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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 the 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.
Introduction

This is the sixth edition of the Assurance Textbook of the Singapore CA Qualification.

The Singapore CA Qualification is a postgraduate accountancy qualification programme with three main components:

- Academic Base
- Professional Programme
- Practical Experience

The Professional Programme aims to equip Candidates with the knowledge, skills and professional values that are required of a Chartered Accountant of Singapore. It is a self-study programme that offers flexibility and learning support to suit the individual study and working needs of each Candidate. The Ethics and Professionalism module is a pre-requisite for all the technical modules. The technical modules may be attempted in any sequence, and only upon completion of the Ethics and Professionalism module and passing all four technical modules will a Candidate be eligible for the Integrative Business Solutions Module. Together, the following modules make up the entirety of the Professional Programme:

- Ethics and Professionalism
- Taxation
- Financial Reporting
- Assurance
- Business Value, Governance and Risk
- Integrative Business Solutions

Recommended Progression

The Ethics and Professionalism module must be completed before enrolment in any technical module. There is no other pre-requisite in the Professional Programme for this module.

Module Assessment

Each technical module in the Singapore CA Qualification is assessed by way of a written end-of-module examination that accounts for 100% of a Candidate's final grade. For more information, please refer to the Candidate Handbook on the Singapore CA Qualification website: www.SingaporeCAQualification.com

Module Objective

Upon completion of the Assurance Module, Candidates will be able to analyse, exercise judgment, evaluate and conclude on the assurance engagement and other audit and assurance issues in the context of best practice and current developments in Singapore and internationally. The module addresses a wide variety of issues that a Chartered Accountant of Singapore may encounter. It develops the Candidates' understanding of professional and ethical considerations as well as ensuring they have a broad understanding of the regulatory environment in Singapore. The module covers procedures in practice management, including quality control and the acceptance and retention of professional engagements; the audit of financial statements including planning, managing, evidence and review, as well as other assignments and reporting.

Cognitive Levels

This document includes learning outcomes which Candidates are expected to achieve. Each learning outcome is identified with a cognitive level ranging from 1 to 3. The cognitive levels are described below.
Cognitive level 1
An ability to communicate sound knowledge and insight in relation to emerging trends, current issues, and regulatory changes, with some practical application.

Cognitive level 2
An ability to analyse and apply knowledge to moderately complex scenarios that a Candidate would be likely to encounter in the workplace to derive the best possible outcome.

Cognitive level 3
An ability to demonstrate an elevated level of application of knowledge, as well as synthesise and evaluate information in more complex scenarios in order to arrive at value-added solutions.

The cognitive levels give an indication of the intellectual depth which Candidates are expected to achieve.

The technical modules in the Professional Programme are designed at postgraduate level and build on knowledge, skills and values achieved during the prior tertiary studies. The technical modules are designed to develop higher order skills of application, analysis, synthesis and evaluation. For this reason, there are very few learning outcomes with cognitive level 1.
## Module Syllabus

### Learning Outcomes

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<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
<th>Chapter where covered</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LEGAL AND PROFESSIONAL FRAMEWORK</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory frameworks for audit and assurance services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Explain the need for laws, regulations, standards and other guidance relating to audit, assurance and related services in Singapore and how they align with international regulatory frameworks, such as those issued by the International Auditing and Assurance Standards Board (IAASB).</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Outline and explain the need for the legal and professional framework including:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Public oversight of an audit and assurance practice; and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• The role of audit committees and the impact on audit and assurance practice.</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td><strong>Anti-money laundering and terrorism financing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Explain the scope of ‘money laundering and terrorism financing’ and the related obligations of a Chartered Accountant of Singapore.</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Explain national Singaporean and international efforts to combat money laundering.</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td><strong>Laws and regulations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compare and contrast the respective responsibilities of directors, management and auditors concerning compliance with laws and regulations in an audit of financial statements.</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Describe the auditor’s considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.</td>
<td>2</td>
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</tr>
<tr>
<td>Explain how, why, when and to whom non-compliance should be reported and the circumstances in which an auditor should withdraw from an engagement.</td>
<td>3</td>
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</tr>
<tr>
<td><strong>CONSIDERATIONS FOR THE PROFESSIONAL ACCOUNTANT</strong></td>
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<tr>
<td><strong>Code of Professional Conduct and Ethics</strong></td>
<td></td>
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</tr>
<tr>
<td>Explain the fundamental principles of the Code of Professional Conduct and Ethics.</td>
<td>3</td>
<td>2, 6</td>
</tr>
<tr>
<td>Recognise conflicts in the application of fundamental ethical principles.</td>
<td>3</td>
<td></td>
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<tr>
<td>Discuss the importance of auditors’ independence and professional scepticism in planning and performing an audit.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Recommend a suitable course of action for a professional accountant to take upon discovering a breach of professional ethics by themselves or by others.</td>
<td>3</td>
<td></td>
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<tr>
<td><strong>Fraud and error</strong></td>
<td></td>
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</tr>
<tr>
<td>Compare and contrast the respective responsibilities of management and auditors relating to fraud and error.</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Describe the matters to be considered and procedures to be carried out in response to risks of misstatements arising from fraud and error.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Learning outcome</td>
<td>Cognitive level</td>
<td>Chapter where covered</td>
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<tr>
<td>---------------------------------------------------------------------------------</td>
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<td>-----------------------</td>
</tr>
<tr>
<td><strong>Professional liability</strong></td>
<td></td>
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<tr>
<td>Recognise circumstances in which professional accountants may have legal liability.</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Explain the concept of due care in the performance of work and describe the factors to determine whether or not an auditor is negligent in given situations.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Recognise the auditor's liability to clients and third parties, including those in transnational engagements and non-audit engagements.</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Evaluate the practicability and effectiveness of ways in which legal liability may be restricted.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Discuss and appraise the principal causes of audit failure and other factors that contribute to the ‘expectation gap’ (eg responsibilities for fraud and error).</td>
<td>3</td>
<td></td>
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<tr>
<td><strong>Communication</strong></td>
<td></td>
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<tr>
<td>Describe the auditor’s responsibility to communicate with those charged with governance and understand the importance of effective two-way communication of specific matters that are required to be communicated to those charged with governance under local and international auditing standards.</td>
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<td>3, 16</td>
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<tr>
<td><strong>PRACTICE MANAGEMENT</strong></td>
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<tr>
<td><strong>Quality control</strong></td>
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</tr>
<tr>
<td>Explain the principles and purpose of quality control of audit and other assurance engagements under the regulatory framework.</td>
<td>3</td>
<td>4, 2</td>
</tr>
<tr>
<td>Select and justify quality control procedures that are applicable to a given firm and audit engagement.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Assess whether an engagement has been planned and performed in accordance with professional standards and public oversight requirements.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Discuss how the provision of non-audit services to audit clients (including auditor initiated audit adjustments arising from audit work) may compromise the independence of the audit process.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td><strong>Advertising, publicity, obtaining professional work and fees</strong></td>
<td></td>
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<tr>
<td>Recognise situations in which specified advertisements are acceptable.</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Explain the restrictions on practice descriptions and the names of public accounting entities.</td>
<td>2</td>
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<tr>
<td>Outline the determinants of fee setting and justify the basis on which fees and commissions may and may not be charged for services.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Discuss the ethical and other professional issues, for example, lowballing, involved in establishing and negotiating fees and other types of remuneration for a specified assignment.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Learning outcome</td>
<td>Cognitive level</td>
<td>Chapter where covered</td>
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<tr>
<td>---------------------------------------------------------------------------------</td>
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<tr>
<td><strong>Appointment and reappointment of auditors</strong></td>
<td></td>
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<tr>
<td>Discuss the reasons why entities change their statutory auditors/professional</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>accountants.</td>
<td></td>
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<tr>
<td>Recognise and explain the factors to be considered when a firm is invited to</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>submit a proposal or fee quote for an audit or other professional engagement.</td>
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<tr>
<td>Identify the information to be included in a proposal.</td>
<td>2</td>
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<tr>
<td>Explain the matters to be considered and the procedures that an audit firm/</td>
<td>3</td>
<td></td>
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<tr>
<td>professional accountant should carry out before accepting and/or continuing a</td>
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<tr>
<td>specified client/engagement including:</td>
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<tr>
<td>• Client acceptance and continuance;</td>
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<td></td>
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<tr>
<td>• Engagement acceptance and continuance;</td>
<td></td>
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<tr>
<td>• Establish whether the preconditions for an audit are present;</td>
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<tr>
<td>• Communicating with the predecessor auditor; and</td>
<td></td>
<td></td>
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<tr>
<td>• Agreeing the terms of engagement.</td>
<td></td>
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<tr>
<td>Recognise the key issues that underlie the agreement of the scope and terms of</td>
<td>2</td>
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<tr>
<td>an engagement with a client including the full scope of a statutory audit.</td>
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<tr>
<td><strong>PERFORMING THE AUDIT</strong></td>
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<tr>
<td><strong>Planning, materiality and assessing the risk of misstatement</strong></td>
<td></td>
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<tr>
<td>Define materiality and performance materiality and demonstrate how it should be</td>
<td>2</td>
<td>6, 7</td>
</tr>
<tr>
<td>applied in accordance with professional auditing standards.</td>
<td></td>
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<tr>
<td>Identify and explain the importance of understanding the entity and its</td>
<td>3</td>
<td></td>
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<tr>
<td>environment, including internal controls in risk assessment.</td>
<td></td>
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<tr>
<td>Identify and explain material and significant audit risks (broken into risks of</td>
<td>3</td>
<td></td>
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<tr>
<td>material misstatement and detection risks) for a given assignment.</td>
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<tr>
<td>Discuss and apply the use of analytical procedures in the planning of an</td>
<td>3</td>
<td></td>
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<tr>
<td>assignment.</td>
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<tr>
<td>Explain how the result of planning procedures determines the relevant audit</td>
<td>2</td>
<td></td>
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<tr>
<td>strategy.</td>
<td></td>
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<tr>
<td>Explain the planning procedures specific to an initial audit engagement.</td>
<td>2</td>
<td></td>
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<tr>
<td>Apply the further considerations and audit procedures relevant to initial</td>
<td>2</td>
<td></td>
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<tr>
<td>engagements.</td>
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<tr>
<td>Learning outcome</td>
<td>Cognitive level</td>
<td>Chapter where covered</td>
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<tr>
<td>Explain the matters that are likely to be relevant in determining what constitutes sufficient, appropriate evidence.</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Evaluate whether evidence given scenario represents sufficient evidence.</td>
<td>3</td>
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<tr>
<td>Explain the rules for documentation of audit evidence, using appropriate media and the reasons for those rules.</td>
<td>3</td>
<td></td>
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<tr>
<td>Identify and describe audit procedures to obtain sufficient audit evidence from identified sources, eg inquiries, inspection, observation and re-performance.</td>
<td>3</td>
<td></td>
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<tr>
<td>Assess whether more cost-efficient methods for obtaining evidence to support an assertion would have been possible in a given scenario.</td>
<td>3</td>
<td></td>
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<tr>
<td>Identify and evaluate the audit evidence expected to be available to support the assertions about classes of transactions, account balances, and presentation and disclosure.</td>
<td>3</td>
<td></td>
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<tr>
<td>Apply analytical procedures as substantive audit procedures using financial and non-financial data.</td>
<td>3</td>
<td></td>
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<tr>
<td>Explain the specific audit risks and procedures concerning related parties and related party transactions including significant transactions outside normal business.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Recognise circumstances that may indicate the existence of unidentified related parties and select appropriate audit procedures.</td>
<td>3</td>
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<tr>
<td>Explain the use of written management representations to support other audit evidence and the limitations of representations as evidence.</td>
<td>3</td>
<td></td>
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<tr>
<td>Identify and explain the circumstances in which an auditor is likely to need an expert opinion to obtain sufficient, appropriate evidence on a matter.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Explain the differences for evidence evaluation between an expert appointed by an auditor and an expert appointed by a client.</td>
<td>3</td>
<td></td>
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<tr>
<td>Evaluate the work required to be done when there is the use of an expert including:</td>
<td>3</td>
<td></td>
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<tr>
<td>• Evaluating the relevance, completeness and accuracy of that source data significant to that expert's work provided by management;</td>
<td></td>
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<tr>
<td>• Evaluation of the expert's competence, capabilities and objectivity for the statutory auditor's purposes;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Adequacy of the expert's work; and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• The auditor's duty to form a concurring opinion with the expert.</td>
<td></td>
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</tbody>
</table>

