inventory listing and ascertain whether these are held at cost or net realisable value (NRV) by comparing their purchase price to their value in the inventory listing.  

*Purpose:*

This will help assess whether inventory is being overvalued.

Review sales of incandescent bulbs after the end of the reporting period.  

*Purpose:*

To determine whether the value assigned to inventory by management has been realised.

Find the actual selling price of the incandescent bulbs from the Lee Toh website and compare this to the value in the inventory listing.  

*Purpose:*

To check that the NRV is not greater than the value of individual items of inventory resulting in an overstatement.

Compare the selling price of the incandescent bulbs on the Lee Toh website with the selling prices charged elsewhere.  

*Purpose:*

If prices elsewhere are lower, Lee Toh may have overstated the value of the inventory in the financial statements.

Enquire of management of their plans for any inventory of incandescent bulbs in the French warehouse after 30 June 20X4, ie would this have to be scrapped or can it be sold outside the European Union?  

*Purpose:*

If management plan to scrap the inventory it should be written off and may be overstated in the financial statements.

Verify any management plans to sell the lightbulbs by observing Board minutes, shipping documentation or sales invoices, if these items have been shipped and sold after the year end.  

*Purpose:*

To provide evidence of the net realisable value of the bulbs.

Check the number of incandescent bulbs held in inventory and their selling prices for as long after the period end as possible.  

*Purpose:*

To provide evidence of the net realisable value of the bulbs.

**8 marks**
### Answer points

(a) The Paris factory contains machinery with a carrying amount of $250k used for the production of incandescent bulbs which will soon be out of use following a new European Energy Directive. It is unlikely that this machinery will be transferred to Lee Toh's other factories in Asia as incandescent bulb sales are falling there. The machinery is 2% of total assets and 2.5% of revenue in the draft financial statements which is material.

This machinery may be overstated in the financial statements and needs to be reviewed for impairment. If the carrying amount of the machinery is greater than its recoverable value (higher of...
value in use and fair value less costs of disposal) the machinery will be overstated and will require adjustment.

The value of depreciation will therefore also be affected (if the asset is written down).

(b) Audit procedures which could be performed are as follows.

- Obtain a copy of management’s impairment review and reperform all calculations to ensure there are no mathematical errors in the impairment review.
- Discuss with management any assumptions made in their impairment review, for example when estimating value in use or fair value, to assess the reasonableness of assumptions made by management and whether they are in line with the auditor’s expectations.
- Recalculate depreciation on the basis of any impaired amount to assess the accuracy of the depreciation figure.

(c) The inventory figure in the financial statements of the French subsidiary corporation may contain a substantial number of incandescent bulbs which will soon be obsolete. It is possible that these bulbs could be shipped to Asia to sell, although the market is waning there also. If these bulbs appear to be unsaleable, these bulbs may need to be written down to the lower of cost and net realisable value as per SFRS(I) 1-2 Inventories or inventory will be overstated in the financial statements of Lee Toh.

Any impairment of inventory will also result in a reduction of profit for the year ending 31 December 20X3.

(d) Audit procedures which could be performed on the inventory of incandescent bulbs in the French subsidiary corporation are as follows.

- Obtain an inventory listing for the French subsidiary corporation of Lee Toh. Identify any incandescent bulbs within the inventory listing and ascertain whether these are held at cost or net realisable value (NRV) by comparing their purchase price to their value in the inventory listing. This will help assess whether inventory is being overvalued.
- Review sales of incandescent bulbs after the end of the reporting period. This helps the auditors determine whether the value assigned to inventory by management has been realised.
- Find the actual selling price of the incandescent bulbs from the Lee Toh website and compare this to the value in the inventory listing. This is to check that the NRV is not greater than the value of individual items of inventory resulting in an overstatement.
- Compare the selling price of the incandescent bulbs on the Lee Toh website with the selling prices charged elsewhere. If prices elsewhere are lower, Lee Toh may have overstated the value of the inventory in the financial statements.
- Enquire of management of their plans for any inventory of incandescent bulbs in the French warehouse after 30 June 20X4, ie would this have to be scrapped or can it be sold outside the European Union? If management plan to scrap the inventory it should be written off and may be overstated in the financial statements.
- Verify any management plans to sell the lightbulbs by observing Board minutes, shipping documentation or sales invoices, if these items have been shipped and sold after the year end. This provides evidence of the net realisable value of the bulbs.
- Check the number of incandescent bulbs held in inventory and their selling prices for as long after the period end as possible to provide evidence of the net realisable value of the bulbs.
(e) Audit procedures to be performed on the lease are as follows.

- Examine the lease contract to check that it contains a lease as defined by SFRS(I) 16. If this is not the case, Lee Toh should not recognise a lease on the statement of financial position. This procedure is especially important as it is the first year that Lee Toh is applying SFRS(I) 16 and management lack experience of applying the new standard.

- Agree the value of the leased premises (the right-of use asset) to the lease contract in order to confirm the asset’s initial valuation.

- Obtain a copy of management’s depreciation calculations for the leased premises and confirm their accuracy by recalculating them.

- Consider the reasonableness of the depreciation rates used by management to assess the valuation of the depreciation calculations.

- Obtain a copy of management’s lease liability calculations for the leased premises and confirm their accuracy by recalculating them.

- Obtain the interest rate used to calculate the present value of lease payments from management’s lease liability calculations and check the rate used is in line with the requirements of SFRS(I) 16.

- Ensure the ‘discount’ year has been properly allocated over the life of the lease.

- Examine the leases disclosures to be included in the financial statements to check they fulfil the requirements of SFRS(I) 16. Again, this procedure is important as it is the first year that Lee Toh is applying SFRS(I) 16 and management lack experience in producing these disclosures.
11. Happy Hotels

Happy Hotels Pte Ltd (Happy Hotels) is a national chain of budget hotels. The emphasis of the hotels is on quality but affordable rooms for all types of customers, from those on business trips to tourists. The company had been in a slump for a number of years, having gained a reputation as a cheap hotel chain, offering not very much for very little money. However, the new Managing Director who was employed a couple of years ago, has rebranded the hotel chain as ‘quality you can afford’ with the focus on comfort and quality and price. As a consequence, the company is now doing very well, although it had to finance its rebranding with a large ten-year bank loan.

Customers who want to stay at Happy Hotels can either book rooms online via its new and improved website, or over the phone. Many of the people who stay at Happy Hotels are from overseas who are visiting Singapore on holiday although, since the rebranding exercise, the company has also seen an increase in the number of people who stay on business trips. Rooms can be booked up to a year in advance, although all rooms have to be paid for in full on reservation.

Customers can also choose to have breakfast. This can either be included when they book in advance or can be paid for on the day. Each Happy Hotel includes a restaurant for evening meals, which is open to both residents and non-residents. There is also a bar, which operates on the same system. Some of the larger hotels have a gym, of which hotel residents have complimentary use. Membership of the gyms is also offered to non-residents who pay a monthly fee depending on whether they want to use the gym during peak hours or non-peak hours. All gym members have to pay a one-off membership fee when they join, and the monthly fees are paid in advance.

Happy Hotels employs management, reception, kitchen and housekeeping staff in its hotels. Management employees usually start with the company at Grade 1 level and progress to Grade 5 which is the highest level.

During the year, one Grade 5 member of staff retired and three new Grade 1 employees were employed. As a result of the retirement, internal promotions were made to fill the gaps at each level (ie someone was promoted from Grade 4 to fill the Grade 5 gap, someone was promoted from grade 3 to fill the Grade 4 gap, etc). There was little turnover of management staff, and there were no changes in management staff this year. All staff were given a 3% pay rise at the start of the year.

Happy Hotels operates a defined contribution pension scheme for management staff.

Required

(a) Identify and explain six audit risks in the audit of Happy Hotels. (12 marks)
(b) Recommend the audit response for each audit risk identified for Happy Hotels. (6 marks)
(c) Describe five audit procedures to be performed on the payroll at Happy Hotels. (5 marks)
(d) State two audit procedures to be performed on the Happy Hotels defined contribution pension plan and explain the purpose of these procedures. (2 marks)

(Total = 25 marks)
11. Happy Hotels: Answer

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<td>Apply and evaluate audit procedures for all transactions in the extant syllabus for the Financial Reporting module.</td>
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Tutorial notes

This question tests Candidates’ knowledge of audit risks and appropriate responses and audit procedures. Candidates must understand the importance the difference between audit risk and business risk as marks will not be awarded for describing business risks in this question.

Taking the scenario line-by-line is the best approach to this requirement. It is important that the audit responses are relevant to the scenario and realistic.

Marking guide

(a) Award up to two marks per audit risk identified and explained up to a maximum of six risks. 12 marks

Revenue

Revenue is always a significant risk area due to the rebuttable fraud risk described in SSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.

Rooms are paid for in advance so revenue may be recognised too early (cut-off issue) instead of being credited to deferred income.

There is a similar issue with gym membership where fees are paid monthly in advance although the revenue from gyms is smaller than room revenue.

Cut-off issues will result in revenue being overstated and deferred income understated.

Going concern

The company may be unable to meet its loan repayments or breach loan covenants resulting in a recall of the loan. This could place the going concern status of Happy Hotels in jeopardy.

The financial statements may need to be prepared on a break-up basis or may need to contain disclosure of a material uncertainty.

There is a risk that the financial statements are not prepared on the correct basis or that disclosure of a material uncertainty is not made in the financial statements.

Bank loan

The company has a ten year bank loan which must be split between current and non-current liabilities.
There is a risk that the split is not calculated correctly and that the required disclosures are not made.

**Happy Hotels website**

The website is new and there is a risk that bookings recorded incorrectly can lead to misstatements in the financial statements.

Cyber-attacks/viruses could result in lost/corrupt data.

**Foreign exchange**

Overseas customers may be paying in foreign currencies and these must be accounted for in accordance with SFRS(I) 1-21 *The Effects of Changes in Foreign Exchange Rates.*

There is a risk of incorrect rates or calculations leading to misstatements.

**Cash takings in bars and restaurants**

Hotel bars and restaurants are likely to have a large amount of cash takings.

These are at risk of misappropriation and cash may not be complete.

**Inventory**

Food and drink for hotel bars and restaurants are at risk of misappropriation and perishable.

Inventory may be overstated in the statement of financial position.

**Impairment of non-current assets**

Hotel assets and gym equipment may be damaged or suffer wear and tear and their carrying values may need to be written down.

Assets could be overstated in the financial statements.

(b) Award up to one mark per response explained up to a maximum of six responses. **6 marks**

**Revenue recognition**

Increase substantive testing on revenue.

Focus on occurrence and cut-off.

Test the different revenue streams separately.

**Going concern**

Discuss future plans for repaying the loan with management applying professional scepticism.

Review forecasts.

**Bank Loan**

Agree the loan contract to confirm the loan terms.

Send a bank confirmation letter to obtain external evidence.

Review the disclosures in the financial statements.

Reperform all calculations to check mathematical accuracy.

**Foreign exchange**

Verify exchange rates to a reliable source.

Recalculate a sample of foreign exchange balances to check mathematical accuracy.

**Cash takings**

Attend cash counts.

Review the reliability of controls over handling of cash.
**Inventory**

Attend inventory counts and check whether food and drink is saleable.

Review the reliability of controls over inventory.

**Impairment**

Discuss any indicators of impairment with management.

Review impairment reviews performed by management.

(c) Award up to one mark per procedure up to a maximum of five procedures.

Perform a proof-in-total calculation for the current year payroll (analytical procedure. This will involve taking the prior year figures for payroll and performing calculations to adjust them for the given changes in staff and pay during the year.

Obtain a copy of the payroll and select an appropriate sample of entries.

Check individual remuneration per payroll to personnel records.

Confirm existence of employees by meeting them.

Check validity of other deductions, eg pension contributions by reading the terms and conditions of the pension scheme.

Reconcile a sample of employees from their records to the payroll.

Establish whether joiners have been paid in the correct month.

Obtain a list of employees who have left the company throughout the year from the human resources department and check whether leavers have been correctly removed from the payroll run for the last month of the year.

Reperform casts of the payroll.

Confirm payment of pay to bank transfer records.

Agree net pay per cashbook to payroll.

Agree payroll to general ledger.

Review bonus expense.

Scrutinise payroll and investigate any unusual items.

5 marks

(d) Award up to one mark per procedure up to a maximum of two procedures.

Compare the payments in relation to the defined contribution scheme to number of staff in scheme and terms of the scheme to assess whether payment appears reasonable (a reasonableness test as part of analytical procedures).

Verify payment to cash book/bank statements.

Re-performance of the calculation for a sample of contributions to verify the accuracy of the amounts paid.

Review disclosures in the financial statements and check these are in line with the requirements of SFRS(I) 1-19.

2 marks

**Answer points**

(a) **Revenue recognition**

In accordance with SSA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, revenue recognition is a rebuttable significant risk, hence revenue recognition is always an audit risk.

Happy Hotels accepts room bookings up to a year in advance. Income received in advance should be credited to deferred income until the room is occupied. As all rooms have to be paid for in full on reservation on the website/telephone, there is a risk that revenue may be misstated in the
financial statements if it is recognised in advance of the room being occupied. The assertion of cut-off is relevant here. As room income is going to be the biggest source of income for the company, there is a risk it will be materially misstated in the financial statements.

The same issue also applies to gym membership as members have to pay monthly in advance, however the risk of material misstatement here may be a lot less as not all the hotels have gyms and the fee income from this source will not be as great as that from the room reservations.

For both gym and room revenue, cut-off issues will result in revenue being overstated and deferred income understated.

As well as the risk that revenue will be recorded incorrectly in error, there is also the risk that revenue could be deliberately manipulated in order to improve the apparent performance of the company. However, there does not seem to be any incentive (such as performance based bonuses) for management to deliberately manipulate the revenue figures.

Going concern

The company took out a large ten year bank loan to finance its rebranding under its new Managing Director. There may be a risk that the company defaults on its repayments or breaches its covenants, if any, and consequently that it cannot continue as a going concern, which may mean the financial statements would have to be prepared on a break-up basis. The audit risk here is that the financial statements are prepared on an incorrect basis.

Alternatively, there is an audit risk that disclosures relating to going concern are incorrect or incomplete. For example, a material uncertainty related to going concern that is not adequately disclosed in the financial statements.

Bank loan

The company took out a ten year bank loan to help in rebranding. The loan should be presented in the financial statements under both current and non-current liabilities in accordance with the requirements of SFRS(I) 1-1 Presentation of Financial Statements Para 61. There is therefore a risk of incorrect calculation of the split. Additionally, there is a risk that the required disclosures relating to this loan are not made or are incorrect.

Happy Hotels website

The Happy Hotels website is new and is the main way that customers can book rooms at a good rate. Although there may be good controls in place for security of transactions placed online, there is a risk of cyber-attacks or viruses and accounting data could be lost or corrupted if these controls are weak. Alternatively glitches in the new system may not have been discovered resulting in bookings being taken incorrectly and misstatements in the financial statements.

Foreign exchange

As many of the hotels' visitors are from overseas, they are likely to be paying in currencies other than the Singapore dollar. Balances in the financial statements may be misstated if they have not been correctly accounted for in accordance with SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates. There is a risk that incorrect exchange rates have been used or that calculations are not accurate.

Cash takings in bars

As all the hotels operate a bar and restaurant, there may be a large amount of cash in the tills at the end of each day. There is a risk that cash may be misappropriated by hotel staff and consequently lead to misstatements in the financial statements.

Inventory

As all the hotels operate restaurants and bars, there will be large amounts of food and drink items at each site. These are open to the risk both of misappropriation and obsolescence as the food will have a limited shelf life and may therefore be overvalued in the year-end financial statements.
Impairment

There is a risk that hotel assets and gym equipment may be impaired due to damage or excessive wear and tear or if the projected cash flows for the business indicate that the value in use of the business is below the carrying amount. There is a risk that property, plant and equipment is overstated on the statement of financial position.

(b) Revenue Recognition

The auditors will need to respond to these risks by increasing their substantive testing on revenue, focussing on occurrence and cut-off in particular. The assertion of existence must also be considered. Procedures would include vouching revenue to bank statements to ascertain that sales are legitimate. These revenue types are all different in nature and must be quantified as separate populations and tested separately.

Going concern

The auditors should discuss the company's future plans with the relevant personnel and review forecasts and cash flow statements to assess whether the company can continue in the foreseeable future. They should also discuss with the Finance Director plans for repayment of the loan and apply professional scepticism in both discussions.