Note: in this paragraph, 'expert' is used as defined in the Singapore Standards on Auditing.
<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
<th>Chapter where covered</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Evaluation and review</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apply and evaluate audit procedures for all transactions in the extant syllabus</td>
<td>3</td>
<td>9, 10, 12</td>
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<tr>
<td>for the Financial Reporting module.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Explain the use of analytical procedures in evaluation and review.</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Explain and demonstrate how the auditor's responsibilities for corresponding</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>figures, comparative financial statements, and 'other information' are discharged.</td>
<td></td>
<td></td>
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<tr>
<td>Discuss the limitations of the standards on auditing and the possible modifications</td>
<td>2</td>
<td></td>
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<tr>
<td>that they may require in the audits of smaller entities.</td>
<td></td>
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<tr>
<td>Discuss the courses of action available to an auditor when documents containing</td>
<td>2</td>
<td></td>
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<tr>
<td>audited financial statements and the auditor's report include other information</td>
<td></td>
<td></td>
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<tr>
<td>that is inconsistent with or undermines the credibility of those financial</td>
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<td></td>
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<tr>
<td>statements and the auditor's report.</td>
<td></td>
<td></td>
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<tr>
<td>Specify audit procedures designed to identify subsequent events that may require</td>
<td>2</td>
<td></td>
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<tr>
<td>adjustment to, or disclosure in, the financial statements of a given entity or steps</td>
<td></td>
<td></td>
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<tr>
<td>to be taken for subsequent discovery of facts.</td>
<td></td>
<td></td>
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<tr>
<td>Identify accounting estimates and recommend audit procedures and evaluate evidence</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>supporting the assumptions and reasonableness of the estimates, including the</td>
<td></td>
<td></td>
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<tr>
<td>related disclosures.</td>
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<tr>
<td>Identify and explain indicators that the going concern basis may be in doubt and</td>
<td>2</td>
<td></td>
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<tr>
<td>evaluate mitigating factors.</td>
<td></td>
<td></td>
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<tr>
<td>Recommend audit procedures to evaluate the evidence that might be expected to be</td>
<td>2</td>
<td></td>
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<tr>
<td>available and assess the appropriateness of the going concern basis in given</td>
<td></td>
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<tr>
<td>situations.</td>
<td></td>
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<tr>
<td>Assess the adequacy of disclosures in financial statements relating to going</td>
<td>2</td>
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</tr>
<tr>
<td>concern and explain the implications for the auditor's report with regard to the</td>
<td></td>
<td></td>
</tr>
<tr>
<td>going concern basis.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Learning outcome</td>
<td>Cognitive level</td>
<td>Chapter where covered</td>
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<tr>
<td><strong>Group audits</strong></td>
<td></td>
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<tr>
<td>Recognise the specific matters to be considered before accepting appointment as</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>auditor of group financial statements.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Identify and explain the matters specific to planning an audit of group financial</td>
<td>2</td>
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</tr>
<tr>
<td>statements including assessment of the group, its components, and their</td>
<td></td>
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<tr>
<td>environments, the impact of non-coterminous year ends within a group and</td>
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<tr>
<td>changes in group structure.</td>
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<tr>
<td>Justify the situations where a joint audit would be appropriate.</td>
<td>2</td>
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<tr>
<td>Recognise the audit issues and describe audit procedures specific to a business</td>
<td>3</td>
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<tr>
<td>combination.</td>
<td></td>
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<tr>
<td>Identify and explain the audit risks and necessary audit procedures relevant to</td>
<td>3</td>
<td></td>
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<tr>
<td>the consolidation process and group-wide controls.</td>
<td></td>
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<tr>
<td>Identify and describe the matters to be considered and the procedures to be</td>
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<tr>
<td>performed at the planning stage, when a group engagement team considers the</td>
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<tr>
<td>use of the work of component auditors.</td>
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<tr>
<td>Explain effective communication between the group engagement team and</td>
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<tr>
<td>component auditors and the determination and communication of materiality for</td>
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<tr>
<td>a group audit, including materiality at the component level.</td>
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<tr>
<td>Explain the responsibilities of component auditors in the context of a group audit.</td>
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<tr>
<td>Consider how the group engagement team should evaluate the audit work performed</td>
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<tr>
<td>by a component auditor.</td>
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<td>Explain the implications for the auditor’s report on the financial statements of</td>
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<tr>
<td>an entity where the opinion on a component is qualified or otherwise modified in</td>
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<tr>
<td>a given situation.</td>
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<td><strong>Review engagements and audit-related services</strong></td>
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<td>Describe the nature of a review engagement and audit-related services, the</td>
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<td>circumstances in which they might be required and the comparative levels of</td>
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<tr>
<td>assurance provided by public accounting entities and distinguish between:</td>
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<tr>
<td>• A review engagement, audit-related services and an audit of historical</td>
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<tr>
<td>financial statements; and</td>
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<tr>
<td>• An attestation, review or compilation engagement including compiling</td>
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<td>proforma financial information for a prospectus.</td>
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<td>Plan review engagements, for example:</td>
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<td>• A review of interim financial information; and</td>
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<td>• A review of historical financial information.</td>
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<td>Explain the nature and extent of enquiry and analytical procedures in review</td>
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<td>engagements and apply these procedures.</td>
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<td><strong>Assurance services other than statutory audit</strong></td>
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<td>Describe the main categories of assurance services that public accounting</td>
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<td>entities can provide and assess the benefits of providing these services to</td>
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<td>management and external users.</td>
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<td>Justify a level of assurance (reasonable or limited) for an engagement</td>
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<td>depending on the subject matter evaluated, the criteria used, the procedures</td>
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<td>applied and the quality and quantity of evidence obtained.</td>
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<td>Recognise the ways in which different types of risk (eg strategic, operating,</td>
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<td>information) may be identified and analysed and how it is communicated to</td>
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<td>management.</td>
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<td>Explain the usefulness to management and other stakeholders of combined</td>
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<td>assurance, especially in the context of risk management.</td>
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<td>Identify and describe the matters to be considered before accepting a specified</td>
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<td>Describe examination procedures for forecasts and projections.</td>
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<td>Apply extant standards for examination and reporting of PFI engagements.</td>
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<td>Compare the content of a report on an examination of PFI with reports made in</td>
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<td>providing audit-related services and apply the regulatory prescriptions.</td>
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<td>Evaluate the potential impact of an internal audit function on the planning</td>
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<td>and performance of the statutory audit.</td>
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<td>Explain how external and internal auditors may work together to provide</td>
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<td>stakeholders with combined assurance, including the need to plan all</td>
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<td>Recognise and evaluate the impact of outsourced functions on the conduct of an</td>
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<td>Critically appraise the form and content of an auditor’s report in a given situation.</td>
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<td>Recognise and evaluate the factors to be taken into account when forming an opinion in a given situation and justify opinions that are consistent with the results of audit or assurance procedures.</td>
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<td>Assess whether a proposed audit opinion is appropriate.</td>
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<td>Advise on the actions that may be taken by the auditor in the event that a modified audit report is issued including actions that must be taken under the existing regulatory framework.</td>
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<td>Explain when the use of an ‘emphasis of matter’ paragraph and ‘other matter’ paragraph would be appropriate.</td>
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<td>Reports to those charged with governance and management</td>
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<td>Critically assess the quality of reports by others and by management to those charged with governance and management.</td>
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<td>Advise on the content of reports to those charged with governance and management in a given situation.</td>
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<td>Analyse the form and content of the Professional Accountant’s report for an assurance engagement as compared with an auditor’s report and the restricted use of reports.</td>
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<td>Discuss the content of a report on examination of prospective financial information.</td>
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<td>Discuss the effectiveness of the ‘negative assurance’ form of reporting and evaluate situations in which it may be appropriate to express a reservation or deny a conclusion.</td>
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<td><strong>CURRENT ISSUES AND DEVELOPMENTS</strong></td>
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<td>Discuss the relative advantages of an ethical framework and a rulebook.</td>
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<td>2, 19</td>
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<td>Identify and assess relevant emerging ethical issues and evaluate the safeguards available.</td>
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<td>Discuss ethical issues in the context of current developments in Asia and internationally.</td>
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<td><strong>Information technology (IT)</strong></td>
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<td>Describe recent trends in IT and their current and potential impact on auditors (eg the audit implications of 'cyber incidents' and other risks).</td>
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<td>Explain how IT may be used to assist auditors and discuss the issues that may be encountered in automating the audit process.</td>
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<td>Explain the circumstances in which enhancements to data capture and information processing systems may add value to a client's activities.</td>
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<td>Discuss how business reporting on the internet and growing use of XBRL impacts on the duties of the auditor and how assurance may best be given to stakeholders using such information.</td>
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<td><strong>Social and environmental auditing</strong></td>
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<td>Explain the auditor's main considerations in respect of social and environmental matters and how they impact on entities and their financial statements (eg impairment of assets, provisions and contingent liabilities).</td>
<td>2</td>
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<tr>
<td>Describe substantive procedures to detect potential misstatements in respect of socio-environmental matters.</td>
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<tr>
<td><strong>Other current issues</strong></td>
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<td>Explain current developments in Singapore and international auditing standards including the need for new and revised standards and evaluate their impact on the conduct of audits.</td>
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</tr>
<tr>
<td>Discuss other current legal, ethical, professional and practical matters that affect accountants, auditors, their employers and the profession.</td>
<td>1</td>
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<tr>
<td>Explain the circumstances in which listed entity audit failures have mostly taken place in Singapore and overseas in the preceding 20 years, paying particular attention to the apparent ethics of management (including family-owned companies), internal and statutory auditors and others involved in the financial reporting chain.</td>
<td>1</td>
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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.
Chapter Features

This Textbook has been designed to provide Candidates with numerous features to assist the Candidates in preparing for exams.

- **Essential Reading** directs you to information that you will need to synthesise and/or apply in order to successfully complete this module.

- **Important information** highlights issues that you should be aware of, relating to areas currently undergoing change or which are the subject of discussion.

- **Section Introductions** explain how the section fits into the chapter.

- **Key Terms** are the core vocabulary you need to learn.

- **Key Points** are points that you have to know, ideas or calculations that will be the foundations of your answers.

- **Formulae To Learn** are formulae you must remember in the exam.

- **Examples** show how theory is put into practice.

- **Questions** give you the practice you need to test your understanding of what you've learnt.

- **Case Studies** link what you've learnt with the real-world business environment.

- **Links** show how the syllabus overlaps with other parts of the qualification, including Knowledge Brought Forward that you need to remember from previous exams.

- **Website References** link to material that will enhance your understanding of what you're studying.

- **Further Reading** will give you a wider perspective on the subjects you're covering.

- **Section Summaries** allow you to review each section.

- **Flags** highlight key legislation which you should familiarise yourself with.
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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PART A
LEGAL AND PROFESSIONAL FRAMEWORK
THE REGULATORY FRAMEWORKS FOR ASSURANCE SERVICES

This chapter covers a wide range of regulations that affect the work of assurance professionals. It is important to be aware of the international nature of the assurance market and the main issues driving the development of regulatory frameworks including the impact of corporate governance measures.

The requirement for a company to be subject to an audit in Singapore is given in part VI of the Companies Act. In Singapore, the Institute of Singapore Chartered Accountants (ISCA) issues Singapore Standards on Auditing (SSAs) which all auditors are required to follow. ISCA also issues other standards, for example, on quality control. All the standards are based on international standards published by the International Auditing and Assurance Standards Board (IAASB). Standards issued by ISCA are quoted throughout this Textbook.

The Public Accountants Oversight Committee (PAOC) promotes audit quality and protects the public interest in Singapore. A lack of trust in corporate governance and the audit process can end in market failure, such as the Enron scandal. This scandal resulted in the Sarbanes-Oxley Act 2002 to regain investor's trust in the US stock market and is described in Section 1.

The Companies Act also contains provisions covering internal control and audit committees which are explored in Sections 2 and 3 of this chapter. These two topics are further guided by the Code of Corporate Governance.

Money laundering is particularly topical together with increasing world-wide concern regarding the financing of terrorism. Both local and international law has been developed in order to combat this illegal activity.

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<td>4 Laws and regulations</td>
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<td>5 Money laundering</td>
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### Syllabus Handbook

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<th>Cognitive level</th>
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<tr>
<td><strong>Regulatory frameworks for audit and assurance services</strong></td>
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<tr>
<td>Explain the need for laws, regulations, standards and other guidance relating to audit, assurance and related services in Singapore and how they align with international regulatory frameworks, such as those issued by the International Auditing and Assurance Standards Board (IAASB).</td>
<td>2</td>
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<tr>
<td>Outline and explain the need for legal and professional frameworks including:</td>
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<td>- Public oversight of an audit and assurance practice; and</td>
<td></td>
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<td>- The role of audit committees and the impact on audit and assurance practice.</td>
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<tr>
<td><strong>Anti-money laundering and terrorism financing</strong></td>
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<tr>
<td>Explain the scope of ‘money laundering and terrorism financing’ and the related obligations of a Chartered Accountant of Singapore.</td>
<td>2</td>
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<tr>
<td>Explain national Singaporean and international efforts to combat money laundering.</td>
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</tr>
<tr>
<td><strong>Laws and regulations</strong></td>
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</tr>
<tr>
<td>Compare and contrast the respective responsibilities of directors, management and auditors concerning compliance with laws and regulations in an audit of financial statements.</td>
<td>2</td>
</tr>
<tr>
<td>Describe the auditor's considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.</td>
<td>2</td>
</tr>
<tr>
<td>Explain how, why, when and to whom non-compliance should be reported and the circumstances in which an auditor should withdraw from an engagement.</td>
<td>3</td>
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</tbody>
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### ESSENTIAL READING

- Ethics Pronouncement 200 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore
- Ethics Pronouncement 200 Implementation Guidance 1 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore
- Preface to the Singapore Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements
- Risk Governance Guidance for Listed Boards
- SSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
- SSA 260 (Revised) Communication with Those Charged with Governance
- SSA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
1 Regulatory frameworks for assurance services

SECTION INTRODUCTION

This section describes the need for laws, standards and guidance over the different types of assurance provided by Chartered Accountants and the framework for providing this, both in Singapore and internationally. You will be reminded of the elements of an assurance engagement and introduced to the different types of engagement or service covered in this Textbook, along with the various standards governing each.

Part III of the Accountants Act defines who can be a ‘public accountant’ and The Second Schedule to the Accountants (Public Accountants) Rules states the requirements for registration as a public accountant. However, there is no regulatory framework or Singapore statute that restricts the use of the title ‘accountant’. Nonetheless, the general understanding is that an accountant is an individual skilled in the art (and science) of analysing and interpreting financial and management accounting information and can advise relevant stakeholders on a wide range of matters. While not mandatory, an accountant is usually also a member of good standing with at least one of the professional accounting bodies recognised in Singapore, with the national body being the Institute of Singapore Chartered Accountants (ISCA).

The Chartered Accountant designation is conferred by ISCA on behalf of the Singapore Accountancy Commission. Section 26 of the Singapore Accountancy Commission Act mandates registration in order to use the CA (Singapore) designation and Section 25 mandates restrictions on the use of the title. Changes to the Singapore Accountancy Commission Act were passed by Parliament on 8 October 2014 and took effect in the second quarter of 2015.

Prior to these changes, only a sole proprietorship or partnership comprised wholly of Chartered Accountants of Singapore was permitted to use the professional designation ‘Chartered Accountant of Singapore’ or initials ‘CA (Singapore)’ as part of its name. A company or an LLP was not permitted to do so.

The changes allowed entities providing public accountancy services and registered under the Accountants Act to use the ‘Chartered Accountant of Singapore’ or ‘CA (Singapore)’ professional designation as part of their entities’ names. Entities providing accountancy services, but not registered under the Accountants Act, can apply to the Singapore Accountancy Commission to use the designation.

These changes aimed to promote the professional designation in the Singapore accountancy sector and align with legislation regulating other professions, which allows companies and LLPs to use the professional designations in their entities’ names.

WEBSITE

ACRA has published a fact sheet which includes the amendments to the Singapore Accountancy Commission Act. It can be found at the following website.


In 2017, ACRA also consulted on proposed changes to the Companies Act and LLPs Act with a view to reducing the regulatory burden on, and enhancing the transparency of, business entities, as well as changes to the Accountants Act clarifying the existing provisions on disciplinary action for breaches of EP 200. This consultation can be found at the following website.

1.1 Types of assurance engagement

An assurance engagement performed by a Chartered Accountant will consist of the following elements:

(a) **A three party relationship.** The three parties are the intended user, the responsible party and the Chartered Accountant.

(b) **An appropriate subject matter.** This is the data to be evaluated that has been prepared by the responsible party. It can take many forms including financial performance (e.g., historical financial information), non-financial performance (e.g., key performance indicators), processes (e.g., internal control) and behaviour (e.g., compliance with laws and regulations).

(c) **Suitable criteria.** The subject matter is evaluated or measured against criteria in order to reach an opinion.

(d) **Evidence.** Sufficient appropriate evidence needs to be gathered to support the required level of assurance.

(e) **A written assurance report.** A report containing the Chartered Accountant’s opinion is issued to the intended user.

**KEY TERMS**

**ASSURANCE ENGAGEMENT** is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria. Under the Framework for Assurance Engagements there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

**REASONABLE ASSURANCE ENGAGEMENT** – the objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner’s conclusion.

**LIMITED ASSURANCE ENGAGEMENT** – the objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner’s conclusion.

(A SSA Glossary)

**A FINANCIAL STATEMENTS AUDIT** is the independent examination of and an expression of opinion on the financial statements of an organisation. A financial statements audit is a type of reasonable assurance engagement.

Assurance engagements include statutory financial statements audits but also include other engagements and services such as reporting on cash flow or profit forecasts. Throughout this Textbook, you will be expected to understand the different types of assurance engagements performed by Chartered Accountants. Chapters 13, 14 and 17 of this Textbook look at assurance engagements other than a financial statements audit in more detail, but a brief summary of the different types of assurance engagement is produced here.
<table>
<thead>
<tr>
<th>Engagement/Service</th>
<th>Type of assurance provided</th>
<th>Examples</th>
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<tr>
<td>External audit of financial statements</td>
<td>Reasonable</td>
<td>Statutory audit</td>
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<tr>
<td>Review of historical financial statements</td>
<td>Limited</td>
<td>Review of financial statements of a company below the audit threshold</td>
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<tr>
<td>Review of interim information</td>
<td>Limited</td>
<td>Review of interim financial statements</td>
</tr>
<tr>
<td>Examination of prospective financial information</td>
<td>Limited</td>
<td>Reporting on cash flow and profit forecasts</td>
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<tr>
<td>Assurance engagements other than audit or the review of historical financial information</td>
<td>Reasonable or limited</td>
<td>Due diligence</td>
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<tr>
<td>Agreed-upon procedures</td>
<td>None</td>
<td>Report on figures included in a Statement of Achievement submitted in connection with the incentive conditions of the Singapore Economic Development Board (EDB), for example total business expenditure or total employment</td>
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<td>Report on revenue figures to be used in calculating royalties</td>
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<tr>
<td>Compilation</td>
<td>None</td>
<td>Preparation of financial statements</td>
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<td></td>
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<td>Preparation of tax returns</td>
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The Preface to the Singapore Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements published by the Institute of Singapore Chartered Accountants (ISCA) describes which type of pronouncements apply to each type of engagement.

1.2 The need for laws, regulations, standards and other guidance

Assurance is provided by independent professionals to set standards. Users expect assurance providers to be independent and objective (which we shall consider in the next chapter) and competent. They expect an appropriate amount of work to be done to support the conclusion being given. Assurance engagements are carried out in the public interest. It is important that they are carried out within a context of professional and ethical standards.

In relation to audit, users want assurance when making comparisons of financial statements that the reliability of the financial statements does not vary from company to company. This assurance will be obtained not just from knowing each set of financial statements has been audited, but knowing that each set of financial statements has been audited to common standards.

Hence there is a need for audits to be regulated so that auditors follow the same standards. Auditors have to follow rules issued by a variety of bodies. Some obligations are imposed by governments in law, or statute. Some obligations are imposed by the professional bodies to which auditors are required (by law) to belong.

There has been a great deal of re-examination of regulatory and standard-setting structures both nationally and internationally in recent years. Changes have aimed to enhance the quality and uniformity of practice worldwide.

More recently, the global financial crisis has brought the audit profession under close scrutiny from the users of auditor's reports. For example, following calls to provide more useful and informative information in the auditor's report, additional content has been added (see Chapter 16 for further details).
1.3 The legal and professional framework

The following summaries will provide a quick reminder of the regulatory framework.

1.3.1 Overview of the Singapore regulatory framework

**WEBSITE**

The Accounting and Corporate Regulatory Authority (ACRA) was formed in April 2004 and is the national regulator of business entities and public accountants in Singapore. It is responsible for the regulation of public accountants and accounting entities (AEs). The Public Accountants Oversight Committee (PAOC) is responsible for assisting ACRA. ACRA adopts standards issued by the Institute of Singapore Chartered Accountants (ISCA) and in doing so undertakes oversight of the process followed by ISCA in developing and issuing the standards.


**WEBSITE**

ISCA is the national professional accounting body in Singapore and sets professional standards for its members. While Section 10(1)(b) of the Accountants Act prescribes the qualifications for registration and notes that for an applicant to be registered as a public accountant they must hold membership in any professional accountancy body or organisation, the Public Accountants Oversight Committee will not register any person as a public accountant unless they are a member of ISCA. A member of ISCA shall not include a provisional member, an honorary member, or a member-in-retirement.

Singapore’s auditing and assurance standards are developed by ISCA’s Auditing and Assurance Standards Committee (AASC).

[http://www.isca.org.sg/the-institute/isca-committees/](http://www.isca.org.sg/the-institute/isca-committees/)

The following diagram illustrates the auditing and assurance publications made by the AASC.
The AASC's aims are as follows:

- To develop high quality auditing standards which serve the public interest.
- To adopt the auditing and assurance standards issued by the International Auditing and Assurance Standards Board (IAASB), with such amendments as are necessary to serve the public interest in Singapore and to conform with Singapore's regulatory environment and statutory requirements, taking into account the benefits and intention of aligning as closely as possible with international standards.
- To monitor policy and implementation issues relating to the development of auditing and assurance standards internationally and in Singapore, and to give consideration to the need for guidance or additional requirements where appropriate and in the public interest.
- To engage with international bodies and promote Singapore's interests in relation to auditing and assurance standards and, where appropriate, take a leading role in representing regional interests.
- To raise public awareness and understanding of the standard setting process and the standards, in particular to deepen stakeholder engagement and promote confidence in auditing and assurance standards.

http://www.isca.org.sg/tkc/aa/standards/

1.3.2 International standard setting

International Standards on Auditing (ISAs) are produced by the International Auditing and Assurance Standards Board (IAASB), a technical standing committee of the International Federation of Accountants (IFAC).

http://www.ifac.org/auditing-assurance

You should also be familiar with the International Ethics Standards Board for Accountants (IESBA), another body of the International Federation of Accountants and the producer of the IESBA Code of Ethics (see Chapter 2).

http://www.ifac.org/ethics
PART A LEGAL AND PROFESSIONAL FRAMEWORK

1: The regulatory frameworks for assurance services

The IAASB's Preface to the International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements (Revised 2014) states that all of the IAASB's 'engagement standards' above are 'authoritative pronouncements', which means that they must be followed in an audit conducted in accordance with ISAs.

The IAASB also publishes three kinds of 'non-authoritative material':

- International Auditing Practice Notes (IAPNs). These do not impose additional requirements on auditors, but provide them with practical assistance.
- Practice Notes Relating to Other International Standards, eg International Review Engagement Practice Notes (IREPNs), International Assurance Engagement Practice Notes (IAEPNs) and International Related Services Practice Notes (IRSPNs).
- Staff Publications, which are used to help raise awareness of new or emerging issues, and to direct attention to the relevant parts of IAASB pronouncements.

Within each country, local regulations govern, to a greater or lesser degree, the practices followed in the auditing of financial or other information. Such regulations may be either of a statutory nature, or in the form of statements issued by the regulatory or professional bodies in the countries concerned.

National standards on auditing and related services published in many countries differ in form and content. The IAASB takes account of such documents and differences and, in the light of such knowledge, issues ISAs which are intended for international acceptance. ISAs are structured as follows:

- **Objective.** This provides the context in which the requirements of the ISA are met.
- **Requirements.** These are contained in a separate section and expressed using the word 'shall'.
- **Application and other explanatory material.** This is an integral part of the ISA.

Generally in Singapore, ISAs are usually adopted wholesale with slight amendments.

### 1.4 Public oversight

**KEY POINT**

Public oversight of the audit profession and of standard-setting has been a trend in recent regulatory developments internationally and locally in Singapore.
1.4.1 Public oversight in the US

CASE STUDY

Amongst other significant scandals in the US in recent years was the Enron scandal. Enron Corporation was an energy company based in Houston, Texas. At its peak it was one of the world’s largest producers of electricity and gas as well as having large-scale pulp, paper and communications businesses. At the time it filed for Chapter 11 bankruptcy (protection from creditors’ claims under US law) in December 2001, Enron employed over 20,000 people. By the end of that year, it had been revealed that Enron had been used as a vehicle for systematic accounting fraud, with its major executives directly involved in the criminal activities.

Prior to bankruptcy, Enron had been highly successful and reputable. It had been voted America’s most innovative company on several occasions. In addition to marketing energy, Enron actually built the pipelines and power plants (backward integration). To spread its risks beyond the energy industry, it moved successfully into telecommunications and e-commerce as well as trading derivatives.

Once the problems were uncovered, it emerged that Enron’s financial statements were completely misleading. Its recorded assets were inflated in value and in some cases non-existent. The company had placed debts and other obligations with offshore entities, thereby not consolidating them in the group financial statements.

The systematic false accounting that had taken place led to a criminal investigation and the arrest and indictment of several senior figures in the company. Several of the directors paid significant sums of money to settle lawsuits against them. Jeffrey Skilling, the former Chief Executive Officer, was sentenced to 24 years in prison on numerous charges, including fraud.

The scandal exposed a number of deficiencies in the company’s governance:

(a) A lack of transparency in the financial statements, especially in relation to certain investment vehicles that were kept off-balance sheet.

(b) Board control of Enron was maintained by one individual, non-executive directors were weak, and there were conflicts of interest.

(c) Inadequate scrutiny by the external auditors. Arthur Andersen failed to spot or failed to question dubious accounting treatments. Since Andersen’s consultancy arm also did a lot of work for Enron and was one of Arthur Andersen’s largest fee paying customer, there were allegations of conflicts of interest.

(d) Information asymmetry where the directors and managers knew more than the investors.

(e) Executive compensation methods were meant to align the interests of shareholders and directors, but seemed to encourage overstatement of short-term profits. Particularly in the US, where the tenure of Chief Executive Officers is fairly short, the temptation is strong to inflate profits in the hope that share options and bonuses will have been cashed before problems are discovered.

The scandal also resulted in the disappearance of Arthur Andersen, one of the then-Big Five accountancy firms who had audited Enron’s financial statements. The firm was accused of deliberately destroying evidence related to the Enron audit and was found guilty of obstruction of justice in 2002. Any US company required to submit audited financial statements to the Securities and Exchange Commission (SEC) found it could no longer use Arthur Andersen as an auditor, since the SEC could not accept audits from convicted felons.
In the US, the response to the breakdown of stock market trust caused by perceived inadequacies in corporate governance arrangements and the Enron scandal, was the Sarbanes-Oxley Act 2002. The Act was signed in July 2002 and applies to all companies that are required to file periodic reports with the Securities and Exchange Commission (SEC).

**WEBSITE**

The Public Company Accounting Oversight Board (PCAOB) is a private sector body in the US created by Sarbanes-Oxley. Its aim is to oversee the audits of public companies.

[www.pcaobus.org](http://www.pcaobus.org)

The creation of the PCAOB was a significant development in the US since it ended self-regulation by the audit profession.

The PCAOB's stated purpose is to 'protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports'. Its responsibilities are as follows.

- Registration of accounting firms auditing public companies trading in the US securities market
- Setting of auditing, quality control, ethics and independence standards for registered public accounting firms to follow
- The inspection of registered public accounting firms to assess compliance with Sarbanes-Oxley, the rules of the PCAOB Board, the rules of the SEC and professional standards
- Investigation and disciplining registered public accounting firms and persons associated with those firms for non-compliance with Sarbanes-Oxley, the rules of the PCAOB and the SEC, and other laws, rules, and professional standards

In Singapore, all subsidiary companies of US SEC organisations and companies that are registered as foreign private issuers with the SEC need to comply with Sarbanes-Oxley. Note that in the US, the term 'issuer' means an issuer of shares (called securities), who is required to file audit reports with the SEC.

Sarbanes-Oxley has been criticised in some quarters for not being strong enough on certain issues, for example the selection of external auditors by the audit committee, and at the same time being over-rigid on others.

In addition, it has been alleged that a Sarbanes-Oxley compliance industry has sprung up focusing companies' attention on complying with all aspects of the legislation, irrespective of how significant they may be. This has distracted companies from improving information flows to the market and then allowing the market to make well-informed decisions. The Act has also done little to address the temptation provided by generous stock options to inflate profits, other than requiring possible forfeiture if financial statements are subsequently restated.

Most significantly perhaps, there is recent evidence of companies turning away from the US stock markets and towards other markets such as London. An article in the Financial Times suggested that this was partly due to companies tiring of the increased compliance costs associated with the Sarbanes-Oxley regulatory regime.

**1.4.2 Public oversight internationally**

In February 2005 the Public Interest Oversight Board (PIOB) was launched to exercise oversight for all of IFAC's 'public interest activities' including its standard-setting bodies such as the IAASB. Its work involves:

- Monitoring the standard-setting boards
- Overseeing the nomination process for membership of these boards
- Co-operation with national oversight authorities.
The objective of the international PIOB is to increase the confidence of investors and others that the public interest activities of IFAC are properly responsive to the public interest. The PIOB is based in Madrid, Spain, where it operates as a non-profit Spanish foundation.

http://www.ipiob.org/

1.4.3 Public oversight in Singapore

In Singapore, the Public Accountancy Division (PAD) regulates and facilitates the development of Singapore's public accountancy sector. It consists of the Practice Monitoring Department (PMD) and the Professional Oversight Department (POD).

https://www.acra.gov.sg/About_Acra/Departments_and_Divisions/

The PAD's key responsibilities are:

**Practice Monitoring Department (PMD)**

- Administration of Practice Monitoring Programme to promote high quality audit and corporate financial reporting
- Performing practice reviews of audits carried out by public accountants
- Helping ACRA cooperate with audit regulators in other jurisdictions

**Professional Oversight Department (POD)**

- Overseeing the registration and disciplinary matters of public accountants and public accounting entities
- Also reviews the adoption of the ethical standards applicable to public accountants in Singapore
- Reviews adoption of ethical standards applicable to public accountants in Singapore.

PAD also oversees strategy and policy for the accountancy sector to promote quality in both financial reporting and audit, both domestically and internationally, via the Accounting Policy Department (APD). Legal matters are dealt with on ACRA's behalf by the Legal Services Department (LSD).
CASE STUDY

In 2004, China Aviation Oil, a Singapore based jet-fuel trader owned by a Chinese parent company, lost $550m on speculative trading on oil prices. The scandal caused concern about the oversight system of the Singapore Exchange. In order to maintain their reputation, the Singapore Exchange commissioned PricewaterhouseCoopers to investigate the circumstances leading to the losses so that appropriate action could be taken. Their report found China Aviation Oil failed to disclose the losses and reported a pre-tax profit of $49.6 million when it should have reported pre-tax losses of $379 million. The report also found that the company overrode its internal controls and had weak corporate governance. The CEO, Chen Jiulin, and other officials at China Aviation Oil were subsequently prosecuted for fraud and failure to disclose losses.

SECTION SUMMARY

Singapore Standards on Auditing (SSAs) are issued by ISCA. These are based on International Standards on Auditing (ISAs) issued by the IAASB. In Singapore, the Public Accountancy Division (PAD) oversees the development and adoption of Singapore auditing standards and promotes audit quality.

2 Audit committees

SECTION INTRODUCTION

This section looks at the role of audit committees and their impact on audit. Audit committees play an essential role within a company’s governance framework under both the Companies Act and the Code of Corporate Governance.

This section, and Section 3, consider the format that ‘those charged with governance’ will take in a company. An auditor will need to liaise with those charged with governance throughout their career and so an appreciation of their responsibilities relating to the audit will help create a smoother audit process.

Singapore Standards on Auditing often require auditors to make specific disclosure to those charged with governance at a company, for example SSA 260 (Revised) Communication to Those Charged with Governance and SSA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management. These standards and others which place a responsibility on the auditor to report to those charged with governance are examined in more detail later in this Textbook.

2.1 Companies Act provisions

WEBSITE

The Companies Act can be found at https://www.acra.gov.sg/Legislation/Companies_Act/

Section 201B of the Companies Act (Chapter 50) requires every listed company to have an audit committee. It stipulates that the function(s) of the audit committee are as follows:
1. The regulatory frameworks for assurance services

(a) To review:

- With the auditor, the audit plan
- With the auditor, their evaluation of the system of internal accounting controls
- With the auditor, their auditor’s report
- The assistance given by the company’s officers to the auditor
- The scope and results of internal audit procedures
- The financial statements of the company and to submit them to the directors

(b) To nominate the auditors

2.2 Corporate Governance Code provisions

2.2.1 Eligibility

The Code of Corporate Governance 2018 states that the board should have an audit committee which discharges its duties objectively. This should comprise at least three directors, the majority of whom, including the audit committee chairman, should be independent. All members should be non-executive directors with at least two members (including the chairman) having recent and relevant accounting or related financial management expertise or experience.

A former partner or director of the company’s existing AE should not act as a member of the audit committee:

(a) Within a period of 2 years commencing on the date of ceasing to be a partner or director of the AE and in any case

(b) For as long as they have any financial interest in the AE.

WEBSITE

The Code of Corporate Governance 2018 can be found at:


2.2.2 Duties

In accordance with the Code of Corporate Governance 2018, the duties of the audit committee include:

(a) Reviewing the significant financial reporting issues and judgments so as to ensure the integrity of the financial statements of the company and any announcements relating to the company’s financial performance.

(b) Reviewing at least annually the adequacy and effectiveness of the company’s internal controls.

(c) Reviewing the assurance from the CEO and the CFO on the financial records and financial statements.

(d) Making recommendations to the Board on: (i) the proposals to the shareholders on the appointment and removal of external auditors; and (ii) the remuneration and terms of engagement of the external auditors.

(e) Reviewing the adequacy, effectiveness, independence, scope and results of the external audit and the company’s internal audit function (see Chapter 15).

(f) Reviewing the policy and arrangements for concerns about possible improprieties in financial reporting or other matters to be safely raised, independently investigated and appropriately followed up on. The company publicly discloses, and clearly communicates to employees, the existence of a whistle-blowing policy and procedures for raising such concerns.
2.2.3 Relationship with external auditors

The audit committee should meet both the external auditors and internal auditors at least annually, and without the presence of management in each case.

Where the external auditors also supply a substantial volume of non-audit services to the company, for example tax, internal audit or corporate governance services, the audit committee should keep the nature and extent of these services under review to ensure that objectivity is maintained. This will be covered in more detail in Chapter 2.

WEBSITE

The Monetary Authority of Singapore (MAS), ACRA and the Singapore Exchange (SGX) jointly issued the Guidebook for Audit Committees in Singapore (second edition) on 19 August 2014 following a review of the original edition by the Work Group to Review Guidebook for Audit Committees in Singapore. In this publication, the importance of an understanding of the role of the external auditor is stressed.

The guide can be found at https://www.acra.gov.sg/uploadedFiles/Content/Publications/Guides/Guidebook%20for%20ACs%20(2nd%20edition).pdf

Section 6.2.8 of the guide suggests that the audit committee should consider the following questions as a means of enhancing their understanding:

- What are the objectives of the external audit?
- How do the external auditors define materiality in setting their audit scope?
- What are the company's financial reporting requirements and what is the expected time frame to comply with these requirements?
- How do the external auditors identify the key financial statement risks that will affect the audit and the audit approach. How will the external auditors communicate these risks to the audit committee?
- Do the external auditors have a role in detecting material errors, fraud and illegal acts? How will these be addressed in the audit?
- How do the external auditors evaluate the adequacy and effectiveness of the company's internal controls over the financial reporting functions?
- Are there any financial statements areas where the external auditor does not plan to rely on internal controls and why not?
- How will the external auditors co-ordinate their work with the internal auditors?
- How do company computer systems and applications affect the audit approach and how will these areas be audited?
- How will recent changes in accounting policies or regulatory requirements impact this year's financial statements?
- How do the external auditors obtain assurance over areas that involve management judgment and estimates?
- How will the external auditors identify and audit related party transactions?
- How will any recent changes in the company – eg major acquisitions or disposals of investments, new product lines – affect the audit scope and approach?
- How will the external auditors follow up on the audit issues highlighted in the previous period?
2.3 Advantages and disadvantages of audit committees to external auditors

The key advantage to an external auditor of having an audit committee is that such a committee of independent non-executive directors provides the auditor with an independent point of reference other than the executive directors of the company, in the event of disagreement arising.

Other advantages that are claimed to arise from the existence of an audit committee include:

(a) It will lead to increased confidence in the credibility and objectivity of financial reports.
(b) By specialising in the problems of financial reporting and thus, to some extent, fulfilling the directors' responsibility in this area, it will allow the executive directors to devote their attention to management.
(c) In cases where the interests of the company, the executive directors and the employees conflict, the audit committee might provide an impartial body for the auditors to consult.
(d) The internal auditors will be able to report to the audit committee, enhancing the credibility and objectivity of their reports too.