Bank loan

The auditors should review the loan agreement to confirm the terms of the loan and send a confirmation letter to the bank regarding the amount outstanding at the year-end. They should review the disclosure relating to the loan in the draft financial statements.

The auditors should check that the balance outstanding on the loan has been correctly determined using the amortised cost method.

Foreign exchange

The auditors should obtain independent verification of exchange rates to reliable external sources and recalculate balances relevant to the financial statements to ensure they have been correctly accounted for in accordance with SFRS(I) 1-21.

Cash takings in bars

Auditors should attend the cash counts at the year-end for a sample of hotels to verify year-end cash in hand balances. They should also review controls around cash handling and assess whether these appear to be reliable or not. The auditors should review the results of surprise cash counts conducted by management.

Inventory

If the system adopted is a periodic system auditors should attend the inventory counts at the year-end for a sample of hotel bars and restaurants to inspect the condition of food and drink items. They should also review controls around inventory to assess whether these appear to be reliable or not.

Impairment

The auditors should discuss with the management whether there are indicators of impairment. Any impairment review carried out by management will need to be reviewed.

(c) Any from the following procedures could be performed:

- Perform a proof-in-total calculation for the current year payroll (analytical procedure).
- This will involve taking the prior year figures for payroll and performing calculations to adjust them for the given changes in staff and pay during the year.
- Obtain a copy of the payroll and select an appropriate sample of entries.
- Check individual remuneration per payroll to personnel records.
- Confirm existence of employees by meeting them.
- Check validity of other deductions, eg pension contributions by reading the terms and conditions of the pension scheme.
- Reconcile a sample of employees from their records to the payroll.
- Establish whether joiners have been paid in the correct month.
- Obtain a list of employees who have left the company throughout the year from the human resources department and check whether leavers have been correctly removed from the payroll run for the last month of the year.
- Reperform casts of the payroll.
- Confirm payment of pay to bank transfer records.
- Agree net pay per cashbook to payroll.
- Agree payroll to general ledger.
- Review bonus expense.
- Scrutinise payroll and investigate any unusual items.

(d) Any from the following procedures could be performed:
- Compare the payments in relation to the defined contribution scheme to the number of staff in the scheme and the terms of the scheme to assess whether payment appears reasonable (a reasonableness test as part of analytical procedures).
- Verify payment to cash book/bank statements.
- Re-performance of the calculation for a sample of contributions to verify the accuracy of the amounts paid.
- Review disclosures in the financial statements and check these are in line with the requirements of SFRS(I) 1-19 Employee Benefits.
12. Tampine Ltd

Tampine Ltd (Tampine), a listed company, provides business consultancy services throughout Singapore. Its financial statements have been audited by the accounting entity Carter Xhen for a number of years. Carter Xhen are the appointed auditor for the year ended 31 December 20X3. On 31 August 20X3 Tampine acquired 100% of the share capital of Tiga Pte Ltd (Tiga), an IT software development company, for cash consideration of $50 million with a further $25 million payable in one year's time if Tiga's revenue grows by 5% per annum. The net assets of Tiga at the date of acquisition were externally valued and had a fair value of $45 million. Tiga is Tampine's only subsidiary corporation and Tampine is required to prepare group financial statements for the first time. Tiga prepares financial statements to 30 September each year and its financial statements are audited by the small Singaporean accounting entity, Wu Associates, which is unknown to Carter Xhen.

The CFO of Tampine has made the following financial information from the draft financial statements available to the audit engagement partner:

<table>
<thead>
<tr>
<th>$ million</th>
<th>Tampine individual financial statements At 31 December 20X3</th>
<th>Tampine group financial statements At 31 December 20X3</th>
<th>Tiga individual financial statements At 30 September 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>95.0</td>
<td>103.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>19.5</td>
<td>21.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,200.0</td>
<td>1,325.0</td>
<td>110.0</td>
</tr>
</tbody>
</table>

At the recent planning meeting with Tampine's CFO, the audit engagement partner also ascertained the following:

- On 1 October 20X3 Tiga migrated its accounting records to the accounting system used by Tampine. Tampine's directors were keen to achieve this quickly to benefit from efficiencies in using the same system. No parallel running of the two systems was undertaken.
- On 10 October 20X3, Tiga received notice that a major client, Unum Pte Ltd (Unum), accounting for 50% of Tiga's revenue, had gone into administration. At 30 September 20X3 Unum owed Tiga $2.3m and no amounts have been or are expected to be received in respect of the outstanding amount. The amount had been outstanding for a number of months but the sales director of Tiga had refrained from following Tiga's credit control procedures in respect of overdue balances for fear of upsetting the management at Unum.
- Tiga is currently working on developing a new client relationship management (CRM) system for Tampine and is billing Tampine on the basis of hours worked by Tiga employees on the system.
- No formal monitoring of Tiga's operations or financial information has yet been set up by Tampine, as it is unsure of what procedures are needed, nor has it reviewed the internal controls in place at Tiga. In addition, no processes have been implemented for reporting by Tiga to Tampine at the year end and intra-group transactions and balances have not been monitored or reconciled.

Required

(a) Comment on why there is significant risk of material misstatement for the goodwill recorded on acquisition of Tiga. (10 marks)

(b) Identify and explain five other risks of material misstatement in the group financial statements of Tampine. (5 marks)

(c) With reference to appropriate Singapore Standards on Auditing, explain the communication Wu Associates would anticipate from Carter Xhen in relation to the group audit. (10 marks)

(Total = 25 marks)
12. Tampine Ltd: Answer

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<tr>
<td></td>
<td>Identify and explain the audit risks and necessary audit procedures relevant to the consolidation process and group-wide controls.</td>
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<td></td>
<td>Explain effective communication between the group engagement team and component auditors and the determination and communication of materiality for a group audit, including materiality at the component level.</td>
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</tr>
</tbody>
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Tutorial notes

This question tests Candidates’ knowledge of audit risks and risk of material misstatement in group audits and component auditors’ communications.

When commenting on the risks of material misstatement in a goodwill calculation, Candidates should consider the potential risks for each line of the calculation.

The risks of misstatement for the group financial statements will arise from each of the component financial statements as well as from the process of consolidation and the related adjustments. The individual financial statements of Tampine will include an investment in Tiga and Candidates should consider the impact of the events on the valuation of the investment.

Marking guide

(a) **Goodwill calculation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($m)</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash consideration paid on 31 August</td>
<td>$50m</td>
<td></td>
</tr>
<tr>
<td>Contingent future consideration</td>
<td>$25m</td>
<td></td>
</tr>
<tr>
<td>Less: Fair value of identifiable net assets acquired</td>
<td>($45m)</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>30m</td>
<td></td>
</tr>
</tbody>
</table>

**Cash**

The cash consideration can be easily verified and is at low risk of misstatement.

**Contingent future consideration**

Judgment will have to be exercised as to the likelihood that the future consideration will be paid.

Based on current information this seems unlikely given the loss of business from Unum which accounts for 50% of revenue.

Management may be reluctant to ignore the contingent future consideration in the goodwill calculation as this will significantly reduce the value of this asset.
If contingent consideration is included then this would need to be valued at fair value which will involve a further judgment into the calculation and increases the risk of misstatement.

**Fair value of identifiable assets and liabilities**
Valuation of identifiable net assets and liabilities involves judgment which increases the risk of misstatement.
If there are issues with the external valuer's competence or independence, the valuation report may be less reliable.
Identifiable net assets may not include the amount due from Unum at the date of acquisition and could be overstated.
Amount due from Unum is 5.1% of net assets at the date of acquisition and is material.
Goodwill may be overstated as it needs to be impaired given the loss of business from Unum.

(b) Award up to one mark per risk of material misstatement identified and explained up to a maximum of five risks.

Changeover in Tiga's accounting systems and lack of parallel run.
Inadequate group-wide controls means a material misstatement may not be prevented or detected.
Unum's administration may mean trade receivables are overstated. The amount owing is 11% of group PBT and material.
Management override of credit control procedures could mean other balances are irrecoverable.
Tiga may no longer be a going concern and may be overstated in the financial statements (FS) of Tampine.
Lack of experience in group accounting at Tampine increases the risk of error. Already it can be seen that the consolidated FS include all Tampine's revenue from 20X3 where it should be from the purchase date.
Risk that intercompany balances have not been eliminated on consolidation.

(c) Carter Xhen will contact Wu Associates to inform them if they intend to rely on their work for the purposes of the Tampine Group Audit.

**Understanding the component**
SSA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).
Para 17 – The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. The group engagement team shall:
(a) enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage; and
(b) obtain an understanding of the consolidation process, including the instructions issued by group management to components.

Para A28 – The key members of the engagement team are required to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions may also include the component auditors. The group engagement partner's determination of who to include in the discussions, how and when they occur, and their extent, is affected by factors such as prior experience with the group.
Understanding the component auditor

Carter Xhen will contact Wu Associates to gain an understanding of the matters referred to below. Communication could be a discussion or questionnaire.

Para 19 – If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following:

(a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent;
(b) The component auditor’s professional competence;
(c) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
(d) Whether the component auditor operates in a regulatory environment that actively oversees auditors.

Note. Para numbers are not required; the principle is required

Carter Xhen will ask Wu Associates to confirm cooperation.

Significance of component

Tiga’s total assets are 8.3% of group assets and only 4 months profit is consolidated therefore it is not financially significant to the group.

Tiga may be significant due to its associated risks and Carter Xhen will contact Wu Associates to gain knowledge of these.

Planning and risk assessment

Carter Xhen will communicate the following.

- The need to review Wu Associates audit strategy and plan
- Specific audit procedures to be performed
- Group materiality levels and component materiality
- Group accounting policies
- Known related parties
- Significant risks relevant to the audit of Tiga

Review of Wu Associates Work

SSA 600 Para 42 – The group engagement team shall evaluate the component auditor’s communication. The group engagement team shall:

(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and
(b) Determine whether it is necessary to review other relevant parts of the component auditor’s audit documentation.

Note. Para numbers are not required; the principle is required.

Answer points

(a) Goodwill comprises:

<table>
<thead>
<tr>
<th>Description</th>
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<tr>
<td>Cash consideration paid on 31 August</td>
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<td>($45m)</td>
</tr>
<tr>
<td></td>
<td>30m</td>
</tr>
</tbody>
</table>
As the cash consideration on 31 August has been paid at $50m this is easily verified. However, there are significant risks associated with the other components of the calculation:

**Contingent future consideration**

Judgment will have to be exercised as to the likelihood that the future consideration will be paid, ie whether Tiga's revenue will reach the 5% increase target. Based on current information this seems unlikely given the loss of business from Unum which accounts for 50% of revenue.

Management may be reluctant to ignore the contingent future consideration in the goodwill calculation as this will significantly reduce the value of this asset. If contingent consideration is included then this would need to be valued at fair value which will involve a further judgment into the calculation.

**Fair value of identifiable assets and liabilities**

As the determination of the fair value of net assets at $45m was carried out externally the AE should be able to obtain a copy of the report prepared by the external valuer. However, there may be risks associated with the valuer's competence or independence, and the valuation of identifiable net assets acquired is inherently risky as it requires a degree of estimation.

There is also a potential question as to whether the net assets included the amounts due from Unum at the date of acquisition, as Tampine's finance director has indicated that the amount was outstanding for 'a number of months'. The fact that this amount was not recoverable at the date of acquisition may not have been appropriately identified or taken into account by the external valuer, which would result in the overstatement of the identifiable net assets acquired.

The amount due from Unum represents 5.1% of the net assets at the date of acquisition and is therefore significant in determining the appropriate value of goodwill arising at that date.

Given the loss of business from Unum there is also a question as to whether the goodwill has been impaired – again this is a matter of judgment which the directors must make when carrying out their impairment review. There is a significant risk that goodwill may be overstated.

(b) There are a number of issues which increase the audit risk in the individual financial statements of Tiga which will have a 'knock on' effect on the risk of a material misstatement being brought into the consolidation:

- Changeover of Tiga's accounting system increases risks of misstatement in figures included in consolidation for Tiga. This is compounded by the fact there was no parallel running of the two systems to check the new system was functioning correctly.

- Inadequate group-wide controls over Tiga's operations and financial information increases the risk of material misstatements in Tiga's financial statements not being prevented or detected.

- The subsequent event of Unum going into administration may lead to a risk of overstatement of trade receivables. The amount owed to Tiga by Unum is 11% of group draft profit before tax and therefore material to the group financial statements.

- There appears to have been management override of credit control procedures by the sales director at Tiga. This may indicate an increased risk of management override of controls elsewhere in Tiga's business and an increased risk of other trade receivables balances being irrecoverable.

- The loss of Unum and the write-off of the amounts due to Tiga would remove almost all profits made by Tiga in the year, and may indicate a potential going concern issue if Tiga is unable to replace the business it has lost from Unum with business from other clients. This could result in an overstatement of its net assets.

The management at Tampine has not previously had to account for a subsidiary corporation or prepare group financial statements and its lack of experience in this area will increase the risk of errors and material misstatements. The draft group financial statements appear to comprise a combination of the parent company figures as at 31 December 20X3 and the subsidiary
corporation figures as at 30 September 20X3 (ie revenue 95 + 8.3 = 103.3). This would be incorrect on two grounds, firstly, that revenue of Tiga should only be consolidated from purchase date (ie 31 August 20X3) and secondly, adjustment should have been made to the Tiga financial statements so they are consolidated at 31 December 20X3, at the parent company's year-end. The auditors will have to ensure that the CFO understands how the financial statements should be consolidated so that the group financial statements give a true and fair view.

In addition, the transactions and balances between Tampine and Tiga may not be appropriately identified or eliminated, particularly given the absence of group wide controls. The draft financial statements as they stand imply that any revenue earned by Tiga from Tampine has not been eliminated, as the total revenue included in the draft group financial statements is equal to the combined draft revenue recorded in the financial statements of the individual companies (ie 95 + 8.3 = 103.3 – no deductions for intra-group transactions).

(c) Only one month of the statement of profit or loss and comprehensive income being audited by Wu Associates will be relevant to the group audit, and the statement of financial position at 30 September 20X3 will have to be adjusted to the group year-end of 31 December 20X3.

Thus it is not clear if Carter Xhen will be relying on Wu Associates for the purposes of the group audit. Wu Associates should expect communication from Carter Xhen to inform them of whether Carter Xhen intend to use their work or request specific audit procedures.

Understanding of the component

SSA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) Para 17 requires Carter Xhen to obtain an understanding of the components of Tampine, which will include Tiga. This will enable Carter Xhen to identify and assess the risks of material misstatement.

There are several sources of information concerning Tiga, but as Wu Associates is the continuing auditor, Wu Associates would anticipate that the Carter Xhen partner or manager will contact them to obtain information about Tiga. SSA 600 Para A28 explains how component auditors may be included in the discussions required by SSA 240 regarding the susceptibility of the financial statements to material misstatements as a result of fraud. These discussions can be used as an opportunity for Carter Xhen to gain a better understanding of Tiga and its associated risks.

Understanding of the component auditor

If Carter Xhen do decide to use any of Wu Associates’ audit work or to request that Wu Associates perform procedures on the financial information prepared to reconcile Tiga's financial statements to the group year end, then Wu Associates becomes a component auditor for the purposes of the Tampine group audit.

Carter Xhen is required to obtain an understanding of any component auditors as per SSA 600 Para 19. As group auditor, Carter Xhen is responsible for ensuring that Wu Associates meets quality control and ethical requirements for the purposes of the group audit, and has the professional capability to carry out audit work to support the audit opinion.

Wu Associates is unknown to Carter Xhen. Therefore, it is likely Carter Xhen would contact Wu Associates in order to discuss Wu Associates policies and procedures in respect of quality control and to ensure that Wu Associates are independent for the purposes of the group audit. Alternatively, the partner at Carter Xhen might forward Wu Associates a questionnaire to complete detailing such matters. Carter Xhen will also ask Wu Associates to confirm their cooperation with the Tampine group audit.

Determination of significance of component

Carter Xhen is required to determine the significance of Tiga to the Tampine group. SSA 600 Para 9 defines a significant component as 'a component identified by the group engagement team that is of individual financial significance to the group, or that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements'. Carter Xhen must then plan audit procedures necessary to support the Tampine group audit opinion on the basis of this determination.
Tiga's total assets at 30 September 20X3 represent approximately 8.3% of group assets at 31 December 20X3. Events subsequent to Tiga's year-end suggest that the net assets will have fallen rather than increased in the time period up to 31 December 20X3. In terms of revenue and profit, only 4 months of Tiga's trading will be included in the consolidation, and so these will also reflect small percentages of the group totals. In terms of financial significance therefore, it appears that Tiga is not significant to the group (15% is generally considered financially significant).