Opponents of audit committees argue that the disadvantages are as follows:

(a) There may be difficulty selecting sufficient non-executive directors with the necessary competence in auditing matters for the committee to be really effective.
(b) The establishment of such a formalised reporting procedure may dissuade the auditors from raising matters of judgment and limit them to reporting only on matters of fact.
(c) Company's compliance on audit committees will increase costs and increase bureaucracy such as the time taken to approve projects by management. Costs may be increased as non-executive directors will need to be appointed and regular meetings will need to be arranged. For example, in their 2015 annual report, Keppel Corporation reported that their audit committee chairman was paid $50,000 per annum and each audit committee member was paid $27,000 per annum.

2.4 Role and function of audit committees

If they operate effectively, audit committees can bring significant benefits. In particular, they have the potential to:

(a) Improve the quality of financial reporting, by reviewing the financial statements on behalf of the board.
(b) Create a climate of discipline and control which will reduce the opportunity for fraud.
(c) Enable the non-executive directors to contribute an independent judgment and play a positive role.
(d) Help finance directors, by providing a forum in which they can raise issues of concern, and which they can use to get things done which might otherwise be difficult.
(e) Strengthen the position of the external auditor, by providing a channel of communication and forum for issues of concern.
(f) Provide a framework within which the external auditors can assert their independence in the event of a dispute with management.
(g) Strengthen the position of the internal audit function, by providing a greater degree of independence from management.
(h) Increase public confidence in the credibility and objectivity of financial statements.
2.5 Evaluation of quality of work performed by external auditors

WEBSITE

The document emphasises the importance of effective interaction between audit committees and external auditors to deliver a quality audit outcome which is inextricably linked to the external auditor's ability to deliver value to the company's shareholders. The audit committee may wish to consider the merits of involving their auditors in reviewing the company's interim results announcements throughout the financial year.

2.5.1 Enhancing the value of the audit

The Guidance states that the value of the audit is enhanced when the auditor is able to engage effectively on all audit and related matters and when the auditor's report is substantiated by underlying audit work of high quality. The Guidance focuses on four important indicators of audit quality observed through ACRA's Practice Monitoring Programme (PMP):

- Emphasis on quality by the audit engagement partner and the AE
- Allocation of adequate and appropriate human resources
- Substantial involvement of the audit engagement partner
- Exercise of professional scepticism

Both the audit committee and the external auditors should take an interest in the indicators of audit quality.

2.5.2 Emphasis on quality by the audit engagement partner and the AE

The emphasis on providing quality audit work to the client must be driven by the engagement partner and the culture of the AE must reflect the importance it places on audit quality. The audit committee must obtain a sense of the AE's commitment to quality by doing the following:

(a) Asking for a presentation on or description of the AE's system of quality control and how this satisfies relevant auditing standards.
(b) Considering the priority placed by the AE's leadership on ensuring the robustness and effectiveness of quality controls.
(c) Considering the quality of thought leadership provided by the audit engagement partner and AE in areas of relevance to the company.
(d) Requiring audit plans to be presented, discussed and approved at an early stage of the audit cycle with subsequent changes and the rationale behind them being reported back on a timely basis.
(e) Considering the extent of involvement of the audit engagement partner. Substantial involvement of the audit engagement partner is critical to ensure that all audit issues are identified and resolved quickly and appropriately.

2.5.3 Allocation of adequate and appropriate human resources

Whilst the system of quality control in an AE can provide the infrastructure and a conducive environment for quality work, audit quality is very much driven by the individuals performing the audit. The audit
committee should give due consideration to the skills and qualities of key members of the audit team. In particular the audit committee should perform the following procedures:

(a) Assess whether the audit engagement partner has sufficient experience to understand the company's business so as to be able to advise the audit committee on the following:

(i) Risk areas on a timely basis
(ii) Audit and accounting issues arising from changes in the business
(iii) Changes in industry and operating environments as well as changes in accounting standards and regulatory requirements

(b) When reviewing and approving the audit plan, the audit committee should ask for a list of all the audit team members, including information on their seniority, industry experience, technical knowledge, language skills and expected role in the forthcoming audit.

(c) Ask the audit engagement partner to confirm the independence of each team member.

(d) Enquire specifically on issues relevant to the company's business such as specialist expertise in certain areas.

(e) Assess sufficiency of audit resources assigned to the company by asking for a detailed plan outlining each member of the audit team's involvement/areas of responsibility and areas of work to be completed within the stated audit periods.

2.5.4 Substantial involvement of the audit engagement partner

The substantial involvement of senior members of the audit team is critical to ensure that all audit issues are identified and resolved quickly and appropriately. In this respect the audit committee should give particular attention to the extent of involvement of the audit engagement partner. The audit committee may wish to consider the merits of involving their auditors in reviewing the company's interim results announcements throughout the financial year.

2.5.5 Exercise of professional scepticism

In order to demonstrate technical competency and audit effectiveness, the auditor needs to exercise an appropriate level of professional scepticism. In engaging with the auditor on various audit issues the audit committee must consider whether the auditor has exercised an appropriate level of professional scepticism. The audit committee should be alert to indications that the auditor is insufficiently sceptical and too ready to accept management assertions. An auditor's willingness to speak up on key issues and challenge management's assertions contributes to the effectiveness of an audit. The audit committee should also consider the following:

(a) Whether the auditor intends to rely on the work of an external expert. The audit committee should query the auditor's approach and understanding of the assumptions and methods adopted by the expert.

(b) For groups with extensive foreign operations audited by component auditors the audit committee should inquire and discuss with the group auditor the audit procedures being carried out so that reliance can be placed on the work of the component auditor.

(c) Discussion with the audit partner and the audit team regarding their approach to the confirmation process on whether the auditor intends to rely on external confirmations of cash, assets and liabilities.

(d) How the audit team plan to verify the completeness of information on related parties as related party balances and transactions may be susceptible to fraudulent financial reporting.
Question 1.1

The audit committee is a key part of effective corporate governance.

Required

(a) Explain what you understand by the term audit committee.
(b) List and briefly describe the duties and responsibilities of audit committees.
(c) Discuss the advantages and disadvantages of audit committees.

2.6 Study on the Profile of Audit Committees of Listed Companies in Singapore

In June 2015 a study was released by ISCA that provided a comparative understanding of the compliance of audit committees of listed companies in Singapore in relation to the Companies Act, the Code of Corporate Governance, the Guidebook for Audit Committees in Singapore and the Listing Rules of the Singapore Exchange.

This study found that there were an increasing number of financially trained individuals in audit committees. The percentage of audit committees with two or more members who are financially-trained increased from 45.8% in 2011 to 67.6% in 2015. The percentage of audit committee chairmen who listed accountancy/audit or banking/finance/investment as their major full-time experience was 64.6% in 2015 (59.8% in 2011).

It also found that there was a decrease in individuals holding multiple chairmanships and memberships. In 2015, there were 6 individuals holding more than 4 audit committee chairmanships (16 in 2011) and 2 individuals holding more than 6 audit committee memberships (3 in 2011).

Audit committee chairmen and members need to have enough time to carry out their duties and would expect to meet quarterly, so some may argue that it would be desirable to have a threshold on the number of chairmanships or memberships that an individual may accept at one time.

The study did find that there were 38 executive directors in the audit committees surveyed, despite the Code of Corporate Governance only allowing non-executive directors in the audit committee.

SECTION SUMMARY

The audit committee has oversight responsibilities regarding the quality and integrity of the company’s financial information and the work of the external auditor.

3 Internal control effectiveness

SECTION INTRODUCTION

Internal control is one key area of good corporate governance. Directors are responsible for maintaining a system of control that will safeguard the company’s assets. You will need to understand the relative responsibilities of directors and auditors in relation to internal control before studying money laundering and laws and regulations later in this chapter.
3.1 Importance of internal control and risk management

**KEY TERM**

**Internal Control** is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term 'controls' refers to any aspects of one or more of the components of internal control.

In Section 199 (2A) of the Companies Act, it states that every public company and every subsidiary company of a public company shall devise and maintain a system of internal accounting controls sufficient to provide a reasonable assurance that:

(a) Assets are safeguarded against loss from unauthorised use or disposition; and

(b) Transactions are properly authorised and recorded as necessary to permit the preparation of the true and fair financial statements and to maintain accountability of assets.

Principle 9 of The 2018 Singapore Code of Corporate Governance states that 'The Board is responsible for the governance of risk and ensures that Management maintains a sound system of risk management and internal controls, to safeguard the interests of the company and its shareholders'.

Internal control systems help a company to manage risks it takes in trying to achieve its strategic objectives. Internal control also helps to prevent and detect fraud, and to safeguard the company's assets for the shareholders.

Additional guidance for the boards of listed companies is provided in *Risk Governance Guidance for Listed Boards* published by the Monetary Authority of Singapore in 2012. This document provides practical guidance and is not prescriptive.

3.2 Directors’ responsibilities

The ultimate responsibility for a company's system of internal controls lies with the board of directors. The Listing Rules of the Singapore Exchange require the Board to review the adequacy and effectiveness of the company's risk management systems and internal controls at least annually. This should include a review of financial, operational, compliance and information technology controls.

Part of setting up an internal control system will involve assessing the risks facing the business, so that the system can be designed to ensure those risks are minimised or avoided. The system of internal control in a company will reflect the control environment, which includes the attitude of the directors towards risk, and their awareness of it.

Internal control systems will always have inherent limitations, the most important being that a system of internal control cannot eliminate the possibility of human error, or the chance that staff will collude to override an internal control in fraud.

Once the directors have set up a system of internal control, they are responsible to review it regularly, to ensure that it still meets its objectives.

The board may decide that in order to carry out their review function properly they have to set up an internal audit function to undertake this task. The role of internal audit is discussed in more detail in Chapter 15. This involves employing suitably qualified accountants (for instance, a Chartered Accountant of Singapore) who will recommend, implement, review and monitor the company's internal control functions.
The Code of Corporate Governance (Provision 9.2) requires the board of directors of listed companies to disclose that it has received assurances from:

(a) the CEO and CFO that the financial records have been properly maintained and the financial statements give a true and fair view of the company's operations and finances; and

(b) the CEO and other such key management personnel as may be responsible, regarding the adequacy and effectiveness of the company's risk management and internal control systems.

### 3.3 Auditors' responsibilities

Under Statement of Auditing Practice (SAP) 3, *Audit of Listed Companies*, the audit committee should review with the external auditor their findings on their evaluation of the listed company's system of internal controls. The review would assist the board of directors in developing policies that would enhance the controls and operating systems of the listed company.

Where a statement is included in the annual report on corporate governance processes and activities in relation to the controls and operating systems of the listed company, the auditor is not expected to provide assurance that the statement is free from misstatements or inconsistencies. This is because whilst the auditor may obtain audit evidence through tests of controls, due to the test nature and other inherent limitations of an audit, taking into account the inherent limitations of any accounting and internal control system, the auditor is not in a position to form an opinion on the overall effectiveness of the controls and operating systems of the company based purely on the audit process. The responsibility for the accuracy of the disclosures made in relation to the controls and operating systems vests with the board of directors.

For both non-listed and listed companies, the auditor's responsibilities are dealt with in SSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Singapore Standards on Auditing*. This is examined in Chapter 6.

### 3.4 Assurance services

Chartered Accountants may also provide assurance services relating to internal control systems. This is discussed in Chapter 13.

The board of directors are responsible for a company's system of internal controls, not the auditors.

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### SECTION SUMMARY

The board of directors are responsible for a company's system of internal controls, not the auditors.

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### 4 Laws and regulations

**SECTION INTRODUCTION**

All Chartered Accountants, including auditors, must be aware of laws and regulations as part of their planning and must be aware of any statutory duty to report non-compliance by the company.
4.1 Legal requirements relating to the company

Companies are increasingly subject to laws and regulations with which they must comply. Some examples are given in the following diagram.

![Diagram of Laws and Regulations]

An auditor must be aware of the effect that non-compliance with the laws and regulations would have on the financial statements.

SSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements provides guidance on the auditor’s responsibility to consider laws and regulations in an audit of financial statements.

**IMPORTANT**

Responding to non-compliance with laws & regulations (known as NOCLAR) is a topical area. The IAASB published ISA 250 (Revised) Consideration of Laws and Regulations in an Audit of Financial Statements in October 2016. ISCA has not yet published a revised version of SSA 250 or an exposure draft. Chapter 19 contains further details of this development.

4.2 Responsibility of management for compliance

It is the responsibility of management (with oversight from those charged with governance) to ensure the entity's operations are conducted in accordance with laws and regulations.

The following policies and procedures, among others, may be implemented to assist management in the prevention and detection of non-compliance with laws and regulations:

- Monitor legal requirements and ensure that operating procedures are designed to meet these requirements.
- Institute and operate appropriate systems of internal control.
- Develop, publicise and follow a code of conduct.
- Ensure employees are properly trained and understand the code of conduct.
- Monitor compliance with the code of conduct and act appropriately to discipline employees who fail to comply with it.
- Engage legal advisers to assist in monitoring legal requirements.
- Maintain a register of significant laws and regulations with which the entity has to comply within its particular industry, and a record of complaints.

‘Non-compliance’ refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by the entity, or on its behalf by its management or employees. It does not include personal misconduct.
4.3 Responsibility of the auditor

As with fraud and error, the auditor is not, and cannot be held responsible for preventing non-compliance. There is an unavoidable risk that some material misstatements in the financial statements go undetected, even though the audit is properly planned and performed.

Certain factors will increase the risk of material misstatements due to non-compliance with laws and regulations not being detected by the auditor.

(a) There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

(b) Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.

(c) Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Laws and regulations governing a business entity can vary enormously (financial disclosure rules, health and safety, pollution, employment, etc). Whether an act constitutes non-compliance is a legal matter that may be beyond the auditor's professional competence, although the auditor may have a fair idea in many cases through their knowledge and training. Ultimately such matters can only be decided by a court of law.

The less matters of non-compliance is related to the events and transactions normally reflected in the financial statements, the less likely the auditor will be aware of such circumstances.

SSA 250.10

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

4.4 The auditor's consideration of compliance

SSA 250.12

As part of obtaining an understanding of the entity and its environment in accordance with SSA 315 Identifying And Assessing The Risks Of Material Misstatement through Understanding The Entity And Its Environment, the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

The auditor may obtain a general understanding of laws and regulations affecting the entity in the following ways.

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors.
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements.
• Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
• Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations.
• Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

The auditor should obtain sufficient appropriate audit evidence of compliance with those laws and regulations which have a direct effect on the determination of material amounts and disclosures in the financial statements. These laws and regulations should be well-established, known to the entity and within the entity's industry and be relevant to the entity's financial statements. They could relate to the following:

• The form and content of financial statements
• Industry specific financial reporting issues, eg money lenders and changers
• Accounting for transactions under government contracts
• The accrual or recognition of expenses for income tax or Central Provident Fund

In obtaining this general understanding the auditor should obtain an understanding of the procedures followed by the entity to ensure compliance. The auditor should recognise that some laws and regulations may have a fundamental effect on the operations of the entity, ie they may cause the entity to cease operations or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's licence or other title to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements).

A key practical problem with SSA 250 can be the difficulty in establishing the distinction between:

• Laws which have a direct effect on the determination of material amounts in the financial statements
• Other laws and regulations

In practice:

(a) For some businesses, certain laws and regulations have a direct effect on material amounts in the financial statements, for other businesses the same laws and regulations will not.
(b) For some businesses, laws and regulations which did not have a direct or material effect last year may have this year (for example, where the maximum penalty for a first offence is a warning, but subsequent infringements may lead to closure of the business).

SSA 250.14
The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

SSA 250.15
During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

Examples include the following:

• Reading minutes
• Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments
• Performing substantive tests of details of classes of transactions, account balances or disclosures
There is a distinction between checking systems of compliance and checking actual compliance. An example would be emissions from a chemical factory; auditors would review the company’s systems for keeping these under control, and would also review correspondence with the environmental authority. However, the auditors would not be expected to check the actual emissions.

**SSA 250.16**

The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures other than those detailed above.

### 4.4.1 Audit procedures when non-compliance is identified or suspected

**SSA 250.18**

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and
(b) Further information to evaluate the possible effect on the financial statements.

The SSA sets out examples of the type of information that might come to the auditor’s attention that may indicate non-compliance.

- Investigation by a regulatory organisation or government department or payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees or government employees
- Sales commissions or agents’ fees that appear excessive in relation to those normally paid by the entity or in its industry or to the services actually received
- Purchasing at prices significantly above or below market price
- Unusual payments in cash, purchases in the form of cashiers’ cheques payable to bearer or transfers to numbered bank accounts (bank accounts where the name of the account holder is kept private and does not appear on bank statements)
- Unusual transactions with companies registered in tax havens
- Payments for goods or services made other than to the country from which the goods or services originated
- Payments without proper exchange control documentation
- Existence of an information system that fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence
- Unauthorised transactions or improperly recorded transactions
- Adverse media comment

When evaluating the possible effect on the financial statements, the auditor should consider the following.

- The potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation
1 The regulatory frameworks for assurance services

- Whether the potential financial consequences require disclosure
- Whether the potential financial consequences are so serious as to call into question the fair presentation given by the financial statements, or otherwise make the financial statements misleading

### SSA 250.19

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance.

Such discussions are subject to the laws concerning 'tipping off'. If information provided by management is not sufficient, the auditor may find it appropriate to consult the client's lawyer and, if necessary, their own lawyer on the application of the laws and regulations to the particular circumstances and what further action, if any, the auditor would take.

### SSA 250.20/21

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

On this last point, as with fraud and error, the auditor must reassess the risk assessment and the validity of written representations. In exceptional cases, the auditor may consider whether withdrawal from the engagement is necessary. If withdrawal from the engagement is not possible under applicable law or regulation, the auditor may consider alternative actions including describing the non-compliance in an Other Matters paragraph in the auditor's report.

### 4.5 Reporting of identified or suspected non-compliance

#### 4.5.1 To those charged with governance

### SSA 250.22/23/24

... The auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance... is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board.

In relation to the last point, where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider seeking legal advice.
4.5.2 To the users of the auditor's report

**SSA 250.25/26/27**

If the auditor concludes that the non-compliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor shall... express a qualified opinion or an adverse opinion on the financial statements.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor shall... express a qualified opinion or an adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit...

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion...

If the auditor concludes there has been non-compliance with the Companies Act, and the auditor believes the matter will not be adequately dealt with by a comment in the auditor's report or by communicating the matter to the directors of the company, the auditor must immediately report the matter in writing to the Registrar.

4.5.3 To regulatory and enforcement authorities

Confidentiality is an issue again here, but it may be overridden by the law, statute or a court order. The auditor should obtain legal advice. If the auditor has a statutory duty to report, a report should be made without delay.

Alternatively, it may be necessary to make disclosures in the public interest. In practice it will often be extremely difficult for an auditor to decide whether making a disclosure in the public interest is warranted. As elsewhere, the auditor should obtain legal advice.

The Companies Act requires immediate disclosure to the Minister where an auditor has reason to believe that a serious offence involving fraud or dishonesty is being or has been committed against the company by officers or employees of the company. The Act describes a serious offence as one requiring imprisonment for more than two years or where the value of property obtained exceeds or would have exceeded $100,000.

The reporting of offences and suspicious transactions under the Corruption, Drug Trafficking and other Serious Crimes (Confiscation of Benefits) Act is covered by Section 5.5.2 of this chapter.

4.6 Withdrawal from the engagement

As is the case for fraud or error, withdrawal may be the only option if the entity does not take the remedial action the auditor thinks is necessary, even for non-material matters.

4.7 Documentation

The auditor must document identified or suspected non-compliance with laws and regulations and the results of discussions with management and, where applicable, those charged with governance and other parties outside the entity.
SECTION SUMMARY
The auditor must obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

5 Money laundering

SECTION INTRODUCTION
Anti-money laundering law is an important issue for auditors to be aware of. Auditors must abide by the requirements of Ethics Pronouncement 200 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore which contains requirements for Chartered Accountants in business, in addition to those working in AEs. In this section we will focus on the requirements placed on auditors.

KEY TERM
MONEY LAUNDERING is the funnelling of cash or other funds generated from illegal activities through financial institutions and businesses to conceal or disguise the true ownership and source of the funds.

(EP 200 Appendix A para A2)

5.1 What is money laundering?

5.1.1 Background
Having obtained money through crime, criminals face a difficulty when it comes to actually using it. For example, money may be generated illegally via illegal arms sales, drugs trafficking, smuggling, bribery or embezzlement. Criminals might generate huge amounts of money through these illegal activities, but will need to disguise the illegal origin of the money so that they can enjoy the proceeds without attracting unwanted attention from the authorities.

Money laundering is the attempt to conceal the origin of this money by making it look legitimate or ‘clean’. It is impossible to give an exact estimate of the amount of money that is laundered globally each year due to the illegal nature of the transactions. However, in 2011, a research report entitled Estimating illicit financial flows resulting from drug trafficking and other transnational organized crime published by the United Nations Office on Drugs and Crime (UNODC) estimated that 2.7% of 2009 global GDP was related to money laundering.

Singapore has established the strict and rigorous Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime through its comprehensive and sound legal, institutional policy and supervisory framework. This regime comes under the purview of the Monetary Authority of Singapore (MAS). As a member of the Financial Action Task Force (FATF), Singapore also contributed actively towards international AML/CFT standards setting discussions at the FATF.
5.1.2 How money is laundered

There are essentially three stages in laundering money:

1. **Placement** is the process of disposing the proceeds from drug trafficking or criminal conduct, for example by transferring the illegal funds into the financial system in a way that financial institutions and government authorities are not able to detect. Money launderers pay careful attention to national laws, regulations, governance structures, trends and law enforcement strategies and techniques to keep their proceeds concealed, their methods secret and their identities and professional resources anonymous.

2. **Layering** is the process of generating a series or layers of transactions to distance the proceeds from their illegal source and to obscure the audit trail. Common layering techniques include outbound electronic funds transfers, usually directly or subsequently into a 'bank secrecy haven' or a jurisdiction with lax record-keeping and reporting requirements, and withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders or travellers cheques.

3. **Integration**, the final money-laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable funds into an economy. This is accomplished by spending, investing and lending, along with cross-border, legitimate-appearing transactions.

**WEBSITE**

To gain a picture of how widespread money laundering is and the importance of deterring it, you should read beyond this Textbook.

In January 2014, a steering committee comprising the Ministry of Home Affairs, the Ministry of Finance and the Monetary Authority of Singapore published the (NRA). The key aim of the NRA was to deepen *Singapore National Money Laundering and Terrorist Financing Risk Assessment Report* the understanding of money laundering and terrorist financing risks in Singapore. It can be found at:


Annex A of the NRA contains a number of illustrative case studies.

**Question 1.2**

Money laundering I

Explain the reasons why it would be difficult for an external auditor to detect money laundering activities.

5.2 International recommendations

5.2.1 Financial Action Task Force

The world-wide importance of dealing with money laundering is demonstrated by the inter-governmental body, Financial Action Task Force on Money Laundering (FATF). This was established to set standards and develop policies to combat money laundering and terrorist financing. FATF has issued a series of recommendations for governments on how to combat these offences and these recommendations have
PART A LEGAL AND PROFESSIONAL FRAMEWORK | 1: The regulatory frameworks for assurance services

now been endorsed by more than 130 countries. First issued in 1990, FATF recommendations were revised in 1996, 2001, 2003 and 2012 to ensure that they remain up to date and relevant.

FATF requires countries to:

- Criminalise money laundering and terrorist financing
- Adopt measures to enable the confiscation or freezing of assets obtained through crime

It also requires a number of preventative measures, which apply to professionals including accountants and auditors. One of the most important aspects is customer due diligence procedures. These include:

(a) Identifying the customer and verifying that customer's identity using reliable, independent source document, data or information

(b) Identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the financial institution is satisfied that it knows who the beneficial owner is

(c) Understanding and, as appropriate, obtaining information on the purpose and intended nature of the business relationship

(d) Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with knowledge of the customer, their business and risk profile, including where necessary the source of the funds

Singapore is a member of FATF and has actively contributed to the establishment of a strict and rigorous anti-money laundering regime.

5.2.2 Regime in Singapore

The division consists of three branches:

- The Financial Investigations Branch: this body is responsible for investigating money laundering as well as offences under the Terrorism Act.
- The Proceeds of Crime Unit: identifies and seizes proceeds of crime, managing such assets until they are restituted or confiscated.
- The Suspicious Transaction Reporting Office (STRO): receives and analyses suspicious transaction reports from financial institutions and other parties. It is also Singapore's Financial Intelligence Unit (FIU).

The CAD enforces (not administers) Acts including:

- Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act (Chapter 65A)
- Companies Act (Chapter 50)
- Monetary Authority of Singapore Act (Chapter 186)
- Terrorism (Suppression of Financing) (Chapter 325)
- Banking Act (Chapter 19)
CASE STUDY

The case of Orix Leasing Singapore Ltd gives a real-life example of an investigation by the CAD. You can read about this case study at:

5.3 Auditors' obligations

Many countries have now made money laundering a criminal offence. In some countries, such as Singapore, the UK, Australia and the US, the criminal offences include those directed at public accountants. In Singapore, the basic requirements are:

- To report suspicions of money laundering to the Commercial Affairs Department (CAD);
- For AEs to have systems and controls in place to address money laundering concerns;
- Customer due diligence (CDD) and records keeping at AEs; and
- Reporting procedures, ongoing training, compliance management and training at AEs (good guidance, not mandatory).


In addition to Section 2 of EP 200 (already covered under the Ethics and Professionalism module), the auditors are required to comply with the following.

<table>
<thead>
<tr>
<th>Systems and controls</th>
<th>Description</th>
<th>Reference</th>
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<tbody>
<tr>
<td>AEs shall develop and implement internal policies, procedures and controls to address money laundering concerns.</td>
<td>(EP 200 3.1)</td>
<td></td>
</tr>
<tr>
<td>A risk-based approach shall be adopted, where auditors take enhanced measures to manage and mitigate higher risks. Correspondingly, where the risks are lower, simplified measures may be permitted.</td>
<td>(EP 200 3.3)</td>
<td></td>
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<tr>
<td>Where an AE has branches and/or subsidiary companies, the AE shall develop and implement group-wide programmes on AML and CFT.</td>
<td>(EP 200 3.12)</td>
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<tr>
<td>Customer due diligence (CDD)</td>
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<tr>
<td>• The primary objective of CDD is to enable effective identification and reporting of suspicious activities. The underlying assumption is that unless you truly know your customer well enough to understand and anticipate that customer's business behaviour you can neither reasonably nor effectively distinguish between unusual and possibly suspicious activity from usual and customary behaviour. Details of specific information obtained are dealt with in Section 5.3.1 below. (EP 200 4.1)</td>
<td></td>
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<tr>
<td>• CDD shall be undertaken when establishing business relations, carrying out occasional transactions, there is suspicion of money laundering or terrorist financing or if there are doubts about the veracity or adequacy of previously obtained client information data. (EP 200 4.5)</td>
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<tr>
<td>• If the AE is unable to comply with the CDD requirements, for example the client refuses to provide evidence of identity, the relationship should be terminated and consideration should be made as to whether a suspicious transactions report is necessary. (EP 200 4.20)</td>
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<tr>
<th>Records keeping</th>
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<tr>
<td>• AEs shall prepare, maintain and retain documentation on business relations with clients such that all requirements imposed by law are met. The relevant authorities in Singapore should be able to review the AEs business relations, transactions, records and CDD information and assess the level of compliance with relevant laws and compliance with EP 200. The AE should respond to any enquiry or order from the relevant authorities for information within a reasonable time.</td>
</tr>
<tr>
<td>• All information obtained through CDD measures must be retained for at least five years following the termination of business relations. (EP 200 4.47-8)</td>
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<tr>
<th>Reporting procedures</th>
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<tr>
<td>• AEs should establish a single reference point within the organisation to whom all employees are instructed to promptly refer all transactions suspected of being connected with money laundering, ie the appointment of a Money Laundering Reporting Officer (MLRO).</td>
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<tr>
<td>• The MLRO will determine whether a report to the STRO is necessary. (EP 200 5.1-2)</td>
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<tr>
<th>Training</th>
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<tr>
<td>• AEs should establish an ongoing training programme tailored to its size, nature and complexity. (EP 200 5.4-5)</td>
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<tr>
<th>Compliance management</th>
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<tr>
<td>• AEs should develop appropriate compliance management arrangements to monitor their compliance with AML/CTF policy and procedures, including the appointment of a compliance officer. (EP 200 5.12)</td>
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<th>Hiring</th>
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<tr>
<td>• AEs should have adequate screening procedures in place to ensure high standards when hiring employees. (EP 200 5.14)</td>
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<th>Audit</th>
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<tr>
<td>• There should be an adequately resourced and independent audit function that regularly assesses the effectiveness of the AEs internal policies, procedures and controls and its compliance with AML/CFT requirements. (EP 200 5.15)</td>
</tr>
</tbody>
</table>
In March 2017, ISCA published some amendments to EP 200, effective from June 2017, which responded to feedback from FATF in order to improve the work of AEs when identifying and verifying various parties involved in money laundering investigations.

**WEBSITE**

ISCA's amendments to EP 200 can be accessed online here.


In December 2017, ACRA issued Audit Practice Bulletin (APB) 2 of 2017: *Compliance with ethics pronouncements on anti-money laundering and countering the financing of terrorism*. It was designed to provide more practical guidance to AEs when implementing their internal policies, procedures and controls (IPPCs) as part of compliance with EP 200 (for example, screening tools to be used as part of conducting customer due diligence and the types of people who might be classed as higher risks for money laundering or terrorist financing).

**WEBSITE**

ACRA's Audit Practice Bulletin 2 of 2017 can be accessed online here.

https://www.acra.gov.sg/uploadedFiles/Content/Publications/Audit_Practice_Bulletin/No.%202%20of%202017%20APB%20on%20compliance%20with%20EP%20200%20inspections%20conducted%20by%20ACRA.pdf

### 5.3.1 Conducting customer due diligence

The AE must gather ‘know your customer’ (KYC) information. This can be done when carrying out the procedures required by SSA 315 *Identifying And Assessing The Risks Of Material Misstatement Through Understanding The Entity And Its Environment* and includes:

- The identity and business reputation of the client’s principal owners, key management, related parties and those charged with governance (e.g. by checking passports or identity cards)
- The nature of the client’s operations including its business practices
- Information concerning the attitude of the client’s principal owners, key management and those charged with governance towards such matters as aggressive interpretation of accounting standards and the internal control environment
- Whether the client is aggressively concerned with maintaining the AE’s fees as low as possible
- Indications of an inappropriate limitation in the scope of work for example, not having any documentation for a transaction and giving an unreasonable explanation for the lack of documentation
- Indications that the client might be involved in money laundering or other criminal activities for example, buying or selling investments for no apparent reason or in circumstances that appear unusual such as losing money without seeming concerned
- The reasons for the proposed appointment of the AE and non-reappointment of the previous AE
- The identity and business reputation of related parties

Where the risk of money laundering is lower, AEs are permitted to perform simplified CDD measures. This might occur where reliable information on the client is publicly available or the client is listed and subject to regulatory disclosure requirements, for example. In such a situation, simplified CDD measures may include reducing the frequency of client identification updates or verifying the identity of the client after the business relationship has been established.
Conversely, enhanced CDD measures will be performed where there is a higher risk of money laundering, for example, if a foreign politically exposed person (PEP) is involved or if the client is from a country known to have inadequate AML/CTF measures. Enhanced CDD measures might include obtaining senior management approval and taking reasonable and proactive risk-based measures to establish the source of wealth and funds.

5.4 Indicators of suspicious transactions

On any assignment, the auditor should assess the risk of money laundering activities. Clearly, every circumstance is different, but the following diagram illustrates some risk factors.

Further examples of risk factors can be found in Appendix E of EP 200.

**Question 1.3**

You are the audit manager of Lucky Pte Ltd, a chain of nightclubs. During the course of the audit a junior accountant of the company, informed you that a substantial cash deposit was paid into the company's bank account and a month later, the same amount was paid by direct transfer into a bank account in the name of Evissa, a company based overseas. The employee also informed you that the managing director of Lucky Pte Ltd had said not to record the transaction in the accounting records as it had nothing to do with Lucky Pte Ltd’s business.

**Required**

Comment on the situation outlined above.

5.5 The scope of criminal offences

The AE requires 'know your customer' and CDD procedures to avoid committing any of the wide range of offences under Singapore’s anti-money laundering regulations.

5.5.1 Money laundering offences

These include:

- Laundering own benefits from drug trafficking or criminal conduct
- Assisting another to launder benefits from drug trafficking or criminal conduct
Laundering by acquisition
Assisting another to retain or control the benefits of drug trafficking or criminal conduct
Failure to report suspicious transactions
Tipping-off
Failure to co-operate with law enforcement agencies

5.5.2 Failure to report offences and suspicious transactions under the Corruption, Drug Trafficking and other Serious Crimes (Confiscation of Benefits) Act

Appendix B14 and B15 of EP 200 state that it is mandatory for all persons who, in the course of their trade, profession, business or employment, know or have reasonable grounds to suspect that any property representing the proceeds of drug trafficking or criminal conduct or was used (or is intended to be used) in connection with drug trafficking or criminal conduct, to disclose such knowledge or suspicion to a STRO as soon as is reasonably practicable after it comes to their attention.

Failure to report the knowledge of or suspicion is an offence punishable by a fine of up to $20,000.