However, given the risks associated with controls and the need to adjust Tiga's financial statements for consolidation due to the difference in accounting period, Carter Xhen may determine that Tiga is significant due to associated risks.

Wu Associates should expect Carter Xhen to communicate their thoughts on this matter, so that Wu Associates can contribute to the assessment of risks with their knowledge of Tiga.

Planning and risk assessment

If Tiga is believed to be significant, Carter Xhen will need to contact Wu Associates in order to review their audit strategy and plan as suggested in SSA 600.A55. Wu Associates should expect direction if there are any particular audit procedures which Carter Xhen wants them to carry out during the audit of Tiga. However, as only one month of the Tiga financial statements that Wu Associates is auditing will be consolidated into the group financial statements, Wu Associates should also expect guidance on any other procedures that Carter Xhen wants them to do in respect of the three month period which will require adjustment for the group accounts. Alternatively Wu Associates should expect to be informed that Carter Xhen will audit this adjustment themselves so Wu Associates is not required to.

Wu Associates should expect Carter Xhen to advise on an appropriate level of materiality for group purposes, and the threshold under which errors cannot be considered to be trivial. This is required by SSA 600 para 40 which states that the group engagement team should communicate ‘component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.’

In addition, Carter Xhen should advise Wu Associates of group accounting policies, any significant risks relevant to Wu Associates' work on the component, and also provide Wu Associates with a list of known related parties.

Review of Wu Associates' work

Wu Associates expect any audit work performed on Tiga relevant to the Tampine group audit to be reviewed by the Carter Xhen as required by SSA 600 Para 42 which states that.

The group engagement team shall evaluate the component auditor's communication. The group engagement team shall:

(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

(b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

In the first instance this may take the form of them requesting Wu Associates submit a report or questionnaire covering key audit judgments. However, should they consider it necessary, this review might also extend to Wu Associates' working papers.
13. Changi

Changi Enterprises Ltd (Changi) is a large diversified trading company which operates through a number of divisions. Changi is not part of a group. The auditors of Changi are Lewis Tan LLP and the audit for the year ended 31 December 20X5 is due to commence soon.

Changi had a difficult year in 20X5 and made an overall loss for the year. A significant factor in this loss was in a particular division, where there were unexpected increases in the cost of a significant raw material that Changi felt unable to pass on to its customers due to the existence of severe competition in the market. The Board decided not to declare an interim dividend, and it is unlikely that it will declare a final dividend. There has been speculation in the financial press that the company has failed to adapt to recent changes in the markets within which it operates and that it is unlikely to be able to compete successfully unless it takes drastic action in terms of its strategy and operations. The combination of these issues has had an impact on share price, which has fallen to a significant low.

Changi is financed by a combination of equity and loan finance. It has had a series of short term bank loans and makes full use of its overdraft facility. The most recent bank loan is due to be repaid in full on 31 July 20X6. The overdraft facility expires on that date as well. The Chief Finance Officer (CFO) is in advance talks with the bank about the nature of Changi's financing, and is hopeful that as well as renewing the overdraft facility, the bank will offer better, longer term loan arrangements to the company rather than it relying on short term loans. The company has not considered alternative borrowing arrangements if these negotiations are not successful at this stage. The company owns a number of industrial buildings in Singapore which the bank loans have historically been charged on.

The bank has asked for a business plan to support the application to restructure the loan arrangements, which the CFO is currently preparing. The bank has recently reviewed its lending policies and now is keen to obtain assurance in relation to information given to support loan applications.

The draft financial statements for the year show that as a result of the losses, the cash position has significantly worsened from the previous year.

The Board is considering a number of strategic options as a matter of urgency. One of these strategies is to vertically integrate with the key supplier of the affected raw materials to obtain economies of scale which should make Changi more competitive against the major competitor in that division. Another possible strategy which could also be undertaken is to move a centre of operations used in another division away from Singapore, where operating costs are increasing. The directors are considering moving this division's operations to China which would significantly reduce operating costs in the long run. A number of other options are under review, as the Board is aware that timely action may be necessary if the company is to continue in operation.

Required

(a) Identify and explain five indicators that the going concern basis of accounting may be in doubt for Changi.

(b) Evaluate two factors which mitigate against the doubt in the going concern basis of accounting at Changi.

(c) Conclude whether it is appropriate to prepare the financial statements of Changi using the going concern basis of accounting.

(d) In relation to the going concern basis of accounting, describe five pieces of audit evidence you would expect to see when reviewing the audit working papers of Changi.

(e) Describe the impact of the uncertainty in the going concern basis of accounting at Changi on the auditor's report.

(Total = 25 marks)
### 13. Changi: Answer

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<tr>
<td>Q12 Changi</td>
<td>Identify and explain indicators that the going concern basis may be in doubt and evaluate mitigating factors. Recommend audit procedures to evaluate the evidence that might be expected to be available and assess the appropriateness of the going concern basis in given situations. Assess the adequacy of disclosures in financial statements relating to going concern and explain the implications for the auditor's report with regard to the going concern basis.</td>
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#### Tutorial notes

The question tests Candidates knowledge of going concern issues, including the impact on the auditor's report. The question requires Candidates to think about the factors arising in the scenario in relation to the going concern basis of accounting and conclude whether it is appropriate to prepare financial statements on a going concern basis. When asked for a conclusion, Candidates must provide one with justification.

Evidence expected to be available would be that outlined in SSA 570 Going Concern, although Candidates should focus their answer on information given in the question.

#### Marking guide

(a) Award up to two marks per indicator identified and explained up to a maximum of five indicators.  

- Losses in the year/worsening gross margins.  
- No dividends paid in the year even though dividends were paid previously. Falling share prices as markets expect dividends to be paid.  
- Severe competition may not be sustainable.  
- Market capitalisation may be lower than net assets due to falling share price.  
- Inappropriate reliance on short term loans and overdraft.  
- Uncertainty over renewal of long term loan. No alternative arrangements are in place if the loan is not renewed.  
- Worsening cash position. The company may not be able to pay the short term loans as they fall due.  
- Moving to China would result in the disposal of assets being used to secure loan finance and may result in the bank having no assets on which to secure a charge.

(b) Award up to two marks per mitigating factor identified and explained up to a maximum of two factors.  

- Diversification of the company means that a loss-making division can be closed and resources diverted to profit-making divisions.  
- Profitable strategic options suggested by the company could increase the chances of the company obtaining financing. Positive press announcements concerning the new projects could boost the share price.
Changi has only approached the existing bank and there may be other available sources of finance not yet considered, such as alternative banks, issuing debentures or overseas finance.

(c) It is appropriate to prepare the financial statements of Changi using the going concern basis of accounting. However, there is a material uncertainty which needs to be disclosed (the long term loan which may not be renewed).

(d) Award up to one mark per piece of evidence identified up to a maximum of five pieces.

Management's assessment of going concern, including assumptions made in the assessment.
Changi's internal budgets and projections.
Business plan to support the loan application.
Minutes from management meetings.
Discussions with management about their future intentions.
Confirmation of balances and arrangements with the bank at the end of the reporting period.
Correspondence/contract with the bank regarding any new finance arrangement agreed after the end of the reporting period.
Documentary evidence of alternative finance arrangements eg share prospectus from a share issue.
A cash flow analysis of the operations if the proposed division is transferred to China to assess the improvement in cash position at Changi.
Notes from discussions with management detailing the other options under review to improve the cash flow of Changi, and a cash flow analysis assessing the potential improvement in the cash position at Changi for each option.
A listing of the industrial buildings on which the bank loan charges are on, and assessment of whether Changi's operations can continue should the bank repossess these buildings.

(e) The auditors can issue an unmodified auditor's report if the uncertainty regarding long term financing is resolved and no material uncertainty exists.
If long term financing is not arranged, there is a material uncertainty relating to going concern. If this is disclosed adequately the auditor's report will be unqualified.
The auditor's report will include a separate section headed 'Material Uncertainty Relating to Going Concern' placed immediately after the 'Basis for Opinion' section.
If the long term financing is not arranged and this is not disclosed adequately the opinion in the auditor's report will be qualified or adverse.
A 'Basis for Qualified/Adverse Opinion' section will be included immediately after the opinion paragraph which states a material uncertainty exists that casts significant doubt on Changi's ability to continue as a going concern and that this has not been adequately disclosed.
Answer points

(a) There are a number of financial factors which could indicate that the going concern basis of accounting is in some doubt.

The company has made a loss in the year. There is a possibility that this is an operating loss, due to the significant price increases in raw materials. Even if an operating loss has not been made, there is likely to have been a significant worsening of the gross margin. This is a factor that will have to be considered as part of the assessment of going concern. Substantial operating losses are an indicator of going concern problems.

The company has not paid dividends in relation to the year. Whether this is a significant indicator of going concern issues depends on the company's history of dividend payments, that is, whether this represents a discontinuance of expected dividends. The reduction in share price, partly as a result of the fact that dividends have not been declared, suggests that the market expects dividend payments, so this could be considered to be an indicator of going concern problems.

The existence of severe competition for the company could be an indicator of going concern problems, particularly if the competitor is relatively new to the market and Changi is not able to sustain that level of competition.

The share price of the company is at a significant low. If the company's market capitalisation has fallen below the value of its net assets this would be an indicator of going concern issues.

The company appears to have relied on a series of short term loans and an overdraft facility over a period of time. This appears to be inappropriate matching of short term financing methods with long term finance, which can also be an indicator of going concern problems.

The company's loan facilities expire within the forthcoming 12 months and at present, the company does not have any degree of certainty that these will be renewed. It is implied that non-renewal would be a cause for concern for the company. This fact therefore raises a significant uncertainty over the going concern basis for the financial statements.

At present, the company has not explored any alternative financing arrangements should negotiations with the bank not prove successful, and such alternative arrangements might take time, which could be costly to the company if it cannot cover operational costs in the meantime.

It is not clear whether the company is in a net current asset or liability situation. If the company has net current liabilities this is an indicator of going concern problems. The company has cash flow problems and it is not clear whether it has been able to maintain regular payments against its short term debt or whether it will be able to repay those short term loans as they fall due. Failure to meet required payments on loan finance and an inability to repay debt as it falls due are both indicators of going concern problems.

The general worsening of the cash position of the company may indicate going concern problems. This would be significant if the company had negative operating cash flows or were projecting such negative operating cash flows. It is also important to consider that strategic options designed to improve profitability in the long term may adversely impact cash flow in the short term, which might result in the company being unable to finance its restructuring and future intentions.

Assets used to secure loan finance in the form of charges are possibly at risk of disposal if the company transfers operations to China. It is not clear whether the company would be purchasing different assets on which loan finance could be secured, or whether this would represent additional difficulty in obtaining loan finance from the bank.

(b) A significant mitigating factor is that the company is diversified so that problems in one division may not threaten the company as a whole even if they have affected overall profitability and cash flow in the year under review. An option open to the company in the face of a significant loss-making division is to close that division and to divert resources elsewhere. Such a strategic option would mitigate the loss-making and competition indicators of going concern issues.
Another mitigating factor is the number of strategic options that the Board is considering, any of which could reduce the problems the company is facing in terms of profitability, although not necessarily cash flow in the short term. However, if the business plan proposes plans for future profitability, it may be possible to obtain financing to cover short term working capital problems.

Any announcement to the market of new projects with positive present values should counteract the negative press that has caused share price to fall and should boost share prices, which may improve the overall impression of going concern, and may ultimately open up an alternative source of finance to the company, that is, issuing new shares, if the shares are made more attractive by the company's plans.

Another factor to consider is that currently, the company appears only to have approached one source of finance, which is its existing banker. Even if the company is not able to come to agreement about extending its financing arrangements with the bank, it should be able to identify alternatives, such as different banks or even alternative sources of loan finance, such as issuing debentures. If it is considering relocating production overseas, it may be able to obtain finance overseas as well and match its assets with its liabilities there.

(c) Although the company is facing difficult trading conditions and there are some indicators of possible going concern issues, it is appropriate to present the company using the going concern basis of accounting in the financial statements for the year ended 31 December 20X5. If the financial statements were not to be presented on that basis, it could exacerbate the financial problems and precipitate a going concern problem, as it would increase the unlikeliness of lenders being prepared to lend to Changi, or would increase the cost of any loans that were offered.

However, the fact that the loan facilities expire during the 12 months after the year end date and at present no alternative arrangements have been made does represent a material uncertainty. This would have to be disclosed in the financial statements if arrangements are not in place at the date the financial statements are approved and issued.

(d) The most important piece of evidence that the auditors will expect to be available is management's own assessment of going concern. This is required by SFRS(I) 1-1 Presentation of Financial Statements and should cover a period of at least 12 months from the year end date. The auditors are required under SSA 570 Going Concern to consider a period longer than this, which is 12 months from the end of the reporting period. In this instance, it seems that the critical factor is whether the loan finance can be obtained, which has a relatively short time frame, but when considering management's assessment, the auditors should also consider whether the assumptions within it hold true for the longer term. Factors which they must consider include:

- Analysis of management's assessment in the context of the auditors' understanding of the entity and general knowledge obtained from the audit.
- Related to management's assessment will be internal budgets and projections which will support the assessment. The audit work papers should show that the auditors have evaluated the reliability of any underlying data used to produce the budgets and projections, for example the assumptions made in forecasting projected revenues and costs.
- The business plan produced by Changi to support the application to restructure the loan will also form an important part of the evidence concerning the going concern of the company.
- The auditors would expect evidence about management's future intentions (for example, business plans and decisions about strategic options) to be available in minutes of management meetings and also to be obtained through discussions with management.
- The auditors would expect certain information to be available from the bank, such as confirmation of balances and arrangements at the end of the reporting period. They would also hope that there is information available about any new arrangements entered into prior to the expiry date of the loan arrangements of July 20X6. What form this information takes might depend on the stage of the negotiations, but the auditor could inspect
correspondence with the bank and any draft arrangements, or if arrangements are finalised prior to the end of the audit period, the new contractual arrangements should be available.

- Notes from discussions with management enquiring if financing is being sought from alternative sources (such as alternative debt financing, for example, debentures, or possible share issues). If so, the auditors would expect to see evidence of this, such as prospectuses or correspondence or contractual documents.

- A cash flow analysis of the operations if the proposed division is transferred to China to assess the improvement in cash position at Changi.

- Notes from discussions with management detailing the other options under review to improve the cash flow of Changi, and a cash flow analysis assessing the potential improvement in the cash position at Changi for each option.

- A listing of the industrial buildings on which the bank loan charges are on, and assessment of whether Changi's operations can continue should the bank repossess these buildings.

(e) In order for a standard unmodified report to be issued, the auditors would need to be satisfied that the financial statements are free from material misstatements and they have obtained sufficient appropriate audit evidence. In addition, the financial statements would need to be free of material uncertainties. If the future financing of the company is resolved prior to the date of the auditor's report, it might be possible to issue a standard unmodified auditor's report.

If there is still a material uncertainty about the financing, but it is adequately disclosed, the auditor will be able to issue an unqualified opinion, but the report would include a 'Material Uncertainty Related to Going Concern' paragraph immediately after the 'Basis for Opinion' Section. This section highlights the issue and states that a material uncertainty exists.

If the material uncertainty is not adequately disclosed, the auditor's report would have an adverse or qualified opinion. A 'Basis for Qualified/Adverse Opinion' section will be included immediately after the opinion paragraph. The section states a material uncertainty exists that casts significant doubt on Changi's ability to continue as a going concern and that this has not been adequately disclosed in the financial statements.
14. Prosperity and Health Holdings

Prosperity and Health Holdings Limited (PHH) owns a cosmetic surgery clinic, several spas, and four alternative medicine centres across Singapore. In March 20X5, PHH paid $25 million in cash to acquire 100% of the ownership of AM Pte Limited (AM), a manufacturer of vitamins, food supplements and alternative medicines.

Ip & Soh associates have been group auditors of PHH for six years. It is now March 20X6, and the audit for the year ended 31 December 20X5 is coming to a conclusion. The following information has been brought to your attention:

**AM**

A government grant of $8m was received in October 20X4 to assist in developing a paleo-diet baby formula. The amount was deducted from the development costs of the project. Following worldwide criticism of the safety of such a formula, the project was cancelled in November 20X5. The government have since asked for the grant to be partly repaid.