5.5.3 Tipping off and other offences

EP 200 B16 states that it is an offence to disclose any information to any person if doing so is likely to prejudice an investigation or proposed investigation under the Corruption, Drug Trafficking and other Serious Crimes (Confiscation of Benefits) Act. It is punishable by a fine of up to $30,000, or imprisonment of up to three years or both (Appendix B18).

A defence for a person accused of tipping-off is that they did not know or suspect that the disclosure was likely to be prejudicial to such an investigation or that they had lawful authority for making the disclosure.

SECTION SUMMARY

Auditors must take into account the possibility of money laundering in carrying out audit procedures. The AE must have procedures in place to ensure that any knowledge or suspicion of money laundering is reported to the STRO of the CAD as necessary.
Chapter Roundup

Regulatory Framework, Laws, Standards and Other Guidance

Why are regulations/laws/standards required?

Legal and professional framework

International
- IFAC
- IAASB
- IESBA

Singapore
- ACRA
- ISCA
- AASC

Public oversight

International
- PIOB oversees IFAC

USA
- PAOC

Singapore
- Sarbanes-Oxley established PCAOB after Enron scandal

Audit Committees

- 201B Companies Act
- Required for all listed companies
- Provisions in Code of Corporate Governance
- Eligibility
- Duties/role/function
- Advantages/Disadvantages

Risk of non-compliance with laws and regulations

Auditor’s understanding and responsibility

Search for indication of non-compliance

Action on discovery of non-compliance

Internal Control

- Director vs. Auditors responsibilities
- Provisions in Companies Act and Code of Corporate Governance

Money Laundering

- Client screening
- Risk indicators
- Reporting
- Tipping off
- Types of offence
Quick Quiz

1. List five potential duties of the audit committee.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................
   (5) ..........................................

2. Auditors are responsible for a company's system of internal controls.
   True □
   False □

3. List five items of information that should be obtained as part of customer due diligence.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................
   (5) ..........................................

4. It is the responsibility of the auditor to ensure a client's operations are conducted in accordance with laws and regulations.
   True □
   False □
Answers to Quick Quiz

1. (1) Review of financial statements  
   (2) Liaison with external auditors  
   (3) Review of internal audit procedures  
   (4) Review of internal controls  
   (5) Establishing whistle-blowing policies and procedures

2. False – this is the directors' duty.

3. Any five from the following:
   - The identity and business reputation of the client's principal owners, key management, related parties and those charged with governance (e.g. by checking passports or identity cards)
   - The nature of the client's operations including the business practices
   - Information concerning the attitude of the client's principal owners, key management and those charged with governance towards such matters as aggressive interpretation of accounting standards and the internal control environment
   - Whether the client is aggressively concerned with maintaining the AE's fees as low as possible
   - Indications of an inappropriate limitation in the scope of work
   - Indications that the client might be involved in money laundering or other criminal activities
   - The reasons for the proposed appointment of the AE and non-reappointment of the previous AE

4. False. It is the responsibility of management (with oversight from those charged with governance).
1.1 Audit committees

(a) An audit committee reviews financial information and liaises between the auditors and the company. The audit committee should comprise at least three directors, the majority of whom including the audit committee Chairman, should be independent. All of the members of the audit committee should be non-executive directors (Provisions 10.1 to 10.5 of Code of Corporate Governance).

(b) (i) To review the significant financial reporting issues and judgements to ensure the integrity of the financial statements of the company, and any announcements related to the company's financial performance

(ii) To review at least annually the adequacy and effectiveness of the company's internal controls and risk management systems

(iii) To review the assurances from the CEO and CFO on the financial records and financial statements

(iv) To make recommendations to the board in relation to proposals to the shareholders on the appointment and removal of the external auditors and to approve the remuneration and terms of engagement of the external auditors

(v) To review the adequacy, effectiveness, independence, scope and results of the external audit and the company's internal audit function

(vi) To review the policy and arrangements for concerns about possible improprieties in financial reporting or other matters to be safely raised, independently investigated and appropriately followed up on. The company publicly discloses, and clearly communicates to employees, the existence of a whistle-blowing policy and procedures for raising such concerns (Provision 10.1 of Code of Corporate Governance; and Companies Act Section 201B)

In addition to these responsibilities, any responsible audit committee is likely to want:

1) To ensure that the review procedures for interim statements, appropriate documents and similar information are adequate

2) To review both the management accounts used internally and the statutory financial statements issued to shareholders for reasonableness

3) To make appropriate recommendations for improvements in internal control

(c) There are a number of advantages and disadvantages.

Disadvantages

(i) Since the findings of audit committees are rarely made public, it is not always clear what they do or how effective they have been in doing it.

(ii) It is difficult to find non-executive directors with the relevant skills and experience to form an effective audit committee.

(iii) Additional cost to the company.

Advantages

(i) By its very existence, the audit committee should make the executive directors more aware of their duties and responsibilities.

(ii) It could act as a deterrent to the committing of illegal acts by the executive directors and may discourage them from behaving in ways which could be prejudicial to the interests of the shareholders.

(iii) Where illegal or prejudicial acts have been carried out by the executive directors, the audit committee provides an independent body to which the auditor can turn. In this way, the problem
may be resolved without the auditor having to reveal the matter to the shareholders, either in their report or at a general meeting of shareholders.

(iv) An audit committee consisting of non-executive directors will allow management to devote more of their time to running the company. The audit committee should therefore increase the effectiveness of the board.

(v) Internal audit may be reluctant to report sensitive issues to management. The existence of an audit committee creates an independent reporting point for any internal audit function strengthening their position and independence.

(vi) An audit committee may improve the public perception of the company. Stakeholders will have increased confidence in the independence of the company directors, management and external auditors.

(vii) It may improve the quality of the external audit, since the external auditors' performance is under greater scrutiny.

1.2 Money laundering I

In common with fraud generally, money laundering is difficult to detect because those perpetrating it have an obvious incentive to cover their tracks very carefully. These people are likely to be able to manipulate a company's records, so that the auditor will struggle to detect any problems.

Money laundering would be more difficult to detect than a typical fraud because it involves cash flowing into the business, whereas fraud more typically involves attempts to conceal an outflow of assets. It would be difficult to design audit procedures to detect the recording of fictitious revenue that was backed up by cash in the bank.

As money laundering is associated with criminal activity, it is possible that those involved may be subject to intimidation to co-operate with the scheme, or to deny knowledge of it. This could even extend to members of the audit team. This makes it very difficult for auditors to detect money laundering.

1.3 Money laundering II

The transaction described in the scenario raises suspicion of money laundering for several reasons.

(a) It has been alleged by the junior accountant that the purpose of the transaction has nothing to do with the nightclub business. This could be a sign that the managing director is attempting to legitimise the proceeds of a crime through Lucky by concealing the illegal source of the cash.

(b) The amount of the transaction is substantial for Lucky. An unusually large transaction should alert the auditor to the possibility of money laundering, especially as it does not seem to relate to the business of Lucky.

(c) The cash amount paid into Lucky's bank account is the same as the amount paid to Evissa. This could be an attempt by the managing director to make the cash appear legitimate by moving it through several companies and jurisdictions.

(d) The junior accountant was instructed not to record the transaction in the accounting records of Lucky. Increased secrecy over transactions is another indicator of money laundering.

Lucky's bank statements should be checked to confirm the junior accountant's assertion. The suspicious transaction should be reported to the AE's MLRO who will decide whether it should be referred on to the STRO at the CAD as soon as possible and any ‘tipping off’ must be avoided. It is a criminal offence to not report suspicions of money laundering.
PART B
CONSIDERATIONS FOR THE
STATUTORY AUDITOR
Behaving ethically is an important and distinguishing feature of a professional. The Chartered Accountant is in a position of trust and in order to maintain the confidence of stakeholders, the Chartered Accountant must demonstrate the highest possible standards of behaviour. Knowing that Chartered Accountants are bound by an ethical code gives stakeholders more confidence in the financial information Chartered Accountants provide.

In this chapter, we will examine ethical rules for Chartered Accountants in detail and consider some of the complex ethical issues that Chartered Accountants may face. We also look at the procedures to follow if the rules are breached.

(Note that although Part B of this Textbook is entitled 'Considerations for the Statutory Auditor', the issues explored in this chapter and Chapter 3 apply to all Chartered Accountants in public practice, not just external auditors.)
2: Code of professional conduct and ethics | PART B CONSIDERATIONS FOR THE STATUTORY AUDITOR

Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
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<tbody>
<tr>
<td>Code of Professional Conduct and Ethics</td>
<td></td>
</tr>
<tr>
<td>Explain the fundamental principles of the Code of Professional Conduct and Ethics.</td>
<td>3</td>
</tr>
<tr>
<td>Recognise conflicts in the application of fundamental ethical principles.</td>
<td>3</td>
</tr>
<tr>
<td>Discuss the importance of auditors’ independence and professional scepticism in planning and performing an audit.</td>
<td>3</td>
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<tr>
<td>Recommend a suitable course of action for a professional accountant to take upon discovering a breach of professional ethics by themselves or by others.</td>
<td>3</td>
</tr>
<tr>
<td>Current issues and developments – Professionalism and ethics</td>
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<tr>
<td>Discuss the relative advantages of an ethical framework and a rulebook.</td>
<td>2</td>
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<tr>
<td>Quality control</td>
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<tr>
<td>Discuss how the provision of non-audit services to audit clients (including auditor initiated audit adjustments arising from audit work) may compromise the independence of the audit process.</td>
<td>3</td>
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ESSENTIAL READING

- ACRA Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities
- Audit Practice Bulletin No 2 of 2013 Auditor Independence – Serving as an Officer or Director on the Board of Assurance Clients
- IAASB Staff Questions & Answers – Professional Scepticism in an Audit of Financial Statements
- Ethics Pronouncement (EP) 100 Code of Professional Conduct and Ethics
- Singapore Standard on Quality Control 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements
- SSA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Singapore Standards on Auditing

1 Fundamental principles and the conceptual framework approach

SECTION INTRODUCTION

Chartered Accountants require a code of ethics because they hold positions of trust and public interest.
1.1 The importance of ethics

The Institute of Singapore Chartered Accountants (ISCA) Ethics Pronouncement (EP) 100 Code of Professional Conduct and Ethics 100.1 gives the key reason why accountancy bodies produce ethical guidance.

'A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a public accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer.'

The public interest is considered to be the collective well-being of the community of people and institutions the Chartered Accountant serves, including clients, lenders, governments, employers, employees, investors, the business and financial community and others who rely on the work of Chartered Accountants.

Chartered Accountants must act, and be seen to act, in the public interest rather than in their own interest. They have access to confidential and sensitive information. By adhering to ethical guidance, Chartered Accountants help to maintain the integrity of their profession providing reassurance to stakeholders.

Ethical guidance also provides some protection for Chartered Accountants if they have been accused of acting unethically. One Chartered Accountant cannot be accused of acting differently to other Chartered Accountants if they all follow the same ethical guidance.

1.2 Sources of ethical guidance

As the Chartered Accountant is required to be, and seen to be, ethical in their dealings with clients, ISCA publishes guidance for its members in its Ethics Pronouncement (EP) 100 Code of Professional Conduct and Ethics (known as the ISCA Code). This guidance is given in the form of fundamental principles, guidance and explanatory notes and must be adhered to by all ISCA members.

The ISCA Code is modelled after the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants. IESBA is a body of the International Federation of Accountants (IFAC) which also issues quality control standards (ISQCs) and auditing standards (ISAs), which work together to promote auditor independence and audit quality. ACRA also produces ethical guidance in the form of its Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code). The ACRA Code is also based on the Code of Ethics for Professional Accountants issued by IESBA (known as the IESBA Code) and must be adhered to by all Chartered Accountants in Singapore.

Note that SSA 220 Quality Control for an Audit of Financial Statements cites the ISCA Code and ACRA Code. However, SSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements refers solely to the ACRA Code. These standards will be covered further in Chapter 4.

1.3 The fundamental principles

<table>
<thead>
<tr>
<th>ISCA Code of Professional Conduct and Ethics 100.5</th>
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<tr>
<td><strong>Integrity.</strong> A member should be straightforward and honest in all professional and business relationships.</td>
</tr>
<tr>
<td><strong>Objectivity.</strong> A member should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.</td>
</tr>
<tr>
<td><strong>Professional competence and due care.</strong> A member has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques. A member should act diligently and in accordance with applicable technical and professional standards.</td>
</tr>
</tbody>
</table>
Confidentiality. A member should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

Professional behaviour. A member should comply with relevant laws and regulations and should avoid any action that discredits the profession.

1.4 The conceptual framework

The ethical guidance discussed above is in the form of a conceptual framework. It contains some rules, for example, the ISCA Code prohibits making loans to clients, but mainly it is a framework rather than a set of rules. There are a number of advantages of a framework over a system of ethical rules. These are outlined in the table below.

**Advantages of an ethical framework over a rules based system**

- A framework of guidance places the onus on the Chartered Accountant to actively consider independence for every given situation, rather than just agreeing a checklist of forbidden items. It also requires him/her to demonstrate that a responsible conclusion has been reached about ethical issues.
- The framework prevents Chartered Accountants interpreting rules-based requirements narrowly to get around them. There is a sense in which lists of prohibitive rules engender deception, whereas principles encourage the formation of the positive practices which result in compliance.
- A framework allows for the variations that are found in every individual situation. Each situation is likely to be different.
- A framework can accommodate a rapidly changing environment, such as the one that Chartered Accountants are constantly in.
- However, a framework can contain prohibitions (as noted above) where these are necessary as safeguards are not adequate.

**Disadvantages of an ethical framework over a rules based system**

- The application of a conceptual framework approach requires the use of professional judgment. This may mean that the same practical situation could be dealt with differently depending on how the principles have been applied. This could give the appearance of an inconsistent approach.
- The use of professional judgment is a skill which must be developed over time. It requires a greater degree of expertise than simply following a set of rules.

1.5 Threats to compliance with the fundamental principles

There are five general sources of threat:

- **Self-interest** threat (for example, having a financial interest in a client)
- **Self-review** threat (for example, auditing financial statements prepared by the AE)
- **Advocacy** threat (for example, promoting shares in a listed entity when that entity is a financial statement audit client)
- **Familiarity** threat (for example, long association of senior personnel with the audit client)
- **Intimidation** threat (for example, threats of replacement due to disagreement)
1.6 Available safeguards

In order to counteract these threats to compliance, engagements are subject to safeguards. There are two general categories of safeguard:

- Safeguards created by the profession, legislation or regulation, eg training requirements for entry into the profession, continuing professional development (CPD) requirements for members, professional standards, corporate governance regulations.
- Safeguards in the work environment, which can be either firm-wide or engagement-specific.

Examples of firm-wide safeguards in the work environment include the following.

**Examples of firm-wide safeguards**

| Leadership of the firm that stresses the importance of compliance with the fundamental principles |
| Policies and procedures that will enable the identification of interests or relationships between the AE or staff, and clients |
| Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client (this could create a self-interest and an intimidation threat) |
| Policies and procedures to encourage and empower staff to communicate any issue relating to compliance with the fundamental principles that concerns them |

Specific threats and safeguards within these general areas will be considered in the next section. However, you may be able to use the following general list to help generate ideas in the exam.

**Examples of engagement-specific safeguards**

| Having a Chartered Accountant who was not involved with the engagement review the work performed, or provide advice |
| Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another Chartered Accountant |
| Discussing ethical issues with those charged with governance of the client |
| Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged |
| Involving another AE to perform or reperform part of the engagement |
| Rotating senior engagement team personnel |

**SECTION SUMMARY**

The fundamental ethical principles are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. It is essential that the Chartered Accountant applies these principles.
2 Specific guidance: Independence

SECTION INTRODUCTION
This section covers independence, threats to independence and applicable safeguards. You will study the ISCA guidance on independence which complies with the requirements of the IESBA Code.

2.1 Objective of the guidance

ALERT
The ISCA Code discusses independence requirements for audit and review engagements in Section 290. The guidance states its purpose in a series of steps, which you should know and be able to apply.

The steps detailed in the ISCA Code 290.7 are:

- **STEP 1**: Identify threats to independence.
- **STEP 2**: Evaluate the significance of the threats identified.
- **STEP 3**: Apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level.

It also recognises that there may be occasions where no safeguard is available. In such a situation, it is only appropriate to:

- Eliminate the interest or activities causing the threat
- Decline the engagement, or discontinue it

ALERT
You should apply the three steps set out above when approaching questions on independence. It is important for this exam that you do not simply learn the rules for each situation, but that you can apply the spirit of the guidance to a given situation. Finally, remember that if there appears to be no safeguard, then you must consider the fallback option of not continuing with the professional relationship. This should be seen very much as a last resort however.
2.1.1 Public interest entities

Revisions to the ISCA Code in 2015 introduced the concept of a ‘public interest entity’, which effectively replaces the previous notion of a ‘listed entity’.

**KEY TERM**

**PUBLIC INTEREST ENTITIES are**

(a) All listed entities; and
(b) Any entity
   (i) Defined by regulation or legislation as a public interest entity; or
   (ii) For which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

For the purposes of paragraph (b)(i), a public interest entity means:

(a) Any entity that is listed or is in the process of issuing its debt or equity instruments for trading on a securities exchange in Singapore;
(b) Any entity that is incorporated in Singapore and the securities of which are listed on a securities exchange outside Singapore; or
(c) Any financial institution

Firms and member bodies are encouraged to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

(a) The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, and pension funds;
(b) Size; and
(c) Number of employees.

(ISCA Code 290.25-26)

The distinction between ‘public interest entities' and other entities allows the ISCA Code to prescribe higher independence standards for public interest entities. This is in recognition of the need for greater public confidence in the financial information of such entities.

2.2 What is independence?

A provider of assurance services must be, and be seen to be, independent. What is required for this to be the case?
KEY TERMS

INDEPENDENCE OF MIND – The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

INDEPENDENCE IN APPEARANCE – The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional scepticism had been compromised.

(ISCA Code 290.6)

The degree of independence required is less stringent for a low level assurance engagement to non-audit clients than for audit. This is summarised in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Audit client</th>
<th>Non-audit, general use</th>
<th>Non-audit, restricted use</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit client</td>
<td>The assurance team, the AE and the network firm must all be independent of the client.</td>
<td>The assurance team, the AE and the network firm must all be independent of the client.</td>
<td>The assurance team, the AE and the network firm must all be independent of the client.</td>
</tr>
<tr>
<td>Non-audit assurance client</td>
<td>N/A</td>
<td>The assurance team and the AE must be independent of the client.</td>
<td>The assurance team and the AE must have no material financial interest in the client.</td>
</tr>
</tbody>
</table>

KEY TERMS

NETWORK FIRM – A firm or entity that belongs to a network.

NETWORK – A larger structure:

(a) That is aimed at co-operation, and

(b) That is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources.

ASSURANCE TEAM:

(a) All members of the engagement team for the assurance engagement; and

(b) All others within a firm who can directly influence the outcome of the assurance engagement, including:

(i) Those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the assurance engagement partner in connection with the performance of the assurance engagement;

(ii) Those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; and

(iii) Those who provide quality control for the assurance engagement, including those who perform the engagement quality control review for the assurance engagement.

(ISCA Code: Definitions)
2.2.1 Key audit partner (KAP)

ISCA’s Ethics Pronouncement 100 Implementation Guidance 2 (EP 100 IG 2) was issued in March 2018 to provide ‘Frequently Asked Questions on Key Audit Partner’ regarding clarification on the definition and identification and determination of a KAP, including a ‘key decision or judgement on significant matter’.

‘A key audit partner (KAP) is defined as the engagement partner, the individual responsible for the engagement quality control review, and other audit partners, if any, on the engagement team who make key decisions or judgements on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. Depending upon the circumstances and the role of the individuals on the audit, “other audit partners” may include, for example, audit partners responsible for significant subsidiaries or divisions.’

The FAQs can be found online here: https://isca.org.sg/media/2239523/ep-100-ig-2-for-issuance.pdf

2.3 When must the assurance provider be independent?

The team and the AE should be independent ‘during the period of the assurance engagement’.

The period of the engagement is from the commencement of work until the issuance of the final report, except when the assurance engagement is of a recurring nature. For a financial statement audit the period of the engagement includes the period covered by the financial statements reported on by the AE.

2.4 Revision of threats to independence

The area of threats to independence should not be new to you. This is dealt with in Section 290 of the ISCA Code. You should be aware of many of the threats to independence from your accountancy degree or Foundation Programme or SAC – NP Advanced Diploma in Accountancy. To refresh your memory about independence issues, try the following question.

**Question 2.1**

From any practical experience of auditing you may have, write down as many potential ethical risk areas as you can in the areas below. An example of each ethical risk has been provided. (Some issues may be relevant in more than one column.)

<table>
<thead>
<tr>
<th>Self-interest</th>
<th>Self-review</th>
<th>Familiarity</th>
<th>Intimidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long association with clients</td>
<td>Auditor prepares the financial statements</td>
<td>Personal relationship with the client</td>
<td>Client refuses to pay fees</td>
</tr>
</tbody>
</table>

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*ISCA Code 290.30*
2.5 Self-interest threat

The ISCA Code highlights a number of areas in which a self-interest threat might arise.

A financial interest in a client constitutes a substantial self-interest threat. According to ISCA's Code, the parties listed below are not allowed to own a direct financial interest or an indirect material financial interest in a client:

- A member of the assurance team
- An immediate family member of a member of the assurance team
- The AE
The following safeguards will therefore be relevant:

- Disposing of the interest
- Removing the individual from the team if required
- Keeping the client's audit committee informed of the situation
- Using an independent partner to review work carried out if necessary

AEs should have quality control procedures requiring staff to disclose relevant financial interests for themselves and close family members. They should also foster a culture of voluntary disclosure on an ongoing basis so that any potential problems are identified on a timely basis. This will provide the AE with reasonable assurance that the requirements of the ISCA Code have been met.

### Question 2.2

You are the Ethics Partner at Stewart Saga, an AE of Chartered Accountants. The following situations exist.

(a) Teresa is the audit manager responsible for Recreate, a large listed company. The audit has been ongoing for one week. Yesterday, Teresa's husband inherited 1,000 shares in Recreate. Teresa's husband wants to hold on to the shares as an investment.

(b) Stewart Saga contributes to an employer-sponsored retirement scheme on behalf of all employees. The defined contribution scheme is administered by Friends Benevolent, an unconnected company that owns shares in Peter Group, a listed company with a number of subsidiary companies. Stewart Saga has recently been invited to tender for the audit of one of the subsidiary companies, Paul Ltd.

(c) Stewart Saga has been the auditor of Zoo Bros Ltd, a public company, for a number of years. It is a requirement of Zoo Bros Ltd's constitution that the auditor owns a token $1 share in the company.

**Required**

Comment on the ethical and other professional issues raised by the above matters.

### 2.5.2 Loans and guarantees

Guidance is given in the ISCA Code Paragraphs 290.117–290.122.

The advice on loans and guarantees falls into two categories:

- The client is a bank or other similar institution
- Other situations

If a lending institution client lends an immaterial amount to an AE or member of the assurance team on normal commercial terms, there is no threat to independence. If the loan were material it would be necessary to apply safeguards to bring the risk to an acceptable level. A suitable safeguard is likely to be an independent review (by a partner from outside the AE).

Loans to members of the assurance team from a bank or other lending institution client are likely to be material to the individual, but provided that they are on normal commercial terms, these do not constitute a threat to independence. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

An AE or individual on the assurance engagement should not enter into any loan or guarantee arrangement with a client that is not a bank or similar institution, unless the loan or guarantee amount is immaterial to the AE or individual and the client.
2.5.3 Business relationships

Guidance is given in the ISCA Code Paragraphs 290.123–290.125.

Examples of when an AE and an assurance client have an inappropriately close business relationship include:

- Having a material financial interest in a joint venture with the assurance client
- Arrangements to combine one or more services or products of the AE with one or more services or products of the assurance client and to market the package with reference to both parties
- Distribution or marketing arrangements under which the AE acts as distributor or marketer of the assurance client’s products or services or vice versa

Again, it will be necessary for the partners to judge the materiality of the interest and therefore its significance. However, unless the interest is immaterial and the business interest is insignificant, an AE should not participate in such a venture with an assurance client. Appropriate safeguards are therefore to end the assurance provision or to terminate the (other) business relationship.

If an individual member of an assurance team has such an interest, they should be removed from the assurance team.

However, if the AE or a member (and immediate family of the member) of the assurance team has an interest in an entity when the client or its officers also has an interest in that entity, there is no threat to independence, provided:

- The relationship is clearly insignificant to the AE, the network firm and the client;
- The interest held is immaterial; and
- The interest does not give the investor(s) the ability to control the entity.

Generally speaking, purchasing goods and services from an assurance client on an arm’s length basis does not constitute a threat to independence, for example, an AE purchasing office furniture from an assurance client who is a furniture retailer, provided the cost of the furniture is at an advertised price or the same as the price offered to other customers. If there are a substantial number of such transactions, there may be a threat to independence and safeguards may be necessary.

2.5.4 Serving as a director or officer of an assurance client

Guidance is given in the ISCA Code Paragraphs 290.133–290.136.

A partner or employee of an AE should not serve as a director or officer of an assurance client.

It may be acceptable for a partner or an employee of an AE to perform routine administrative services to support a company secretarial function for an assurance client, provided client management makes all relevant decisions.

Although a partner or employee cannot serve on a client’s board, it is possible for them to attend board meetings. This is common practice, and moreover may be necessary if there are issues that need to be raised with management.

2.5.5 Relative size of fees


When an AE receives a high proportion of its total fee income from just one audit client, there is a self-interest or intimidation threat, as the AE will be concerned about losing the client. This depends on:

- The structure of the AE
- Whether the AE is established or new
- The significance of the client to the AE
It is important not to overlook these caveats: a high percentage fee income from one client does not by itself create an insurmountable threat. The threat from a high percentage fee income from one client might be mitigated by the structure of the AE, or by the fact that the AE is new (so the fee dependence is likely to be temporary). For example, a new AE may only have one client in the first month of operation but as new clients are gained, the percentage fee from the first client will fall.

Possible safeguards include:

- Discussing the extent and nature of fees charged with the audit committee or others charged with governance
- Reducing the dependence on the client
- External quality control reviews
- Consulting a third party, such as a professional regulatory body or a Chartered Accountant, on key audit judgments

The ISCA Code states that where an audit client is a public interest entity and for two consecutive years the total fees represent more than 15% of the AE's total annual fees, the AE must disclose this to those charged with governance and perform a pre- or post-issuance review.

If total fees significantly exceed 15%, then a post-issuance review may not be sufficient, and a pre-issuance review will be required.

The ISCA Code states that the issue of fees for non-audit services must also be considered. Where an audit client is a listed entity or a public company safeguards should be applied where:

(a) The amount of the annual fees received for non-audit services represents 50% or more of the total annual audit fees from the audit client; or

(b) The total size of the annual non-audit fees from the audit client is significant.

KEY POINT

It is not just a matter of the AE actually being independent in terms of fees, but also of it being seen to be independent by the public. It is as much about public perception as reality.

The ISCA Code also states that a threat may be created where an individual partner's fee income from one client is a disproportionately high percentage of their total fee income. The safeguards are as above, except that internal quality control reviews are also relevant.

2.5.6 Overdue fees

Guidance is given in the ISCA Code paragraph 290.220.

In a situation where there are overdue fees, the AE runs the risk of, in effect, making a loan to a client, whereupon the guidance above becomes relevant. Generally the payment of fees should be required before the report is issued.

AEs should guard against fees building up and being significant by discussing the issues with the audit committee or those charged with governance, and, if necessary, the possibility of resigning if overdue fees are not paid.
2.5.7 Contingent fees

Guidance is given in the ISCA Code Paragraphs 290.221–290.224.

**KEY TERM**

**CONTINGENT FEE** – A fee calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.

(ISCA Code: Definitions)

An AE shall not enter into a contingent fee arrangement in respect of an assurance engagement. For both audit and assurance engagements, a contingent fee would carry a threat so great that no safeguards could reduce it to an acceptable level. An AE must not enter into a contingent fee arrangement for a non-assurance service where the amount of fee was contingent on the result of an assurance engagement. In addition, an AE shall not accept or charge a contingent fee, or receive instructions on a contingent fee basis, for any form of professional work to a financial statement audit client that is a listed entity or public company, except where such remuneration is provided for under the provisions of any written law.

For other types of contingent fee arrangements the significance of the threat depends on:

- The range of possible fee amounts
- Whether an appropriate authority determines the outcome of the matter upon which the contingent fee will be determined
- The nature of the service
- The effect of the event or transaction on the assurance engagement

Possible safeguards include:

- Disclosing to the audit committee or others charged with governance the extent and nature of fees charged
- Review or determination of the final fee by an unrelated third party
- Quality and control policies and procedures

2.5.8 Gifts and hospitality

Guidance is given in the ISCA Code Paragraph 290.227.

Unless the value of the gift/hospitality is trivial and inconsequential, an AE or a member of an assurance team should not accept it.

For example, individual members working as part of an assurance team should not accept a gift of an expensive fountain pen from an assurance client. If, however, the pen were a cheap ballpoint pen used for promotions and regularly given to customers at trade fairs and conferences, its value is clearly insignificant and so the ISCA Code allows it to be accepted as a gift by the assurance team. The assurance team should also check that this meets their AE’s quality control policies and guidelines as these may be stricter than the requirements of the ISCA Code.
2.5.9 Pricing
Guidance is given in the ISCA Code Paragraph 240.1–204.8
When an AE quotes a significantly lower fee level for an assurance service than would have been charged by the predecessor AE, there is a significant self-interest threat. If the AE's tender is successful, the AE must apply safeguards such as:
- Maintaining records such that the AE is able to demonstrate that appropriate staff and time are spent on the engagement
- Complying with all applicable assurance standards, guidelines and quality control procedures

2.5.10 Recruitment
Guidance is given in the ISCA Code Paragraphs 290.211–290.212
Recruiting senior management for an assurance client, particularly those able to affect the subject matter of an assurance engagement may create self-interest, familiarity and intimidation threats for the AE. The significance of the threat is dependent on the role of the person to be recruited and the nature of the assistance sought. For instance, the threat from providing a list of candidates suitable for a finance assistant role at an audit client, is less significant than the threat from recommending one individual for the role of Finance Director.

**AEs must not make management decisions for the client.** Their involvement could be limited to reviewing a shortlist of candidates, providing that the client has drawn up the criteria by which they are to be selected.

For an audit client that is a public interest entity, AEs should not provide recruitment services with respect to a director or officer of the entity or senior management in a position to exert significant influence over the preparation of the client's accounting records or the financial statements.

2.6 Self-review threat

![Diagram of self-review threat](image)

The key area in which there is likely to be a self-review threat is where an AE provides services other than assurance services to an assurance client (providing multiple services). There is a great deal of guidance in the ISCA Code about various other services AEs might provide to their clients, and these are dealt with below.

2.6.1 Management responsibilities
Guidance is given in the ISCA Code Paragraphs 290.159–290.163.

If an AE 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.

Examples of activities that would generally be considered a management responsibility are:
- Setting policies and strategic direction
- Directing and taking responsibility for the actions of the entity's employees
- Authorise transactions
- Determine which recommendations of the company should be implemented
- Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- Taking responsibility for designing, implementing and maintaining internal control

To avoid the risk of assuming a management responsibility when providing non-assurance services to an audit client, the AE shall be satisfied that a member of management is responsible for making the significant judgements and decisions that are the proper responsibility of management. Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility.

2.6.2 Preparing accounting records and financial statements

Guidance is given in the ISCA Code Paragraphs 290.164–290.171.

There is clearly a significant risk of a self-review threat if an AE prepares accounting records and financial statements and then audits them.

An AE may provide an audit client that is not a public interest entity with accounting and bookkeeping services of a routine or mechanical nature provided any self-review threat is reduced to an acceptable level through the application of safeguards if necessary. Examples of such services include providing payroll services based on client-originated data, recording transactions for which the client has determined or approved the appropriate account classification or preparing financial statements based on information in the trial balance. Safeguards include:

- Using staff members other than audit team members to carry out the work
- A review of the work by a partner or other senior staff member who is not a member of the audit team

The rules are more stringent when the client is a public interest entity. For public interest entities that are audit clients, AEs should not provide accounting and bookkeeping services or prepare financial statements on which the AE will express an opinion or financial information which forms the basis of the financial statements, unless an emergency situation arises. If an emergency situation does arise, those who provide the services cannot be members of the audit team, the services may be provided for only a short period of time and are not expected to recur and the situation is discussed with those charged with governance.

Fees for the provision of accounting and bookkeeping services to a financial statement audit client that is a listed entity or public company would be collectively significant when the total fees for such services for the group exceed $10,000 or 5% of the consolidated audit fees, whichever is the higher.

2.6.3 Valuation services

Guidance is given in the ISCA Code Paragraphs 290.172–290.177.

**KEY TERM**

A **valuation** comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

(ISCA Code 290.172)

If an AE performs a valuation which will be included in financial statements audited by the AE, a self-review threat arises.
AEs should not carry out valuations on matters which will be material to the financial statements. If the valuation is for an immaterial matter, the AE should apply safeguards to ensure that the threat is eliminated or reduced to an acceptable level. Matters to consider when evaluating the significance and existence of any threat are the extent of the audit client's knowledge of the relevant matters in making the valuation and the degree of judgment involved, how much use is made of established methodologies and the degree of uncertainty in the valuation. Safeguards include:

- Second partner review of the audit or valuation work
- Using separate personnel for the valuation and the audit

### 2.6.4 Taxation services

Guidance is given in the ISCA Code Paragraphs 290.178–290.191. The ISCA Code divides taxation services into four categories:

(a) Tax return preparation
(b) Tax calculations for the purpose of preparing the accounting entries
(c) Tax planning and other tax advisory services
(d) Assistance in the resolution of tax disputes

**Tax return preparation does not generally create a threat to independence**, as long as management takes responsibility for the returns including any significant judgments made.