Wellness Products Limited ‘Wellness’, a large customer of AM, went into liquidation on 3 January 20X6 owing $2m. At this stage the liquidator believes it unlikely that any payment will be made to unsecured creditors. The directors have not made any amendments to the financial statements as the matter occurred after the end of the reporting period.

A loan of $20m is owing to AHB Bank Limited. The loan is due to be repaid on 30 June 20X6. AM currently has insufficient funds available to repay this loan, but the directors are intending to ask that the loan be renewed for a further 12 months and are optimistic that this will take place. When PHH acquired AM, it agreed to take over guarantees of AM's borrowings which had been formerly given by the directors of AM.

**PHH**

In January 20X5 it was discovered that certain items of inventory had been double-counted, resulting in inventory at 31 December 20X4 being overstated by $2.4 million. The financial statements do not reflect this error but the directors have agreed to make a correction following a meeting with the audit partner.

During 20X4 a class action was commenced against PHH by customers who had experienced severe gastrointestinal problems following treatment with some of PHH's dietary supplements. The directors believed that no provision was necessary in respect of these claims, but disclosures were made for the contingent liability. In July 20X5 the cases were settled for $15 million. This has not been reflected in the financial statements as the amount has not yet been paid.

Draft net assets for the PHH Group was $106m and for AM $24 million.

**Required**

(a) With reference to appropriate Singapore Financial Reporting Standards (International), evaluate the treatment of the government grant in the financial statements of AM. (3 marks)

(b) State three audit procedures to be performed in relation to the government grant in the financial statements of AM. (3 marks)

(c) With reference to appropriate Singapore Financial Reporting Standards (International), evaluate the treatment of the insolvent customer in the financial statements of AM. (4 marks)

(d) State three audit procedures to be performed in relation to the receivable from the insolvent customer in the financial statements of AM. (3 marks)

(e) State six audit procedures to be performed in relation to the loan owing to AHB Bank in the financial statements of AM. (6 marks)

(f) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the treatment of the inventory overstatement at PHH and recommend any adjustments to be made in the 20X4 and/or 20X5 financial statements. (3 marks)
(g) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the treatment of the class action in the 20X5 financial statements of PHH and recommend any adjustments to be made.  

(3 marks)

(Total = 25 marks)
14. Prosperity and Health Holdings: Answer

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<td>Q14 Prosperity and Health Holdings</td>
<td>Specify audit procedures designed to identify subsequent events that may require adjustment to, or disclosure in, the financial statements of a given entity or steps to be taken for subsequent discovery of facts.</td>
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<td>Identify accounting estimates and recommend audit procedures and evaluate evidence supporting the assumptions and reasonableness of the estimates, including the related disclosures.</td>
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<td>Apply and evaluate audit procedures for all transactions in the extant syllabus for the Financial Reporting module.</td>
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Tutorial notes

This question tests Candidates’ ability to audit events after the end of the reporting period and prior period events. A sound understanding of SFRS(I) 1-8 and SFRS(I) 1-10 will help Candidates to answer all the requirements in the time allotted.

When asked to provide audit procedures, Candidates should ensure these are specific to the scenario and explain why the procedure is required. In explaining potential misstatements, Candidates must remember to calculate materiality where appropriate and comment on whether the misstatement is material or not.

Marking guide

(a) SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance

Para 24 – Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

Note. Para numbers are not required; the principle is required

The grant is 33.3% of net assets and so is material.

The grant needs to be partly repaid and so the amount to be repaid must be added back to development costs and a liability set up.

Development costs are likely to be impaired unless the work can be used on another project.

(b) Award up to one mark per procedure up to a maximum of three procedures.

Read the terms of the grant to find any details of repayment terms and conditions.

Inspect correspondence between AM and the government to confirm the demand for repayment has been made, how much of the grant must be repaid and when it must be repaid by.

Review the terms of the grant to identify whether there are any penalty clauses and if so how they have been accounted for.
If AM is claiming that the development work can be used on another project, review details of that project to assess that project's likely success.

Considered AM's cash flow forecast in order to assess the likelihood of AM being able to repay the amount owing.

### (c) SFRS(I) 1-10 Events After the Reporting Period

Para 9 – The following are examples of adjusting events after the reporting period that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

... 

(b) the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:

(i) the bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable; ...

Note. Para numbers are not required; the principle is required.

An adjusting event is between the end of the reporting period and the date on which the financial statements are authorised for issue and which provides evidence of conditions that existed at the end of the reporting period.

Now that the customer has gone into liquidation it is evidence that the debt will not be paid and should therefore be written off.

The irrecoverable debt is 8.3% of net assets and is material.

### (d) Award up to one mark per procedure up to a maximum of three procedures.

Agree the amount outstanding at the period end to the receivables ledger to confirm that prior to the liquidation a balance of $2m was owed.

Obtain the notification document from the liquidator to confirm that Wellness has gone into liquidation and the date this was declared.

Review bank statements after the end of the reporting period for any amounts received in relation to the outstanding $2m balance.

Enquire of management as to whether any amounts have been received in relation to the $2m outstanding and ask for documentary evidence.

Consider whether receivables due from other customers are recoverable.

Review Board minutes from after the end of the reporting period for any discussion of the balance outstanding from Wellness.

### (e) Award up to one mark per procedure up to a maximum of six procedures.

Obtain the loan agreement to confirm the following details:

- Name of the lender
- Initial amount of the loan
- Repayment terms and interest rate
- Security

Agree the opening balance to the previous year's financial statements and working papers.

Reconcile the opening balance to the closing balance and trace repayments (if any made during the year) to the cash book.
Recalculate the interest charge for the year based on the details obtained from the loan agreement and trace the entries to the correct general ledger accounts.

Review the disclosures in the financial statements to confirm the loan has been disclosed as a liability due within one year.

Perform a review of the cash flow forecast to confirm that insufficient funds would be available.

Obtain and review documentation to confirm the extent to which AM’s borrowings are guaranteed by PHH.

(f) Overstatement is 2.4% of net assets and material to the financial statements of PHH.

SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors

Para 42 – … an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:
(a) restating the comparative amounts for the prior period(s) presented in which the error occurred.

Note. Para numbers are not required; the principle is required

The error will be corrected in the comparatives of the 20X5 financial statements. The correction will be as follows.
Dr Cost of sales $2.4m
Cr Inventory $2.4m
Being correction of prior period overstatement of inventory.

3 marks

(g) The settlement of the legal case is 14.2% of net assets and is highly material to the financial statements of PHH.

The settlement of the legal cases is a revision of an accounting estimate.

SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors

Para 36 – … The effect of a change in an accounting estimate, … shall be recognised prospectively by including it in profit or loss in:
(a) the period of the change, if the change affects that period only; or
(b) the period of the change and future periods, if the change affects both.

The adjustment proposed would be as follows.
Dr Legal costs (P&L) $15m
Cr Creditor (SOFP) $15m
Being settlement of legal case not yet paid

3 marks

Answer points

(a) The grant was intended to contribute to development costs and so should either have been deducted from development costs or set up as a deferred credit (SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance Para 24) so, although the deferred credit approach is preferred by many, the treatment adopted by AM is acceptable.

The grant will need to be repaid in part, since the project has been cancelled. The amount to be repaid should be added back to development costs and a liability set up.

The grant is 33.3% of net assets so is highly material to the financial statements of AM.

The fact that the project has been cancelled means that the development cost is likely to be impaired. Unless the work can be utilised on some other project, which seems unlikely, it should be written down to zero.
(b) Read the terms of the grant to find any details of repayment terms and conditions.

Inspect correspondence between AM and the government to confirm the demand for repayment has been made, how much of the grant must be repaid and when it must be repaid by.

Review the terms of the grant to identify whether there are any penalty clauses and if so how they have been accounted for.

If AM is claiming that the development work can be used on another project, review details of that project to assess that project's likely success.

Considered AM's cash flow forecast in order to assess the likelihood of AM being able to repay the amount owing.

(c) In accordance with SFRS(I) 1-10 Events After the Reporting Period Para 9b, the insolvency of the customer after the year-end is an adjusting event. This is an event which occurs between the end of the reporting period and the date on which the financial statements are authorised for issue and which provide evidence of conditions that existed at the end of the reporting period. The directors of AM are mistaken in their assertion that no adjustment needs to be made.

The fact that the customer went into liquidation so soon after the period end provides evidence that the receivable recorded at the year-end was not recoverable, as the customer was experiencing financial difficulties. Now that the customer has gone into liquidation it is evidence that the debt will not be paid and should therefore be written off.

The amount of $2 million to be written off is 8.3% of net assets and is material to the financial statements of AM.

(d) Check the amount outstanding at the period end to the receivables ledger to confirm that prior to the liquidation a balance of $2 million was owed.

Obtain the notification document from the liquidator to confirm that Wellness has gone into liquidation and the date on which this has been declared.

Review bank statements after the end of the reporting period for any amounts received from Wellness in relation to the outstanding $2 million balance.

Enquire of management as to whether any amounts have been received from Wellness in relation to the $2m outstanding and ask for documentary evidence.

Consider whether receivables due from other customers are recoverable.

Review Board minutes from after the end of the reporting period for any discussion of the balance outstanding from Wellness.

(e) Obtain the loan agreement to confirm the following details:
- Name of the lender
- Initial amount of the loan
- Repayment terms and interest rate
- Security

Agree the opening balance to the previous year's financial statements and working papers.

Reconcile the opening balance to the closing balance and trace repayments (if any made during the year) to the cash book.

Recalculate the interest charge for the year based on the details obtained from the loan agreement and trace the entries to the correct general ledger accounts.

Review the disclosures in the financial statements to confirm that the loan has been disclosed correctly as a liability due within one year.

Perform a review of the cash flow forecast to confirm that insufficient funds would be available.

Obtain and review documentation to confirm the extent to which AM's borrowings are guaranteed by PHH.
(f) The inventory is 2.4% of net assets and is material to the financial statements of PHH. This overstatement is a prior period error and the financial statements should be corrected as though the error was corrected in the period it was made as per SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors Para 42. Thus the error will be corrected in the comparatives of the 20X5 financial statements. PHH will also need to include disclosure of the prior period error as described in SFRS(I) 1-8 Para 49.

The comparatives in the 20X5 financial statements will need to be restated as follows.

Dr Cost of sales $2.4m
Cr Inventory $2.4m
Being correction of prior period overstatement of inventory.

(g) The settlement of the legal case is 14.2% of net assets and is highly material to the financial statements of PHH.

The settlement of the legal cases represents the revision of an accounting estimate; the estimate of damages was originally estimated at zero but has now been revised to $15m.

SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors Para 36 requires that accounting estimates are adjusted in the year that the revision takes place, so the $15m would be recorded as a charge against the 20X5 profits. The adjustment proposed would be as follows.

Dr Legal costs (P&L)
Cr Creditor (SOFP)

Being settlement of legal case not yet paid.
15. Rochor

Your accounting entity has recently completed the audit work on the financial statements of Rochor Pte Ltd (Rochor) for the year ending 31 December 20X3 and you are responsible for the overall review of the audit evidence obtained. During your review of the audit working papers you note the following uncorrected misstatements:

1. No accrual has been included for telephone expenses for the period 1 November to 31 December 20X3. No invoice has yet been received for this period but telephone expenses for the three months to 31 October 20X3 amounted to $12,110.

2. During audit procedures to physically verify items of plant and equipment it was identified that plant with a carrying value of $17,000 had been scrapped during the year, but was not removed from the asset register. A sample of assets with a carrying value of $7.8 million was tested for physical verification, from a total population of assets with a carrying value of $49 million.

3. For the first time management has included a general provision of $150,000 in the financial statements for unexpected expenses. Your AE has discussed with management that such a provision is not in accordance with Singapore Financial Reporting Standards (International). However, management has refused to remove the provision from the financial statements for the year ending 31 December 20X3.

4. During the inventory count on 31 December 20X3 a small warehouse was omitted from the count in error but this was not identified until 15 January 20X4. The inventory in the small warehouse was counted on 15 January and valued at $87,000. Inventory records indicate that between 1 and 15 January 20X4 goods valued at $15,000 were received and goods valued at $19,000 were despatched from the small warehouse.

Materiality for the audit has been set at $120,000.

**Required**

(a) Produce a schedule of uncorrected misstatements in the financial statements of Rochor for the year ending 31 December 20X3.  
(b) Evaluate the materiality for each uncorrected misstatement identified in (a) above for the financial statements of Rochor for the year ending 31 December 20X3.  
(c) Describe one further audit procedure to be performed on each of the uncorrected misstatements of Rochor for the year ending 31 December 20X3. Explain the purpose of each procedure.  
(d) With reference to appropriate Singapore Standards on Auditing, describe the impact on the auditor's report if no adjustments are made to correct the misstatements.  
(e) With reference to appropriate Singapore Standards on Auditing, describe the impact on the auditor's report if the general provision is removed, but no other adjustments are made to correct the misstatements.

(Total = 25 marks)
15. Rochor: Answer

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<th>Cognitive level</th>
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<td>Q15 Rochor</td>
<td>Explain the use of analytical procedures in evaluation and review.</td>
<td>12</td>
<td>3</td>
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<td>Recognise and evaluate the factors to be taken into account when forming an opinion</td>
<td>16</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>in a given situation and justify opinions that are consistent with the results of audit or assurance procedures.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Tutorial notes

This question test Candidates' knowledge of the action to take where there are uncorrected misstatements in the financial statements and the impact on the auditor's report if the corrections are not made.

Candidates must be familiar with the format of a schedule of uncorrected misstatements in order to score well in this question. Where further audit procedures are asked for, remember that planned audit procedures will already have been performed. Focus the audit procedures on the misstatements identified and do not suggest general audit procedures for inventory, accruals etc.

Describing the impact on the auditor's opinion should be straightforward. Candidates should ensure they refer to the SSAs when this is part of the requirement.

Marking guide

<table>
<thead>
<tr>
<th>(a)</th>
<th>Issue</th>
<th>Statement of profit or loss</th>
<th>Statement of financial position</th>
<th>8 marks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Issue</td>
<td>Dr</td>
<td>Cr</td>
<td>Dr</td>
</tr>
<tr>
<td>1</td>
<td>Unaccrued telephone expenses (W1) (factual)</td>
<td>8,073</td>
<td></td>
<td>8,073</td>
</tr>
<tr>
<td>2</td>
<td>Scrapped equipment included in asset register (W2) (judgmental)</td>
<td>106,796</td>
<td></td>
<td>106,796</td>
</tr>
<tr>
<td>3</td>
<td>General provision not in accordance with Financial Reporting Standards (factual)</td>
<td></td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Omitted inventory (W3) (factual)</td>
<td>114,869</td>
<td>241,000</td>
<td>91,000</td>
</tr>
</tbody>
</table>

W1 Unaccrued telephone expenses

$12,110 \times 2/3 = 8,073$

W2 Scrapped equipment included in asset register

$17,000/7.8 \text{ m} = 0.21795\% \text{ error rate}$
Extrapolate error rate to whole population: \(0.21795\% \times 49\text{ m} = 106,796\)

**W3 Omitted inventory**

Inventory at 15 January 20X4 = $87,000  
Less: inventory received ($15,000)  
Add: inventory despatched $19,000  
$91,000

(b) **Telephone expenses**

The unaccrued telephone expenses are not material as they are less than 10% of materiality.  
However, it is unusual to omit a routine accrual so is significant.

**Scrapped equipment**

The error in the scrapped equipment is immaterial individually but must be extrapolated to the population as a whole as it could be indicative of a wider issue.  
Extrapolating gives an error of $106,796 which is not material.

**Provision**

General provisions are not allowed under SFRS(I) 1-37. As this provision of $150k is above materiality of $110k it is material and must be adjusted.

**Inventory**

The amount of $91k is less than materiality so is not material in isolation. It is not trivial (may be an attempt by management to manipulate profits).

(c) **Award up to two marks per procedure explained up to a maximum of four procedures.**

**Unaccrued telephone expenses**

Review the pattern of usage in prior years.  
**Purpose:**

To ascertain that the assumption that usage throughout the year is even is appropriate.

**Scrapped equipment included in asset register**

Enquire of management as to why the scrapped equipment was included in the asset register.  
**Purpose:**

To ascertain whether the error identified in the sample selected is an anomaly or whether the same rate of error might exist in the population as a whole.

**General provision not in accordance with Financial Reporting Standards**

Further discussion with management to explain why the provision does not meet the requirements of SFRS(I) 1-37 and that if not removed this would constitute a material misstatement necessitating a qualified opinion.  
**Purpose:**

To ensure management understand the consequences of their actions (ie the resultant qualified opinion).

**Omitted inventory**

Observe inventory count records with the quantity of inventory at 15 January 20X4 as well as evidence as to the movements in and out of the warehouse in question (eg goods received notes and goods despatched/delivery notes).

**Purpose:**

To provide evidence of the value of inventory at the end of the reporting period.
Practice Workbook: Section 2 | ASSURANCE

(d) SSA 705 Modifications to the Opinion in the Independent Auditor's Report.

Para 7 – The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements;

Note. Para numbers are not required; the principle is required

The opinion will be qualified ('except for') as there are material misstatements which are not pervasive.

(e) SSA 705 Modifications to the Opinion in the Independent Auditor's Report.

Para 7 – The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements;

There are still material misstatements in aggregate, even though the provision has been removed so the opinion will still be qualified as there are material misstatements that are not pervasive.

Answer points

(a) A number of uncorrected misstatements have been identified during the audit work. The auditor is required by SSA 450 Evaluations of Misstatements Identified during the Audit to accumulate misstatements identified on the audit unless they are clearly trivial. The misstatements identified during this audit can be summarised as follows:

<table>
<thead>
<tr>
<th>Issue</th>
<th>Statement of profit or loss</th>
<th>Statement of financial position</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr</td>
<td>Cr</td>
</tr>
<tr>
<td>1</td>
<td>Unaccrued telephone expenses (W1) (factual)</td>
<td>8,073</td>
</tr>
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<td>Scrapped equipment included in asset register (W2) (judgmental)</td>
<td>106,796</td>
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<td>3</td>
<td>General provision not in accordance with Financial Reporting Standards (factual)</td>
<td>150,000</td>
</tr>
<tr>
<td>4</td>
<td>Omitted inventory (W3) (factual)</td>
<td>91,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>114,869</td>
</tr>
<tr>
<td></td>
<td></td>
<td>241,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>126,131</td>
</tr>
</tbody>
</table>

W1 Unaccrued telephone expenses

$12,110 \times 2/3 = 8,073$

W2 Scrapped equipment included in asset register

$17,000/7.8m = 0.21795\%$ error rate

Extrapolate error rate to whole population: $0.21795\% \times 49m = 106,796$

W3 Omitted inventory

Inventory at 15 January 20X4 = $87,000
Less: inventory received ($15,000)
Add: inventory despatched $19,000

$91,000$
(b) ‘Clearly trivial’ does not mean the same as ‘not material’. Whether an item is clearly trivial should be judged in relation to size, nature and circumstance. The significance of the misstatements must be considered individually.

**Unaccrued telephone expenses**

Two months of telephone expenses have been omitted from the financial statements as no accrual has been included. Based on prior months' telephone usage an accrual of $8,073 is required reducing profit and increasing liabilities. The amount is not material in isolation. In monetary terms, this seems as if it might be clearly trivial, as it represents less than 10% of the monetary materiality level. However, the omission of an accrual that is likely to be routine is unusual, and this in itself gives it significance. In addition, if it is simply an accidental omission on the part of the finance director, it seems reasonable to include it in a list of points to bring to his attention, as he may wish to correct that mistake.

**Scrapped equipment included in asset register**

Inclusion of items of scrapped equipment results in the overstatement of plant and equipment in the financial statements. The error in the sample tested may indicate an error in the population as a whole. Assuming an error rate consistent with that found in the sample of assets tested, plant and equipment as a whole is estimated to be overstated by $106,796. Adjustment will result in reducing profit and assets. The amount is not material in isolation.

**General provision not in accordance with Financial Reporting Standards**

As already discussed, the inclusion of a general provision is not allowed under SFRS(I) 1-37 Provisions, contingent liabilities and contingent assets. SFRS(I) 1-37 sets out the circumstances in which provisions should be accounted for, which is when there is a present obligation as a result of a past event. The fact that this provision is in respect of 'unexpected' expenses proves that it does not relate to a past event and there is no present obligation. Thus it is inappropriate to include it in the financial statements. The amount of $150,000 is material and therefore must be adjusted in order for the financial statements to be presented fairly.

**Omitted inventory**

Inventory held at the end of the reporting period was not included in the year end count resulting in an understatement of inventory and profit amounting to $91,000. This amount is not material in isolation. However, it is not clearly trivial. In combination with the general provision above, it could be seen as an attempt by management to materially understate profits.

(c) **Unaccrued telephone expenses**

Review the pattern of usage in prior years to ascertain that the assumption that usage throughout the year is even is appropriate.

**Scrapped equipment included in asset register**

Audit work will need to be undertaken to ascertain whether the error identified in the sample selected is an anomaly or whether the same rate of error might exist in the population as a whole. The causes of the errors identified, such as lapses in internal control, will need to be discussed with management.

**General provision not in accordance with Financial Reporting Standards**

Further discussion will be required with management if they continue to insist on the inclusion of the provision, as this would constitute a material misstatement necessitating a qualified opinion on this matter.

**Omitted inventory**

The AE will need evidence of the quantity of inventory at 15 January 20X4 (eg inventory count records) as well as evidence as to the movements in and out of the warehouse in question (eg goods received notes and goods despatched/delivery notes) in order to provide evidence of the value of inventory at the end of the reporting period.
(d) In accordance with SSA 705 Modifications to the Opinion in the Independent Auditor's Report Para 7(a), there will be a modified, qualified opinion ('except for') since there will be a material misstatement that is unlikely to be considered pervasive.

(e) Assuming further audit procedures found the error identified in the asset register relating to the inclusion of the scrapped equipment was not an anomaly, the auditors would still have to issue a modified, qualified opinion ('except for') since the aggregate of uncorrected misstatements continues to be material. This is in accordance with SSA 705 Modifications to the Opinion in the Independent Auditor's Report Para 7 which states that 'the auditor shall express a qualified opinion when... having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.'
16. PPP & CCC

Your accounting entity has two clients Pasir Panjang Packaging Pte Ltd (PPP) and Caldecott Conferences and Conventions Pte Ltd (CCC).

Pasir Panjang Packaging

Pasir Panjang Packaging Pte Ltd (PPP) specialises in the manufacture of aluminium bottles and cans used for packaging beverages. Approximately 80% of the company's revenue is earned from the production of cans in the company's sole factory in Pasir Panjang. PPP has plans to purchase new equipment which would be able to produce 25% more cans and bottles in a 24-hour period. The equipment costs $500k and PPP has applied to the bank for a five year loan to cover the cost of investment. They plan to purchase the equipment on 1 January 20X5.

Your accounting entity has been asked to provide assurance on the two year forecast financial statements to support the bank loan application. PPP has provided the following information.

Forecast statement of financial position (extracts)

<table>
<thead>
<tr>
<th></th>
<th>Year ended 31 December 20X3 (audited)</th>
<th>Year ended 31 December 20X4 (forecast)</th>
<th>Year ended 31 December 20X5 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>586</td>
<td>599</td>
<td>765</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(426)</td>
<td>(458)</td>
<td>(114)</td>
</tr>
<tr>
<td></td>
<td>160</td>
<td>141</td>
<td>651</td>
</tr>
<tr>
<td>Receivables</td>
<td>150</td>
<td>152</td>
<td>185</td>
</tr>
<tr>
<td>Inventory</td>
<td>250</td>
<td>256</td>
<td>318</td>
</tr>
<tr>
<td>Bank</td>
<td>16</td>
<td>535</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>416</td>
<td>943</td>
<td>535</td>
</tr>
<tr>
<td>Total assets</td>
<td>576</td>
<td>1,084</td>
<td>1,186</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>481</td>
<td>488</td>
<td>666</td>
</tr>
<tr>
<td>Bank loan</td>
<td>0</td>
<td>500</td>
<td>400</td>
</tr>
<tr>
<td>Trade payables</td>
<td>95</td>
<td>96</td>
<td>120</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td>576</td>
<td>1,084</td>
<td>1,186</td>
</tr>
</tbody>
</table>
### Forecast statement of profit or loss (extracts)

<table>
<thead>
<tr>
<th></th>
<th>Year ended 31 December 20X3 (audited)</th>
<th>Year ended 31 December 20X4 (forecast)</th>
<th>Year ended 31 December 20X5 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Revenue</td>
<td>795</td>
<td>801</td>
<td>1,001</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>472</td>
<td>476</td>
<td>595</td>
</tr>
<tr>
<td>Gross profit</td>
<td>323</td>
<td>325</td>
<td>406</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>205</td>
<td>205</td>
<td>256</td>
</tr>
<tr>
<td>Finance cost</td>
<td>0</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>118</td>
<td>115</td>
<td>125</td>
</tr>
</tbody>
</table>

### Caldecott Conferences and Conventions

Your accounting entity is also carrying out the group audit of Caldecott Conferences and Conventions Pte Ltd (CCC). Events International Pte Ltd (Events International) is the 100% owned subsidiary of CCC.

Audit work on the receivables of Events International revealed an amount of $595k on the receivables ledger which was more than twelve months old relating to a conference arranged for Lalla Pte Ltd (Lalla). The directors of Events International have informed you that Lalla is having financial difficulty. The directors refuse to make an allowance or the outstanding amount as they believe it will eventually be paid. They are unable to provide any evidence to support this assertion. Since the directors are refusing to make this allowance, the auditor's report on the financial statements of Events International is qualified on the basis that receivables are materially misstated.

Events International draft financial statements show revenue of $12.7m, profit before tax of $3.4m and total assets of $15.2m.

### Required

(a) Describe seven procedures that your AE should undertake on the prospective statement of financial position of PPP. Explain the purpose of each procedure. (7 marks)

(b) Describe seven procedures that your AE should undertake on the prospective statement of profit or loss of PPP. Explain the purpose of each procedure. (7 marks)

(c) Describe the form and content the report on the engagement at PPP is likely to take. (5 marks)

(d) Comment on the impact of the outstanding receivable from Lalla on the auditor's report of CCC. (6 marks)

(Total = 25 marks)
16. PPP & CCC: Answer

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<table>
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<td>Describe examination procedures for forecasts and projections.</td>
<td>14</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Explain the implications for the auditor's report on the financial statements of</td>
<td>11</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>an entity where the opinion on a component is qualified or otherwise modified in</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>a given situation.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Tutorial notes

This question tests Candidates' knowledge of performing and reporting on a prospective financial information engagement in addition to group auditor considerations.

When suggesting procedures to perform on the prospective financial information, consider the purpose of the engagement, the assurance required and the nature of the engagement. Procedures must be tailored towards the scenario in the question.

Marking guide

(a) Award up to seven marks per procedure up to a maximum of seven procedures. 7 marks

Examine quotes for the new machinery to verify the additional costs to property, plant and equipment for the year ending 31 December 20X5.

Consider whether the timing of the purchase of the new equipment has been reflected accurately in the forecast financial statements.

Check that the cost and accumulated depreciation of any existing machinery to be sold or scrapped has not been included in the forecast financial statements.

Ensure the depreciation charge in the statement of financial position is consistent with that in the statement of profit or loss.

Examine projected activity to verify the increase in inventory levels.

Agree the cash balance to a forecast cash flow if this exists and enquire of the reason for any differences. This should ensure the assumptions made are in line.

Agree the projected bank loan balance to a loan agreement or application if this exists to assess the valuation of the projected loan.

Agree the projected bank loan balance to a cash inflow on the forecast cash flow statement to ensure this has been taken into account.

Calculate receivables as a percentage of revenue for each of the audited and forecast periods to ensure this is relatively consistent.

Calculate payables as a percentage of cost of sales for each of the audited and forecast periods to ensure this is relatively consistent.

Calculate payables and receivables days for each of the actual and forecast periods and compare to ensure they are relatively consistent.

Ensure that accounting policies used are appropriate and consistent with previous accounting information being used for comparison.
Agree the information for the year ended 31 December 20X3 to the audited statement of financial position to ensure this has been extracted correctly.

Recalculate the statement of financial position to ensure accuracy.

Perform analytical procedures on the forecast financial statements by comparing it with actual figures in the prior year to identify any anomalies. Enquire of management as to the reason for any unusual variances.

Consider the accuracy of any forecast financial information PPP have produced before.

(b) Award up to seven marks per procedure up to a maximum of seven procedures.

Enquire of management how long they anticipate between the purchase of the new machinery on 1 January 20X5 and the new machinery actually being used to produce cans and bottles by PPP.

Enquire as to the plans for the existing machinery in the factory and ensure any profits or losses from sale of this machinery have been included in the forecast financial statements.

Enquire of management if they anticipate any time when the factory at Pasir Panjang is unable to produce bottles or cans due to the switchover to the new machinery.

Enquire of management how they have forecast revenue at PPP, for example have they extrapolated historical data or used known sales and contracts to produce the forecast.

Compare revenue with prior years and ensure that only known changes explain any difference.

Compare cost of sales with prior year and ensure that any changes are consistent with the forecast increase in revenue and production due to the new machinery.

Calculate gross margins and investigate differences.

Ascertain why operating costs are forecast to increase and verify any assumptions appear reasonable/are in accordance with past trends.

Compare any assumptions made with general industry data and trends in the beverages packing industry.

Estimate loan interest on the bank loan using the bank's current rate of interest/copy of loan agreement and ensure that interest payments are included.

Ensure that accounting policies used are appropriate and consistent with previous accounting information being used for comparison.

Agree the information for the year ended 31 December 20X3 to the audited statement of profit or loss to ensure this has been extracted correctly.

Recalculate the statement of profit or loss to ensure this is accurate.

Perform analytical procedures on the statement of profit and loss by comparing it with actual figures in the prior year to identify any anomalies. Enquire of management as to the reason for any unusual variances.

Consider the accuracy of any forecast financial information PPP have produced before.
(c) Form and content of the report are given in SSAE 3400 *The Examination of Prospective Financial Information*.

The report will:

- Include a statement of negative assurance on whether the assumptions provide a reasonable basis for the PFI
- Be addressed to the appropriate party as agreed in the terms of engagement
- Identify the PFI being reported on
- State that the PFI was prepared by PPP management
- Include a restriction on use
- Give an opinion as to whether the PFI has been properly prepared on the basis of the assumptions underpinning the PFI
- Contain caveats as to the likelihood of achievability of assumptions
- Be dated and signed, and contain the auditor's address

5 marks

(d) A subsidiary of CCC has a qualified auditor's report this may be significant for the group auditor's report.

The misstatement giving rise to the qualification is 0.6% of group revenue, 2.3% of group profit before tax and 0.2% of total group assets so is borderline material for the purposes of the group auditor's report.

The subsidiary is not a financially significant component to the group in terms of revenue (12.1%), profit before tax (12.9%) or total assets (5.9%).

SSA 600.A5 suggests the group engagement team considers that components exceeding 15% of the chosen benchmark are significant components (although it also states that a higher or lower percentage may be appropriate depending on the circumstances).

Assuming that the 15% benchmark is appropriate in this case, the auditor's opinion on CCC remains unmodified.

6 marks

Answer points

(a) Any seven from the following:

- Examine quotes for the new machinery to verify the additional costs to property, plant and equipment for the year ending 31 December 20X5.
- Consider whether the timing of the purchase of the new equipment has been reflected accurately in the forecast financial statements.
- Check that the cost and accumulated depreciation of any existing machinery to be sold or scrapped has not been included in the forecast financial statements.
- Ensure the depreciation charge in the statement of financial position is consistent with that in the statement of profit or loss.
- Examine projected activity to verify the increase in inventory levels.
- Agree the cash balance to a forecast cash flow if this exists and enquire of the reason for any differences. This should ensure the assumptions made for cash forecasts are in line.
- Agree the projected bank loan balance to a loan agreement or application if this exists to assess the valuation of the projected loan.
- Agree the projected bank loan balance to a cash inflow on the forecast cash flow statement to ensure this has been taken into account.
Calculate receivables as a percentage of revenue for each of the audited and forecast periods to ensure this is relatively consistent.

Calculate payables as a percentage of cost of sales for each of the audited and forecast periods to ensure this is relatively consistent.

Calculate payables and receivables days for each of the actual and forecast periods and compare to ensure they are relatively consistent.

Ensure that accounting policies used are appropriate and consistent with previous accounting information being used for comparison.

Agree the information for the year ended 31 December 20X3 to the audited statement of financial position to ensure this has been extracted correctly.

Recalculate the statement of financial position to ensure accuracy.

Perform analytical procedures on the forecast financial statements by comparing it with actual figures in the prior year to identify any anomalies. Enquire of management as to the reason for any unusual variances.

Consider the accuracy of any forecast financial information PPP have produced before.

(b) Any seven from the following:

- Enquire of management how long they anticipate between the purchase of the new machinery on 1 January 20X5 and the new machinery actually being used to produce cans and bottles by PPP.

- Enquire as to the plans for the existing machinery in the factory. Ensure any profits or losses from sale of this machinery have been included in the forecast financial statements.

- Enquire of management if they anticipate any time when the factory at Pasir Panjang is unable to produce bottles or cans due to the switchover to the new machinery.

- Enquire of management how they have forecast revenue at PPP, for example have they extrapolated historical data or used known sales and contracts to produce the forecast.

- Compare revenue with prior years and ensure that only known changes, such as the increase in potential production, and reasonable and historically justifiable price rises explain any difference.

- Compare cost of sales with prior year and ensure that any changes are consistent with the forecast increase in revenue and production due to the new machinery.

- Calculate gross margins and investigate differences.

- Ascertain why operating costs are forecast to increase and verify any assumptions appear reasonable/are in accordance with past trends.

- Compare any assumptions made with general industry data and trends in the beverages packing industry, for example whether there is a trend towards other methods of packaging beverages such as plastic bottles.

- Estimate loan interest on the bank loan using the bank's current rate of interest/copy of loan agreement and ensure that interest payments are included.

- Ensure that accounting policies used are appropriate and consistent with previous accounting information being used for comparison.

- Agree the information for the year ended 31 December 20X3 to the audited statement of profit or loss to ensure this has been extracted correctly.

- Recalculate the statement of profit or loss to ensure this is accurate.
• Perform analytical procedures on the statement of profit and loss by comparing it with actual figures in the prior year to identify any anomalies. Enquire of management as to the reason for any unusual variances.

• Consider the accuracy of any forecast financial information PPP have produced before.

(c) The engagement at PPP is to review prospective financial information (PFI) and so the auditors are required to comply with SSAE 3400 The Examination of Prospective Financial Information. Para 27 of this standard describes the form and content of a report on examination of prospective financial information.

The report on PPP will contain a statement of negative assurance as to whether the assumptions provide a reasonable basis for the PFI. It would be addressed to the appropriate party as agreed in the terms of engagement and would identify the PFI being reported on. The report would state that the PFI was prepared by PPP management and it would probably include a restriction on use (that is, only for PPP management and the bank). It would give an opinion as to whether the PFI has been properly prepared on the basis of the assumptions underpinning the PFI and would contain caveats as to the likelihood of achievability of those assumptions. The report would be dated and signed, and contain the auditor's address.

(d) Events International has a qualified auditor's report and so your accounting entity must decide if this is significant for the group. The misstatement of $595k is 0.6% of group revenue, 2.3% of group profit before tax and 0.2% of total group assets. It is therefore borderline material for the purposes of the group auditor's report (the materiality threshold for revenue is 0.5 – 1%).

However, Events International is not a financially significant component to the group in terms of revenue (12.1%), profit before tax (12.9%) or total assets (5.9%). SSA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) Para A5 suggests the group engagement team considers that components exceeding 15% of the chosen benchmark are significant components (although it also states that a higher or lower percentage may be appropriate depending on the circumstances).

Assuming that the 15% benchmark is appropriate in this case, the auditor's opinion on CCC remains unmodified with regards to the outstanding receivable in Events International.
17. Lim & Koh Manufacturing

Lim & Koh Manufacturing Pte Ltd (Lim & Koh) is a family company involved in niche-market engineering. It is an established client of the accounting entity where you work. It has stable year-on-year results and operations. The financial statements currently being audited show total assets of $2.5m and profit for the year of $300,000.

The company owns a series of specialist machines which were developed internally to answer a need in the manufacturing process for one of its products. The machines are not commercially available and are valued at cost, which was the cost of developing the assets ten years ago. The machines are being depreciated over 20 years and the company accounting policy states that a full year's depreciation is charged in both the years of purchase and disposal. The depreciated cost of the machines is $100,000. The annual net cash inflow attributable to the machines is $125,000.

During the review stage of the audit, the audit senior read the Board minutes for the meetings since the end of the financial year. He noticed that the Innovation Director has pitched to the other directors a new technology available which he believes would revolutionise the company's production capacity and make the internally developed machines obsolete. The Board is deferring its decision on whether to replace the machines to the next Board meeting, at which the financial statements will also be finalised before they are presented to members.

Required

(a) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the valuation of the specialist machinery at Lim & Koh. (12 marks)

(b) Assess the materiality of any potential adjustments to the valuation of specialist machinery. (2 marks)

(c) Recommend two further actions the auditor should take in relation to the valuation of the specialist machinery and explain the purpose of these actions. (4 marks)

(d) Describe the impact on the form and content of the auditor’s report if the Board takes a decision now to replace the machines in one to four years' time. (5 marks)

(e) Assume the Innovation Director had been asked by the Board to monitor the new technology in the marketplace for a year and then come back to the Board with a proposal. Explain how your answer to (a) would be affected. (2 marks)

(Total = 25 marks)
17. Lim & Koh Manufacturing: Answer

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Tutorial notes

This question tests Candidates' knowledge of impairment, materiality and auditor's reports. Candidates will need a good understanding of the requirements of SFRS(I) 1-36 to answer this question. Ensure that answers are not general and are tailored to the scenario.

When explaining the impact on the auditor's report, try to describe the impact as fully as possible. Remember to include the changes to the form of the report if it is modified such as the Basis for Qualified Opinion section.

Marking guide

(a) SFRS(I) 1-36 Impairment of Assets 12 marks

Para 8 – An asset is impaired when its carrying amount exceeds its recoverable amount.

Para 6 – The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

Para 9 – An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

Note. para number is not required; the principle is required.

Two impairment indicators in the scenario:

External factor: new technology could make the specialist machinery at Lim & Koh obsolete.

Internal factor: proposal to replace specialist machinery at Lim & Koh.

Fair value of the specialist machinery is low/zero since there is no resale value and the technology is becoming obsolete.
Therefore recoverable amount = value in use.

Estimate of value in use ($125k \times 10 = \$1.25m) exceeds depreciated cost assuming ten years more use of the machinery.

If the machinery is replaced in six months, value in use would be $62.5k (\$125k \times 6/12) which is below depreciated cost.

If the machinery is replaced this year, useful economic life (UEL) would fall and this would impact depreciated cost.

Depreciated charges would rise if the UEL falls.

Depreciated cost would drop to $55k if the machinery is replaced in six months.

In this situation, value in use would be higher than depreciated cost and the machinery would not need to be impaired.

(b) The depreciated cost of the machinery is 4% of total assets and material.

A reduction in the useful life of the asset of five years or more (so that the new depreciation charge became $20,000 or higher) would be a material increase as this is 6.7% of profit.

2 marks

(c) Award up to two marks per further action up to a maximum of two actions.

Request a copy of management's impairment review of the specialist machinery in order to ensure this is reasonable, calculated accurately and the figures within the review can be corroborated.

Obtain written representations from the directors to support the assumptions used in the calculations.

Document any decisions about replacing the machinery taken after the end of the reporting period and obtain supporting evidence such as Board minutes.

4 marks

(d) If the Board decides now to replace the machines in 1 – 4 years' time, there will be an adjustment to depreciation since the UEL will be lower.

An adjustment will need to be made or the machinery will be overstated in the statement of financial position.

If management agree to make the adjustment there will be no impact on the auditor's report.

If management refuse to make the adjustment, and the adjustment is material (which is likely), the audit opinion will be qualified as there is a material misstatement.

The misstatement is confined to non-current assets and is not pervasive so there will be an 'except for' opinion.

A 'Basis for Qualified Opinion' section will be inserted immediately after the Qualified Opinion section. This section includes a description of the matter giving rise to the modification and a quantification of the financial effects.

5 marks

(e) Deferring the decision will mean that the UEL of the assets is still ten years.

No impairment is necessary as the internal factor suggesting impairment is not so significant.

2 marks
Answer points

(a) There are two factors identified in the scenario which might be considered impairment indicators in relation to the internally developed machines. These are:

(a) External factor – the existence of new technology which could potentially make the current machines' technology obsolete

(b) Internal factor – a proposal to replace the machines with the new technology

SFRS(I) 1-36 *Impairment of Assets* – Para 9 states that an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. An asset is impaired if its recoverable amount is lower than its carrying amount (SFRS(I) 1-36 – Para 8) which in this case is depreciated cost. Recoverable amount is the higher of fair value less costs to sell and value in use (SFRS(I) 1-36 – Para 6).

Given that there is no market for these machines and they utilise technology that appears to be becoming obsolete, fair value might be considered to be low to nothing.

Recoverable amount would therefore be considered in terms of value in use to the business. This is where the directors would consider the output of the machine over its remaining intended use and assess its value to the business that way.

The depreciation rate suggests that management intends to use the machines for another ten years, suggesting a rough estimate of value in use (excluding discounting which would be included in a formal calculation of the value in use) might be $1.25m ($125,000 \times 10). This far exceeds depreciated cost, and would still be so if discounted at an appropriate rate.

However, if the machinery was to be replaced imminently (ie during the financial year after the one being audited), then the value in use figure might drop as low as $62,500 ($125,000 \times 6/12) (assuming only half a year's use in the following year given that its replacement is happening before the AGM). This would mean it fell below depreciated cost.

However, this raises another important factor to consider, because if the machines were to be discontinued during the year, this would necessitate a change in useful life estimate which would impact the value of depreciated cost.

**Depreciated cost**

Depreciated cost would be impacted if the directors set a replacement horizon of less than ten years, as the machines are currently being depreciated over 20 years (that is, a further ten years from now). Given that they have been depreciated for half the period, cost for the machines can be assumed to be in the region of $200,000, and the annual depreciation charge $10,000. If the useful life is reduced, the depreciation charge would rise.

In the scenario where value in use was calculated for six months above, the depreciated cost of the machinery would drop to around $55,000 (assuming a depreciated cost of $110,000 being depreciated over two years). Thus value in use is greater than depreciated cost.

If a short to medium term decision is taken about the machinery, then the calculations above show that value in use is likely to be higher than depreciated cost so the question of impairment is removed from the considerations.

(b) The depreciated cost of the asset is 4% of total assets and so it is a material balance. An adjustment of anything in the region of a quarter of the asset's depreciated cost would be material to the statement of financial position.

In terms of the statement of profit or loss and other comprehensive income, with profit of $300,000, an amount in the region of $15,000 (or 5% of profit) is material. A reduction in the useful life of the asset of five years or more (so that the new depreciation charge became $20,000 or higher) would therefore be a material increase.
(c) The auditor should request management’s impairment review in respect of the machines to ensure that the value in use calculations are reasonable, corroborated by other audit evidence (for example, forecasts prepared by management in relation to going concern) and calculated correctly to confirm that it is correct to assume value in use is higher than depreciated cost in this situation.

If the directors take the decision about the machinery, the auditors should document this decision on the audit file, referring to the relevant Board minutes and set out the issue with regard to the useful life of the asset and relevant discussions had with directors in respect of it.

Written representations should be obtained regarding the assumptions used in the calculations.

(d) There is only a significant impact on the financial statements if the Board takes a decision now to replace the machines in the short or medium term, say 1 – 4 years, as this would cause the adjustment to depreciation to be material.

The auditor therefore needs to discuss the proposals with the CFO and outline the possible impact on the valuation of the machines in the financial statements if the Board decided to change the production process making the machines obsolete.

Given that the directors appear ready to take a decision on the machinery before the financial statements are presented to the members, the impact of that decision should be reflected in the financial statements in terms of the useful life of the assets.

If the directors voted to change the production process, they should also amend the financial statements to reflect the new useful life of the self-constructed machines. If they refused to so do, the auditor should reassess the materiality of the disagreement over accounting treatment, and if material (as seems likely) qualify the audit opinion over this issue. This issue is confined to non-current assets and therefore would result in an ‘except for’ qualification. A ‘Basis for Qualified Opinion’ section will be inserted immediately after the Qualified Opinion section. This section includes a description of the matter giving rise to the modification and a quantification of the financial effects.

(e) This would mean that the directors have deferred the decision about whether to change the useful life of the assets for a year, and so the useful life of the assets would at this point validly be the next ten years. The internal factor suggesting an impairment of the asset would not be so significant and no impairment would be necessary.
18. Siglap

You are an audit manager and have recently been seconded to your accounting entity's professional standards review department where your role is to review the audit conclusions drawn by the audit engagement partner on high risk and listed company financial statements. You are working on reviews of the audit conclusions on the following four unrelated audit clients. The year end in each case is 31 December 20X3.

Siglap Ltd (Siglap)

A review of Siglap's Board minutes identified the transfer of a motor vehicle to Ivy Seng at nil cost. The market value of the motor vehicle was $20,000. Ivy Seng is the daughter of Siglap's Managing Director. No disclosure has been made in the financial statements in relation to this transaction. At 31 December 20X3 Siglap's profit before tax was $12.9 million and its total assets were $128.7 million.

The audit conclusion is that the opinion should not be modified as the transaction was not material.

Stamford Ltd (Stamford)

The audit team has documented the review of the going concern status of Stamford which was performed by its directors and which included preparation of a cash flow forecast for the six months to 30 June 20X4. The directors' review concluded that Stamford was a going concern. The audit working papers indicate that the audit team found the assumptions in the cash flow forecast to be appropriate and concluded there was no evidence of any uncertainty as to the going concern status of Stamford.

The audit conclusion is that the opinion should be unmodified.

Ketapang Ltd (Ketapang)

The audit team has identified an issue with the information contained in a statement from Ketapang's Chairman which will be published along with the audited financial statements and auditor's report. The Chairman's Statement comments that Ketapang's 25% growth in profits is attributable to increases in sales brought about by improvements in the performance of the marketing team. However, the audit team disagree with this as the financial statements show a large part of profit improvements were made as a result of cost savings from a reduction in Ketapang's workforce. This is not mentioned in the Chairman's Statement.

The audit team has concluded that this is misleading and that the auditor's report should include an emphasis of matter paragraph to draw users' attention to the matter.

Yeo Ltd (Yeo)

Yeo is a Singapore based owner of shopping malls. All shopping malls are classified as investment property on Yeo's statement of financial position. In line with SFRS(I) 1-40 Investment Property, properties are measured at fair value after their initial recognition. Yeo management employs its own qualified valuer to provide annual valuations of all shopping malls, and investment property is $288m on the statement of financial position of Yeo as at 31 December 20X3. Total assets of Yeo at 31 December 20X3 were $705 million and profit before tax was $560 million.

Your accounting entity is the auditor of Yeo for the period ending 31 December 20X3. During the audit, an auditor's expert was used to provide audit evidence on the fair value of Yeo's shopping malls. The auditor's expert valued the shopping malls at $225 million as at 31 December 20X3.

When the difference between the two valuations was queried with your auditor's expert, she explained that management's expert assumed rental income from the malls would increase by 3% per annum but this was unrealistic due to several leases where the rent was fixed for three years.

The difference was discussed with the directors at Yeo, who believed the assumptions made by their valuer were more accurate than those provided by your auditor's expert and refused to make any amendment to the financial statements. The audit engagement partner has asked for your advice on the most appropriate audit opinion.
Required

(a) Evaluate the appropriateness of the unmodified auditor's opinion for Siglap. (6 marks)

(b) Evaluate the appropriateness of the unmodified auditor's opinion for Stamford. (6 marks)

(c) Evaluate the appropriateness of the unmodified auditor's opinion with an Emphasis of Matter paragraph for Ketapang. (7 marks)

(d) Recommend and justify the appropriate audit opinion for Yeo Ltd. (6 marks)

(Total = 25 marks)
18. Siglap: Answer

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Tutorial notes

This question tests Candidates’ ability to evaluate and recommend audit opinions in situations covering related parties, going concern, other information and experts.

Candidates should adopt the same approach to critiquing the suggested audit opinion as they would take to forming an audit opinion. Once they have reached their own conclusion as to the most appropriate opinion they can then compare this with the conclusions drawn by the audit team.

Candidates should justify their conclusions rather than simply comment on whether the conclusion drawn in the scenario is correct or not.

Marking guide

(a) The market value of the transaction is 0.16% of profit before tax and 0.02% of total assets so is not material.  
   The transfer of the motor vehicle is a related party transaction and must be disclosed as per the requirements of SFRS(I) 1-24 Related Party Disclosures.  
   The transaction is material even though it is carried out at nil cost and the market value is immaterial.  
   The suggestion that the audit opinion is not modified is inappropriate. The audit team should raise the matter with the directors of Siglap and request that the disclosure be included in the financial statements.  
   If the directors agree to make the required disclosures in the financial statements then no modification will be necessary.  

6 marks
If the director(s) do not agree to include the disclosures the opinion will be qualified as the financial statements are materially misstated.

(b) SSA 570 *Going Concern* requires management's assessment to cover a period of at least 12 months from the date of the financial statements.

Stamford's directors have only carried out an assessment of 6 months. The auditors must request this is extended to at least 31 December 20X4.

If the directors extend the review, the auditors must carry out audit procedures on it.

If the directors refuse to extend the review, the auditors may not be able to obtain sufficient and appropriate audit evidence as to whether the going concern basis of accounting is appropriate at Stamford.

The opinion will need to be qualified or a disclaimer of opinion.

The suggestion that the audit opinion is not modified is inappropriate.

(c) There is an inconsistency between the financial statements and the Chairman's Statement (other information). This is due to a misstatement of the other information.

The auditors should point out the misstatement to management, request it is corrected and then check the correction has been made. If management refuse to make the change, the audit team should inform those charged with governance, once again requesting for the change to be made and then determine if any change made is adequate.

If the change is made, there will be no impact on the auditor's opinion.

If management refuse to make the change this may cast doubt on their integrity and the reliability of audit evidence.

An Other Information section must be included in the auditor's report (SSA 720 Para 21) for all listed companies where there is other information. This section will be inserted after the Key Audit Matters Section.

A statement describing the uncorrected misstatement in the other information will be included in the Other Information section.

The auditor's opinion will be unmodified, however if it is felt that refusal to correct the misstatement casts such doubt on the integrity of Ketapang's management and those charged with governance that the reliability of all audit evidence is called into question a disclaimer of opinion may be appropriate.

The suggestion of including an emphasis of matter paragraph is not appropriate.

(d) The difference of $63m is 8.9% of total assets and 11.3% of PBT so is material.

Management's expert may not be objective (as employed by Yeo).

An adjustment needs to be made as investment property and profits are both materially misstated.

If management make this adjustment the auditor's report is not modified.

If management continue to refuse to make the adjustment, the auditor's report must be qualified. The misstatement is not pervasive as it can be isolated to one area of the financial statements.

The opinion paragraph will have the heading 'Qualified Opinion' and is at the start of the report.

The report will contain a Basis for Qualified Opinion paragraph immediately after the Qualified Opinion which describes the basis for the qualification and quantifies its effects.
Answer points

(a) The market value of the transaction is 0.16% of profit before tax and 0.02% of total assets so is not material. However, the transaction is a related party transaction which must be disclosed in order to meet the requirements of SFRS(I) 1-24 Related Party Disclosures.

The financial statements should disclose the related party transaction as it is material even though the transaction is carried out at nil cost and the market value is immaterial. It is important that the transaction is disclosed to shareholders in order that they understand how the directors are exercising their stewardship of the company.

The suggestion that the audit opinion is not modified is inappropriate. The audit team should raise the matter with the directors of Siglap and request that the appropriate disclosure be included in the financial statements.

If the directors agree to make the required disclosures in the financial statements then no modification will be necessary. If the director's do not agree to include the disclosures the opinion will be qualified as the financial statements are materially misstated.

(b) In accordance with SSA 570 Going Concern Para 13, the directors' review should have covered, as a minimum, the 12 months to 31 December 20X4. The audit team should request that the directors extend their review to the 12 months to 31 December 20X4, eg prepare a cash flow forecast to this date.

If the directors agree to extend their review, the audit team will need to undertake further audit procedures on the extended review.

If the directors refuse to extend the period beyond 30 June 20X4 the audit team may be unable to obtain sufficient appropriate audit evidence as to the going concern status of Stamford. This will result in either a qualified opinion or a disclaimer of opinion.

At this stage the conclusion that the audit opinion should be unmodified is inappropriate.

(c) The auditors have identified an inconsistency between the financial statements and the Chairman's Statement and have concluded this is due to a misstatement of the other information in the Chairman's Statement.

Firstly, the audit team should point out the misstatement to management, request it is corrected and then check the correction has been made. If management refuse to make the change, the audit team should inform those charged with governance, once again requesting for the change to be made and then determine if any change made is adequate.

Assuming management or those charged with governance make the requested change, there will be no impact on the auditor's opinion.

If those charged with governance refuse to amend the Chairman's Statement, the auditors must consider if this raises doubt about their integrity and the reliability of audit evidence and whether the auditor's need to seek legal advice or withdraw from the engagement.

An Other Information section must be included in the auditor's report (SSA 720 The Auditor's Responsibilities Relating to Other Information Para 21) for all listed companies where there is other information. This section will be inserted after the Key Audit Matters Section regardless of whether the requested change has been made. A statement describing the uncorrected misstatement in the other information will be included in the 'Other Information' section and this must be communicated to those charged with governance.

The auditor's opinion will be unmodified, however if it is felt that refusal to correct the misstatement casts such doubt on the integrity of Ketapang's management and those charged with governance that the reliability of all audit evidence is called into question a disclaimer of opinion may be appropriate. (SSA 720.A45)

The suggestion of including an emphasis of matter paragraph is not appropriate.
(d) There is a difference of $63m in valuations of the same investment property carried out by the management's and auditor's experts. The difference represents 8.9% of total assets and 11.3% of profit before tax so is material to the financial statements.

Management's expert is employed directly by Yeo and this casts doubt on the objectivity of management's expert. The auditor's expert has been able to show that the assumptions made by management's expert are not accurate and so the valuation by management's expert is not reliable. Investment property and profits are both overstated.

An adjustment should be made to reduce investment property to $225m but the directors of Yeo have refused to amend the financial statements. The misstatement can be isolated to investment property so it is not pervasive to the financial statements.

The directors of Yeo have refused to adjust the financial statements and so the auditor's report must be qualified on the basis that investment property is materially misstated.

As the report has been qualified, the auditors must use the heading 'Qualified Opinion' for the opinion paragraph which is placed at the start of the report.

The auditors must include a paragraph in the auditor's report which describes the basis for the qualification and quantifies its effects.

This shall be inserted immediately after the opinion paragraph in the auditor's report and shall use the heading 'Basis for Qualified Opinion'.
19. Sembawang

Your accounting entity has recently been appointed as the external auditor of Sembawang Pte Ltd (Sembawang), a research and development company incorporated five years ago. As the audit senior, you are responsible for the audit of the opening balances and ensuring that the corresponding figures have been correctly reported and are appropriately classified in Sembawang's financial statements for the year ended 31 December 20X3. You recently met with Sembawang's Finance Director and obtained the following relevant information:

(1) The financial statements for the year ended 31 December 20X2 included an error as a result of depreciation on plant and equipment in one of Sembawang's laboratories being incorrectly calculated.

(2) Changes to SFRS(I) 1-19 Employee Benefits require Sembawang to amend its accounting policy for post-employment benefits in the 20X3 financial statements. The change results in Sembawang being required to recognise a materially larger liability in the statement of financial position and larger losses through 'other comprehensive income'. Retrospective application is required by the financial reporting standard.

(3) Sembawang intends to show comparatives as corresponding figures only.

(4) A decision was taken to outsource the payroll function from 1 January 20X3. You have been told that it was not necessary to put the contract out to tender as the managing director's brother had just set up an outsourcing business and the contract had been awarded to him. The system operates as follows on a monthly basis:

- The payroll manager at Sembawang's collects information regarding hours, overtime, commission, bonuses, details of joiners and leavers etc.
- These are recorded by the payroll manager on a standard spreadsheet provided by the service company.
- The details are received by the service company and recorded and processed using the service company's software.
- A draft report is made accessible to the payroll manager for checking purposes via a portal. This allows the information to be viewed but not amended. The payroll manager then submits a schedule of amendments or confirms that no changes are necessary and authorises payment.
- Where corrections are required, amendments are made and the revised report is made accessible to the payroll manager who authorises payment.
- Payment is made to employees by the service company via the automated bank clearing system and payslips are sent to Sembawang's for distribution to employees.
- Deductions are paid to relevant authorities by the service organisation.
- Sembawang's is invoiced for the service and settles the bill.

Required

(a) State four audit procedures in relation to the opening balances and comparatives, in Sembawang's financial statements for the year ended 31 December 20X3 which would be undertaken regardless of whether the financial statements for the year ended 31 December 20X2 were audited. (6 marks)

(b) The financial statements for the year ended 31 December 20X2 were not audited. State two specific audit procedures to obtain sufficient, appropriate audit evidence in relation to the opening balances and comparatives, in Sembawang's financial statements for the year ended 31 December 20X3. For each procedure, explain the purpose of the procedure. (4 marks)
(c) State **four** specific audit procedures to obtain sufficient, appropriate audit evidence in relation to the opening balances and comparatives, in Sembawang's financial statements for the year ended 31 December 20X3 if the financial statements for the year ended 31 December 20X2 were audited by a different accounting entity of external auditors. For each procedure, explain the purpose of the procedure.  

(8 marks)

(d) Identify and explain **seven** matters that you would need to consider in the audit of wages and salaries expense for the period ending 31 December 20X3.  

(7 marks)

(Total = 25 marks)
19. Sembawang: Answer

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<td>Q19 Sembawang</td>
<td>Explain how the auditor's responsibilities for corresponding figures, comparative financial statements and 'other information' are discharged. Recognise and evaluate the impact of outsourced functions on the conduct of an audit and the use of assurance reports on controls at a third party service organisation.</td>
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Tutorial notes

This question tests Candidates' ability to audit opening balances and comparatives and also considerations for the audit when the payroll is outsourced.

Candidates should appreciate that the auditor has different procedures to undertake depending on whether the financial statements were audited in the prior year or not. Where they are not audited there is no option to rely on the work of the predecessor auditor so alternative audit procedures are required to gain assurance over opening balances.

Candidates should think of a range of issues including risk, materiality, accounting issues and evidence issues in part (d). Candidates should also apply their knowledge of SSA 402 Audit Considerations Relating to an Entity Using a Service Organisation.

Marking guide

(a) Award up to 1.5 marks per procedure up to a maximum of four procedures. 6 marks

Ascertain that accounting policies are consistent with prior year in case there are any policy changes which need to be disclosed.

Agree comparatives to prior year published financial statements in case there are any differences.

Ascertain whether the error in the depreciation charge in the 20X2 financial statements is material to the current year financial statements and whether it requires retrospective adjustment and restatement of comparative amounts.

Enquire of management as to its intentions regarding the error.

Where retrospective adjustment and restatement is required, review Sembawang's working papers and draft financial statements to ascertain if this has been properly reflected.

Ascertain the reasons for the error arising in the prior year and consider whether there is any risk of errors arising in the current year depreciation calculation.

Inspect management's calculations in respect of the changes in accounting policy required by SFRS(I) 1-19. Ascertain that amounts included in the current year apply the new policy correctly and that prior year amounts are correctly restated.

Review the notes to the financial statements to ascertain whether appropriate disclosures regarding the change in accounting policy have been included.
(b) Award up to two marks per procedure up to a maximum of two procedures.

Agree opening balances to any financial information available from Sembawang, such as prior year working papers used to prepare financial statements by Sembawang, trial balances and ledger balances in prior year. This is to provide evidence that opening balances are the same as the closing balances from the prior year.

Consider the extent to which audit procedures performed in the current year provide sufficient, appropriate audit evidence as to the opening balances. Where current year audit procedures are not able to provide sufficient, appropriate audit evidence specific audit procedures will need to be performed to provide evidence regarding opening balances.

(c) Award up to two marks per procedure up to a maximum of four procedures.

Read the prior year auditor's report for information relevant to opening balances, including whether the opinion was modified in respect of the error in the depreciation charge.

Review the professional competence and independence of the prior year auditor to assess the reliability of their work.

Should the accounting entity's review of the prior year auditor's professional competence and independence identify that their work cannot be relied upon, the accounting entity should perform specific audit procedures to provide evidence regarding opening balances, as if the prior year financial statements had not been audited.

Request permission to review the prior year auditor's working papers. This will provide audit evidence of the opening balances and also help with assessing the competence of the prior year auditor.

Agree opening balances to working papers of prior year external auditors to check their accuracy.

(d) Award up to one mark per matter to consider up to a maximum of seven matters.

Information may not have been transferred correctly to the outsourcing company.

Need to gain an understanding of the nature of the services provided and their significance to Sembawang.

Need to gain an understanding of the nature and materiality of the transactions processed by the service organisation.

Need to gain an understanding of the degree of interaction between the activities of the service organisation and Sembawang.

Need to gain an understanding of the nature of the relationship between Sembawang and the service organisation.

The service organisation may not be reliable as it is new and management may not possess the required experience and knowledge.

The service organisation is owned by the MD's brother and so related party transactions may need to be disclosed.

Whether it is possible to gain sufficient appropriate audit evidence from the records maintained at Sembawang.

Lack of segregation of duties in payroll at Sembawang.

Effectiveness of controls over access to the payroll system via the portal.

The extent to which the auditors are expecting to be able to rely on the controls at the service organisation.

Whether to request a type 1 or a type 2 report from the service auditors.

Whether management is aware of any relevant issues identified by the payroll manager's review of reports provided by the service organisation.
**Answer points**

(a) Any four from the following:

- Ascertain that accounting policies are consistent with prior year (other than changes required under SFRS(I) 1-19) in case there are any other policy changes which need to be disclosed.

- Agree comparatives to prior year published financial statements in case there are any differences.

- Ascertain whether the error in the depreciation charge in the 20X2 financial statements is material to the current year financial statements and whether it requires retrospective adjustment and restatement of comparative amounts.

- Enquire of management as to its intentions regarding the error (ie whether they intend to make the necessary adjustments).

- Where such retrospective adjustment and restatement is required, review Sembawang's working papers and draft financial statements to ascertain if this has been properly reflected.

- Ascertain the reasons for the error arising in the prior year (eg control deficiencies) and consider whether there is any risk of errors arising in the current year depreciation calculation.

- Inspect management's calculations in respect of the changes in accounting policy required by SFRS(I) 1-19. Ascertain that amounts included in the current year apply the new policy correctly and that prior year amounts are correctly restated.

- Review the notes to the financial statements to ascertain whether appropriate disclosures regarding the change in accounting policy have been included.

(b) Specific audit procedures to obtain sufficient, appropriate audit evidence in relation to the opening balances and comparatives, in Sembawang's financial statements for the year ended 31 December 20X3 are as follows:

- Agree opening balances to any financial information available from Sembawang, such as prior year working papers used to prepare financial statements, trial balances and ledger balances in prior year. This is to provide evidence that opening balances are the same as the closing balances from the prior year.

- Consider the extent to which audit procedures performed in the current year provide sufficient, appropriate audit evidence as to the opening balances. Where current year audit procedures are not able to provide sufficient, appropriate audit evidence specific audit procedures will need to be performed to provide evidence regarding opening balances.

(c) Any four from the following:

- Read the prior year auditor's report for information relevant to opening balances, including whether the opinion was modified in respect of the error in the depreciation charge.

- Review the professional competence and independence of the prior year auditor to assess the reliability of their work.

- Should the accounting entity's review of the prior year auditor's professional competence and independence identify that their work cannot be relied upon, the accounting entity should perform specific audit procedures to provide evidence regarding opening balances, as if the prior year financial statements had not been audited.
• Request permission to review the prior year auditor's working papers. This will provide audit evidence of the opening balances and also help with assessing the competence of the prior year auditor.

• Agree opening balances to working papers of prior year external auditors to check their accuracy.

(d) Any seven from the following:

Risk is increased if the transition is not well managed. It is possible that there are errors in the information which was initially transferred to the outsourcing company, for example, staff may have been duplicated, or benefits could be incorrect.

In accordance with SSA 402 Audit Considerations Relating to an Entity Using a Service Organisation Para 9, the auditor is required to obtain an understanding of the service provided by the service organisation. In doing so the user auditor must obtain an understanding of how Sembawang uses the services of the service organisation. In particular the following should be considered:

• The nature of the services provided by the service organisation and the significance of them to Sembawang.

Payroll is a material cost in most businesses so it will be significant to the audit.

• The nature and materiality of the transactions processed.

The amounts involved are likely to be material. Also due to the nature of the transactions and the potential for fines from tax authorities if errors are made the transactions are likely to be viewed as material.

• The degree of interaction between the activities of the service organisation and Sembawang.

In this case there appears to be a high level of interaction between the service organisation and Sembawang. Sembawang retains control in that it provides raw data and authorises the payroll and payments whilst the service organisation simply processes the transactions.

• The nature of the relationship between Sembawang and the service organisation.

This will depend on the terms of the contract drawn up between the two parties and will include details such as the extent to which information is to be provided by Sembawang. The auditor will need to consider the type of information provided by the payroll manager and the system by which this information is collected. The level of detail in the draft reports sent by the service organisation will also need to be considered. The auditor will also need to consider whether the agreement allows for direct communication with the service auditor.

Other factors include the following:

• The reliability of the service organisation. In this case this may be in doubt. The service organisation is a new venture and is run by the managing director's brother. Enquiries will need to be made as to whether the organisation has the relevant expertise.

• Possible related party transactions. If the managing director's brother may be viewed as a related party any payments made to the service organisation would have to be disclosed as related party transactions.

• The extent to which sufficient appropriate evidence is available from the records maintained by Sembawang. It may be possible to obtain this evidence from the spreadsheets completed by Sembawang and the reports prepared by the service organisation.
• The effectiveness of controls at Sembawang. The introduction of outsourcing seems to have resulted in:
  – The introduction of outsourcing seems to have resulted in a lack of segregation of duties.
  – The payroll manager provides the raw data, reviews the payroll and authorises payment.

• Effectiveness of controls over access to the payroll system via the portal. If the payroll manager is able to revise/update payroll transaction via the portal rather than simply being able to read the report, risk of error or fraud would be increased.

• The extent to which the auditors are expecting to be able to rely on the controls at the service organisation. This may be increased by the apparent lack of controls at the entity.

• Whether to request a type 1 or a type 2 report from the service auditors.

• Whether management is aware of any relevant issues eg level of errors identified by the payroll manager’s review of reports provided by the service organisation.
20. Nebula

Nebula Ltd (Nebula) is an audit client of your accounting entity with a year end of 31 December 20X6. The company is registered in Singapore and provides venture capital to other companies. Investments are made in start-up companies to help them establish themselves and Nebula withdraws when the company is established to invest in other projects. The investments take different forms, but Nebula usually invests in shares of the company and sells the shares back to the initial owners after an agreed time.

The following situations have arisen this year:

1. In January 20X6, Nebula bought a 25% stake in Luna Co (Luna), a company registered overseas. The stake is due to be bought back in two years. Nebula made the investment on the agreement that it would have minimal management involvement. The expectation is that the stake will significantly increase in value during the investment period. Management of Luna has not allowed the auditors access to financial records but has provided figures to management of Nebula such that the investment has been equity accounted in the financial statements of Nebula. The investment is material to the financial statements of Nebula.

2. In October 20X6, Nebula sold back its 60% stake in Eclipse Pte Ltd (Eclipse), a company registered in Singapore, to its other owners. The relationship between Nebula management and Eclipse management had soured, and Eclipse management has denied both Nebula and your accounting entity any access to the financial records of Eclipse since the sale was completed. Eclipse is material to the financial statements of Nebula.

3. As part of audit procedures, your accounting entity received and read the draft annual report for Nebula. The annual report refers to management's intention to curtail operations in the West Asia Division (WAD) so that management can focus on more profitable divisions. No one in Nebula management has mentioned this intention to anyone on the audit team and it is not referred to in the financial statements. When asked about the intention, the Chief Finance Officer (CFO) confirmed that the Board decided on this strategy in its most recent meeting and they are beginning to enact it in 20X7. WAD contributed 30% of revenue and 15% of the profit of the company in the 20X6 financial statements.

Required

(a) With reference to appropriate Singapore Financial Reporting Standards (International), comment on the appropriateness of the treatment of Luna in the financial statements of Nebula and describe an appropriate audit procedure to confirm whether a misstatement exists. (6 marks)

(b) Evaluate whether the auditors of Nebula have sufficient appropriate audit evidence about Luna on which to form an audit opinion. (3 marks)

(c) With reference to appropriate Singapore Standards on Auditing, explain the audit opinion that would be required in the financial statements of Nebula, given the situation with Luna. Do not refer to the situation with Eclipse in your answer. (4 marks)

(d) Evaluate whether the auditors of Nebula have sufficient appropriate audit evidence about Eclipse on which to form an audit opinion. (4 marks)

(e) With reference to appropriate Singapore Standards on Auditing, explain the audit opinion that would be required in the financial statements of Nebula, given the situation with Eclipse. Do not refer to the situation with Luna in your answer. (1 mark)

(f) State seven audit procedures that should be performed as a result of the disclosure of management's intentions to curtail operations in WAD in the annual report. For each procedure, explain the purpose of the procedure. (7 marks)

(Total = 25 marks)
20. Nebula: Answer

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<td>Discuss the courses of action available to an auditor when documents containing audited financial statements and the auditor's report include other information that is inconsistent with or undermines the credibility of those financial statements and the auditor's report.</td>
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<td>Specify audit procedures designed to identify subsequent events that may require adjustment to, or disclosure in, the financial statements of a given entity or steps to be taken for subsequent discovery of facts.</td>
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Tutorial notes

This question tests Candidates' knowledge of the impact of groups on auditor's reports and also looks at events subsequent to the end of the reporting period.

In the scenario, Candidates are told that Eclipse and Luna are material to the financial statements of Nebula. Therefore, if there is a misstatement or an inability to obtain audit evidence, a modified audit opinion will be necessary.

The final part of this question covers both the audit of other information and the audit of subsequent events, as it deals with a subsequent event that is disclosed in the annual report, but has been omitted from the financial statements. Make sure that you are suggesting specific procedures directed at the issues raised by the disclosures in the annual report.

Marking guide

(a) SFRS(I) 1-28 Investments in Associates and Joint Ventures 6 marks

Para 3 – An associate is an entity over which the investor has significant influence.

Para 5 – If an entity holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case.

Note. Para number is not required; the principle is required.

Nebula owns 25% of the shares of Luna so Luna is an associate of Nebula.

However, Nebula does not have significant influence over Luna as the agreement states it has ‘minimal management involvement’.
Without significant influence, Nebula may need to account for Luna as an available for sale asset. Luna may be misstated in the financial statements of Nebula. Nebula may have significant influence as it is likely that minimal management influence was agreed to only if Luna management act in a way that Nebula agree with. Nebula is able to call a shareholder meeting to influence management. If Nebula has significant influence in this way, equity accounting is appropriate and there is no misstatement.

Procedure: Review the contract between the parties and inquire about the day to day management arrangements over Luna.

Purpose: To identify whether the financial statements are misstated by equity accounting for Luna.

(b) The auditors have been denied access to the financial records underlying the investment in Luna.

The auditors could wait until Luna publishes its audited accounts in order to verify the investment but this is likely to be too late.

There are no other suitable procedures to verify the investment in Luna.

This is a limitation of scope on the audit work.

There is no ethical issue as the limitation is not imposed by Nebula.

3 marks

(c) The investment is material to the financial statements of Nebula and a modified opinion is required.

SSA 705 Modifications to the Opinion in the Independent Auditor's Report.

Para 7 – The auditor shall express a qualified opinion when... The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Para 9 – The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Note. Para number is not required; the principle is required.

The auditors must decide if the matter is pervasive in order to determine if there is a qualified opinion or a disclaimer of opinion.

In this case, it seems not to be pervasive so the opinion is qualified.

4 marks

(d) The financial statements of Nebula should include consolidated results of Eclipse up to the date of sale and any gain/loss on disposal.

Results of Eclipse may need to be disclosed separated as per SFRS(I) 5.

Any error or omissions would be a material misstatement.

The auditors have been denied access to the financial records of Eclipse which may cause a limitation of scope.

There is no ethical issue as the limitation is not imposed by Nebula.

Nebula should have financial records of Eclipse to support the consolidated figures (up to the time Eclipse was sold).

Nebula will have details of the sale of shares and the auditors will be able to verify these through Nebula's own financial records and bank records. The auditors should be able obtain sufficient appropriate audit evidence regarding Eclipse to support the audit opinion.

4 marks
(e) The auditor's report will not be modified. The auditor's report will take the form of the standard unqualified auditor's report given in SSA 700 Forming an Opinion and Reporting on Financial Statements. 1 mark

(f) Award up to one mark per procedure up to a maximum of seven procedures. Asking those charged with governance about the plans. Reading minutes of the directors' meetings where the plan has been discussed to confirm the answers to inquiries and to confirm issues such as how developed the plan is and when it was taken. Reading any presentations made to the Board or any operational plans to implement the decision. This corroborates evidence obtained from those charged with governance. Reading any relevant correspondence or press releases or emails to company staff which relate to the decision. This adds weight to other evidence. Considering, in the light of answers to inquiries and inspection of documents, whether this is a subsequent event that is material to users. Appraising whether information concerning this decision has been withheld from the auditor during the audit. Tests to identify whether any other subsequent events which should be included in the financial statements exist:
- Inquiring with relevant staff if there are subsequent events which impact on the financial statements.
- Reading minutes of directors' Board meetings.
- Reviewing the most recent financial information.
- Continuing to be alert during all routine audit work for indicators of subsequent events. 7 marks

Answer points

(a) According to SFRS(I) 1-28 *Investments in Associates and Joint Ventures* Para 3, an associate is an entity over which the investor has significant influence. SFRS(I) 1-28 Para 5 states that significant influence is presumed when the investor holds 20% or more of the voting rights of an entity so Luna is deemed to be an associate of Nebula, as Nebula owns 25% of the shares. However, by contracting to have 'minimal management involvement' in Luna, Nebula has forgone having significant influence over Luna. If Nebula does not have significant influence over Luna, then it is likely that it would be accounted for as an available for sale financial asset. There is potentially a misstatement here. However, despite the contractual agreement, in economic and legal terms, Nebula has the potential to have significant influence, as it owns a significant stake in Luna, and could call a shareholder meeting to influence management, even if it did not want to influence at a management level. In reality, it is likely that Nebula has agreed to minimal management influence so long as management is not doing things the management of Nebula disagrees with. If management started acting erratically, Nebula could exercise significant influence. If this seems to be the case, it would be appropriate to account for Luna by equity accounting. The auditors should review the contract between the parties and inquire about the day to day management arrangements over Luna to identify whether the financial statements are misstated by equity accounting for Luna.
(b) Management of Luna has provided Nebula with financial information sufficient to account for its investment in Luna in the financial statements, but has denied the auditors of Nebula any access to its underlying financial records to substantiate them.

There do not appear to be any suitable procedures to verify the figures provided by Luna. It is unlikely that the auditors can wait for published financial information from Luna, as the audit of Nebula will need to be completed before such financial information is available. There is no other source of information about the Luna financials.

This is therefore a limitation on the scope of the audit work. It is not imposed by the management of Nebula, so does not cause the auditors particular ethical problems.

(c) The auditors cannot obtain sufficient appropriate evidence about the investment in Luna and this is material to the financial statements. SSA 705 Para 7 states that a qualified audit opinion is required if ‘the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive’.

However if the investment in Luna is considered material and pervasive to the financial statements, a disclaimer of opinion would be necessary (SSA 705 Para 7).

In this instance, the matter is limited to the accounting for the associate. It is possible that the entries relating to the associate (share of profit after tax of Luna and interest in associated company on the statement of financial position) are misstated. As it is restricted to these items, it seems likely that the auditors would determine this matter was not pervasive to the financial statements. Indeed SSA 705 Modifications to the Opinion in the Independent Auditor’s Report Para A11 gives a situation where there is insufficient evidence about the equity accounting for an associate as an example of a qualified audit opinion (‘except for’) due to a limitation.

Therefore a qualified opinion will be most appropriate this situation.

(d) Nebula has sold its controlling stake in Eclipse during the year. The financial statements should include consolidated results of Eclipse up to the date of sale, and should include a gain on disposal (which may have to be disclosed separately per SFRS(I) 1-1 Presentation of Financial Statements). In addition, the results of Eclipse may need to be disclosed separately in accordance with SFRS(I) 5 Non-Current Assets Held for Sale and Discontinued Operations.

With all these accounting issues, there is scope for a misstatement to occur, perhaps by omitting appropriate disclosures, and as Eclipse is material to Nebula, any misstatement would be material and would result in the need for a qualified audit report.

The management of Eclipse has denied the auditors access to the underlying records of Eclipse. It is possible that this causes a limitation on the auditors’ work, again, not caused by Nebula’s management. There is therefore no additional ethical concern in this scenario.

However, as Nebula controlled Eclipse up to the point when the subsidiary corporation was sold back to the other owners, it should have management financial records to support the consolidated figures from that time. In addition, it will have details of the sale of shares and the auditors will be able to verify these through Nebula’s own financial records and bank records. The auditors should be able to carry out sufficient analysis of the records Eclipse submitted to Nebula prior to sale to gain assurance that the consolidated figures are fairly stated.

(e) With regard to the second issue, therefore, unless the auditors discover misstatements relating to the accounting for Eclipse in the course of the audit work they are able to carry out, they are unlikely to need to qualify the auditor’s report in relation to Eclipse. The auditor’s report will take the form of the standard unqualified auditor’s report given in SSA 700 Forming an Opinion and Reporting on Financial Statements.

(f) The disclosure in the financial statements suggests that a major event has taken place after the year end which has not been disclosed to the auditors and may need disclosure in the financial statements.
The audit team should perform the following general tests to identify whether any other subsequent events which should be included in the financial statements exist:

- Inquiry – the audit staff should ask relevant staff questions designed to identify whether there are subsequent events which impact the financial statements. These should include making inquiries of directors, finance staff, internal audit and any relevant operational staff. Questions would include:
  - What management’s system for identifying relevant subsequent events is?
  - Whether the company has entered into any new commitments?
  - Whether there have been any major changes in assets?
  - Whether any significant events have occurred that might impact going concern or asset values.

- Read minutes of directors’ Board meetings up to the most recent available to identify any other subsequent events which may impact the financial statements.

- Review the most recent financial information (management accounts) to see if it includes anything that impacts on the financial statements.

- Continue to be alert until the date of the auditor's report for indicators of subsequent events (for example, from reading press releases or newspaper articles.)

The audit team need to carry out procedures to confirm that the assertion made in the annual report is correct, and whether it has a material impact on the users of financial statements (in which case it ought to be disclosed as a non-adjusting subsequent event). They also need to confirm the timing of the decision, to ensure that it was not taken in the financial year under review. This is because in certain conditions, this might cause disclosures relating to SFRS(I) 5 Non-Current Assets Held for Sale and Discontinued Operations to be necessary. If the decision was taken after the year-end, it is a subsequent event which requires disclosure in the financial statements if it is material to users.

Procedures should include:

- Asking those charged with governance about the plans. These inquiries should seek to ascertain how established the plan is (ie is it a consideration or a determined plan?) and should also find out when the plan was formed and all the stages along the plan (ie discussion of the possibility to strategic decision being taken, to operational decisions being taken and enacted, such as making staff redundant and selling assets).

- Reading the minutes of the directors’ meetings where the plan has been discussed to confirm the answers to inquiries and to confirm issues such as how developed the plan is and when it was taken.

- Reading any presentations made to the Board or any operational plans to implement the decision. This corroborates evidence obtained from those charged with governance – for example, a recent decision is corroborated by no detailed plans, or recent detailed plans.

- Reading any relevant correspondence or press releases or emails to company staff which relate to the decision. Again, this adds weight to other evidence. For example, if all employees have been informed, this indicates the plan is being enacted. If employees were informed a significant time ago, this implies that the decision has been taken earlier than suggested currently.
• Considering, in the light of answers to inquiries and inspection of documents, whether this is a subsequent event that is material to users. Given the division contributes 30% of revenue, and should cause a profit swing (if operations are being diverted away from less profitable operations to more profitable operations) it seems likely that this is material to users. Unless there is clear evidence that there was an enacted plan prior to the year-end, it appears to be a subsequent event.

• Appraising whether information concerning this decision has been withheld from the auditor during the audit (the fact that the auditor read about it in the draft report rather than being told about it during the audit seems odd). Professional scepticism requires that if there is any suggestion that information has been deliberately withheld from the auditors, other assertions made or not made by the directors would be re-evaluated by the auditors.