Tax calculations for the purpose of preparing the accounting entries may create a self-review threat to independence since the AE will be preparing calculations that it will subsequently audit. The significance of the threat depends on:

- The complexity of the relevant tax laws and regulations and the degree of judgment necessary in applying them
- The level of tax expertise of the client’s personnel
- The materiality of the amounts to the financial statements

For clients that are not public interest entities, the AE must establish whether safeguards can reduce the threat to an acceptable level or eliminate it entirely. Safeguards may include:

- Using staff members other than audit team members to carry out the work
- If the service is performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the tax calculations
- Obtaining advice on the service from an external tax professional

For audit clients that are public interest entities, an AE shall not prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the AE will express an opinion, except in emergency situations.

Tax planning and other tax advisory services may create a self-review threat where the advice will affect matters to be reflected in the financial statements. Providing tax planning and other tax advisory services where the advice is clearly supported by tax authority or other precedent, by established practice or has a basis in tax law that is likely to prevail does not generally create a threat to independence.

The AE will need to evaluate the significance of any threat and apply safeguards to eliminate any threat or reduce it to an acceptable level. Examples of such safeguards include:

- Using staff members other than audit team members to carry out the work
- Having another tax professional advise the audit team and review the financial statement treatment
- Obtaining advice on the service from an external tax professional
- Obtaining pre-clearance or advice from the tax authorities
An AE shall not provide tax advice to an audit client where the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements and:

- The audit team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation under the relevant financial reporting framework; and
- The outcome or consequences of the tax advice will have a material effect on the financial statements on which the AE will express an opinion.

An advocacy or self-review threat may be created when an AE represents an audit client in the resolution of a tax dispute. An AE shall not perform assistance in the resolution of a tax dispute for an audit client where the AE is acting as an advocate for an audit client before a public tribunal or court in the resolution of a tax matter and the amounts involved are material to the financial statements on which the AE will express an opinion. In this situation, the advocacy threat created would be so significant that no safeguards could eliminate or reduce the threat to an acceptable level.

In other situations, the AE will need to evaluate the significance of any threat and apply safeguards to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Using staff members other than audit team members to carry out the work
- Having another tax professional advise the audit team and review the financial statement treatment
- Obtaining advice on the service from an external tax professional

### 2.6.5 Internal audit services

Guidance is given in the ISCA Code Paragraphs 290.192–290.197.

A self-review threat may be created where an AE provides internal audit services to an audit client and then uses this work in the subsequent audit. The significance of the threat will depend on factors such as the materiality of the related financial statement amounts, the risk of misstatement of the assertions related to those financial statement amounts and the degree of reliance that will be placed on the internal audit service. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level, for example is using staff members other than audit team members to carry out the internal audit work.

An AE must also take care not to assume management responsibility when providing internal audit services to a client. To avoid assuming a management responsibility, the AE shall only provide internal audit services to an audit client if it is satisfied that:

- An employee of the client has designated responsibility for internal audit activities and for designing, implementing, and maintaining internal control
- The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services
- The client's management evaluates the adequacy of the internal audit service and the findings resulting from their performance
- The client's management evaluates and determines which recommendations resulting from internal audit findings to implement, and manages the implementation process
- The client's management reports to those charged with governance the significant findings and recommendations resulting from the internal audit activities

In the case of an audit client that is a public interest entity, an AE shall not provide internal audit services that relate to any of the following:

- A significant part of the internal controls over financial reporting
- Financial accounting systems that generate information that is, separately or in the aggregate, significant to the client's accounting records or financial statements
2.6.6 Corporate finance
Guidance is given in the ISCA Code Paragraphs 290.213–290.216.

Certain aspects of corporate finance will create self-review and advocacy threats that cannot be reduced to an acceptable level by safeguards. Therefore, 

**AEs are not allowed to promote, deal in or underwrite an assurance client's shares. They are also not allowed to commit an assurance client to the terms of a transaction or consummate a transaction on the client's behalf.**

Other corporate finance services, such as assisting a client in defining corporate strategies, assisting in identifying possible sources of capital and providing structuring advice may be acceptable, providing that safeguards, such as using different teams of staff, and a review by a professional not involved in the corporate finance work.

2.6.7 Other services

The AE might sell a variety of other services to audit clients, such as:

- IT services
- Litigation support
- Legal services

The AE should consider whether there are any threats to independence, such as if the AE were asked to design internal control IT systems, which it would then review as part of its audit. The AE should consider whether the threat to independence could be reduced by appropriate safeguards.

2.6.8 Temporary staff assignments
Guidance is given in the ISCA Code Paragraph 290.140.

**Staff may be loaned to an audit client, but only on the understanding that staff must not assume management responsibilities, or provide non-assurance services that are not permitted by the ISCA Code.**

The audit client must be responsible for directing and supervising the activities of the loaned staff.

In accordance with the ISCA Code, safeguards that should be applied in all circumstances. Examples include:

- Staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised
- An additional review of the work carried out by the loaned staff
- Not including the loaned staff member within the audit team
2.7 Advocacy threat

An advocacy threat arises in certain situations where the AE is in a position of taking the client's part in a dispute or somehow acting as their advocate. The most obvious instances of this would be when an AE offered legal services to a client and, say, defended them in a legal case or provided evidence on their behalf as an expert witness. Advocacy threat might also arise if the AE carried out corporate finance work for the client, for example, if the AE was involved in advice on debt reconstruction and negotiated with the bank on the client's behalf.

As with the other threats above, the AE has to appraise the risk and apply safeguards as necessary. Relevant safeguards might be using different departments in the AE to carry out the work and making disclosures to the audit committee. Remember, the ultimate option is always to withdraw from an engagement if the risk to independence is too high.

Question 2.3

Explain why contingent fees represent an advocacy threat.

2.8 Familiarity threat

A familiarity threat arises where independence is jeopardised by the AE and its staff becoming over familiar with the client and its staff. There is a substantial risk of loss of professional scepticism in such circumstances.

We have already discussed some examples of when this risk arises, because very often a familiarity threat arises in conjunction with a self-interest threat.
2.8.1 Family and personal relationships

Guidance is given in the ISCA Code Paragraphs 290.126–290.131.

Family or close personal relationships between AE staff and client staff could create self-interest, familiarity or intimidation threats. Each situation has to be evaluated individually. Factors to consider are:

- The individual's responsibilities on the audit engagement
- The closeness of the relationship
- The role of the other party at the audit client

When an immediate family member of a member of the audit team is a director, an officer or an employee of the audit client in a position to exert significant influence over the preparation of the client's accounting records or the financial statements and was in such a position during any period covered by the engagement or the financial statements, the individual should be removed from the audit team.

The AE should also consider whether there is any threat to independence if an employee who is not a member of the audit team has a close family or personal relationship with a director, an officer or an employee of an audit client.

An AE should have quality control policies and procedures under which staff should disclose if a close family member employed by the client is promoted within the client to a position that creates a threat to independence.

If an AE inadvertently violates the rules concerning family and personal relationships they should apply additional safeguards, such as undertaking a quality control review of the engagement and discussing the matter with the audit committee of the client, if there is one.

2.8.2 Employment with an audit client

Guidance is given in the ISCA Code Paragraphs 290.132–290.139.

It is possible that staff might transfer between an AE and a client, or that negotiations or interviews to facilitate such movement might take place. Both situations are a threat to independence:

- An assurance staff member might be motivated by a desire to impress a future possible employer (objectivity is therefore affected – self-interest threat). This threat can be reduced to an acceptable level by the application of safeguards including policies and procedures requiring staff to notify the AE when entering serious employment negotiations with a client and removal of such staff from the engagement team. An independent review of any significant judgments made by the staff member while on the engagement might also be appropriate.

- A former partner turned Finance Director has too much knowledge of the AE's systems and procedures.

In general there may be familiarity and intimidation threats when a member of the assurance team joins an assurance client. The existence and significance of these threats depends on:

- The position the individual has taken at the client
- Any involvement the individual will have with the assurance team
- The length of time since the individual was a member of the assurance team or partner of the AE
- The former position of the individual within the assurance team or AE, for example, whether the individual was responsible for maintaining regular contact with the client's management or those charged with governance
Safeguards could include:

- Modifying the assurance plan
- Assigning individuals to the assurance team who have sufficient experience in relation to the individual who has joined the client
- Having an independent Chartered Accountant review the work of the former member of the assurance team

### 2.8.3 Recent service with an assurance client

Guidance is given in the ISCA Code Paragraphs 290.141–290.143.

Self-interest, self-review or familiarity threats may be created if a member of the assurance team has recently served as a director, officer, or employee of the assurance client.

**Individuals who have been a director or officer of the client (or an employee in a position to exert significant influence over the subject matter information of the assurance engagement) in the period under review cannot be assigned to the assurance team.**

If an individual had been closely involved with the client prior to the period under review set out above, the AE should consider the threat to independence arising and apply appropriate safeguards, such as:

- Obtaining a quality control review of the individual's work on the assignment
- Discussing the issue with the audit committee

### 2.8.4 Long association of senior personnel with audit clients


Having an audit client for a long period of time may create a familiarity and self-interest threat to independence. The severity of the threat depends on factors such as how long the individual has been on the audit team, how senior the person is, the structure of the AE, the nature of the audit engagement, whether the client's management has changed and whether the client's accounting issues have changed in nature or complexity.

Possible safeguards include:

- Rotating the audit partner and senior personnel off the audit team
- Having a Chartered Accountant who is not a member of the audit team review the work of the senior personnel
- Regular independent internal or external quality reviews of the engagement

The rules for public interest entities are stricter. **An individual cannot be a key audit partner for more than seven years. After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years.** In addition, the individual cannot provide quality control or consult with the engagement team for the client during this time period.

Key audit partners whose continuity is especially important to audit quality may, in rare cases due to unforeseen circumstances outside the AE's control, be permitted an additional year on the audit team as long as the threat to independence can be eliminated or reduced to an acceptable level by applying safeguards. For instance, due to serious illness of the intended engagement partner.

If a client that was not a public interest entity becomes one, then the seven year limit still applies, starting from the date when the key audit partner commenced serving that client. For example, if an individual has served as key audit partner for two years prior to the client becoming a public interest entity, that individual can continue to act as key audit partner for another two years.
At the time of writing, ISCA has published an amendment to EP 100 which is expected to revise some of the periods covered when considering the threats posed in various situations. The key proposed changes are as follows:

- Increase in the cooling-off period for Engagement Partners (EPs) of public interest entity (PIE) audit clients from 2 years to 5 years;
- Increase in the cooling-off period for Engagement Quality Control Review Partners (EQCRs) of PIEs from 2 years to 3 years;
- Additional restrictions placed on a former key audit partner (KAP), during the cooling-off period, prohibiting him or her from leading or coordinating the firm’s professional services to the audit client or overseeing the firm’s relationship with the audit client; and
- The former KAP is also prohibited, during the cooling-off period, from undertaking any other role, including provision of non-assurance services, that would result in frequent interaction with senior management or those charged with governance.

Details of this amendment can be found here: https://isca.org.sg/ethics/ethics-headlines/ethics-headlines/2018/august/ep-100-amendments-expected-to-be-effective-15-december-2018/

IMPORTANT

AEs in Singapore must be aware of the European Parliament directive on audit reforms when auditing companies based in the European Union.

Considerable controversy was caused within the profession by legislation on audit reform (known as the ‘audit reform package’), approved by the European Parliament on 3 April 2014. The directive will impact group audits in Singapore where holding companies own a subsidiary corporation based in the European Union (EU).

Stricter requirements apply to the audit of public interest entities. To reduce excessive familiarity AEs will be required to rotate after a maximum engagement period of 10 years. If a public tender is carried out, AEs are permitted to act as auditor for an additional 10 years. A maximum of 24 years of using the same auditor is permitted if joint audits are performed, i.e. if the entity being audited appoints more than one AE to carry out its audit, thus potentially improving the quality of the audit performed by applying the ‘four-eyes principle’. Joint audits are not made obligatory but are thus encouraged.

The directive imposes independence requirements on AEs carrying out a statutory audit of a public interest entity greater than those imposed by the current ACRA and ISCA Codes. For example, in Singapore, the ISCA Code of Professional Conduct and Ethics requires the rotation of the key audit partner (not AE) after no more than seven years. The Singapore Exchange Listing rule 713 states that the audit partner of an issuer must not be in charge of more than five consecutive audits. Singaporean AEs auditing subsidiary corporations in the EU must take care that these enhanced independence requirements are met.

Overall, it is hoped that the reforms will contribute to increased financial and economic stability across the region. However, many AEs and institutes have reacted negatively to the reforms, arguing that although well-intentioned, they may not in fact result in an improvement in audit quality. It is also disputed whether the reforms would have made any difference had they been in place in the run up to the financial crisis, since in the view of many auditors, audit quality was not a factor in the crisis.
2.9 Intimidation threat

An intimidation threat arises when members of the assurance team have reason to be intimidated by client staff.

These are also examples of self-interest threats, largely because intimidation may only arise significantly when the AE has something to lose.

The following are examples of intimidation threats.

**Examples of intimidation threats**

<table>
<thead>
<tr>
<th>A threat of dismissal from a client engagement, if it continues to disagree with the client/plans to modify the auditor's report</th>
</tr>
</thead>
<tbody>
<tr>
<td>A threat of not giving an AE a contract for non-assurance work</td>
</tr>
<tr>
<td>A threat of litigation by the client (see below)</td>
</tr>
<tr>
<td>Pressure to reduce the amount of work done in order to reduce fees</td>
</tr>
<tr>
<td>Pressure to agree with the client because the client has more experience on the matter</td>
</tr>
<tr>
<td>A partner within the AE telling a member of the assurance team that they will not be promoted if they disagree with the client on audit related matters</td>
</tr>
</tbody>
</table>

**2.9.1 Actual and threatened litigation**

Guidance is given in the ISCA Code Paragraph 290.228.

There may be an intimidation threat when the client threatens to sue, or indeed sues, the AE for work that has been done previously. The AE is then faced with the risk of losing the client, bad publicity and the possibility that they will be found to have been negligent, which will lead to further problems. This could lead to the AE being under pressure to produce an unmodified auditor's report when they have been modified in the past, for example.

Generally, AEs should seek to avoid such situations arising. If they do arise, factors to consider are:

- The materiality of the litigation
- Whether the litigation relates to a prior assurance engagement

The following safeguards could be considered:

- Disclosing to the audit committee the nature and extent of the litigation
- Removing specific affected individuals from the engagement team
- Involving an additional Chartered Accountant who was not a member of the team to review the work

However, if the safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or decline the assurance engagement.
2.9.2 Second opinions

Guidance is given in the ISCA Code Section 230.

Another way that AEs can suffer an intimidation threat is when an audit client is unhappy with a proposed audit opinion, and seeks a second opinion from a different AE.

In such a circumstance, the second AE will not be able to give a formal audit opinion on the financial statements – only an appointed auditor can do that. However, the problem is that if a different AE indicates to someone else's audit client that a different audit opinion might be acceptable, the appointed auditors may feel under pressure to change the audit opinion. In effect, a self-interest threat arises, as the existing auditors may feel that they will lose next year's audit if they do not change this year's opinion.

There is nothing to stop a company director talking to a second AE about treatments of matters in the financial statements. However, the AE being asked for a second opinion should be very careful, because it is very possible that the opinion they form could be incorrect anyway if the director has not given them all the relevant information. For that reason, **AEs giving a second opinion should ensure that they seek permission to communicate with the existing auditor and they are appraised of all the facts. If permission is not given, the second auditors shall determine whether it is appropriate to provide the opinion sought.**

Given that second opinions can cause independence issues for the existing auditors, AEs should generally take great care if asked to provide one anyway.

Increasingly, new accounting standards do not give a choice of accounting treatments, meaning that second opinions might be less called for.

**Question 2.4**

You are a partner in an AE. The following issues have emerged in relation to three of your clients:

(a) Dakota Ltd is a major client. It is listed on a major stock exchange. The audit team consists of eight members, including Charlie, the audit assistant. Charlie has just invested in a personal pension plan that invests in all the listed companies on the exchange.

(b) You are at the head of a team carrying out due diligence work at Gilly Ltd, a public company which your client, Tilly Ltd, is considering taking over. Your second in command on the team has confided in you that in the course of their work they have met a sibling of the managing director of Gilly Ltd, and are keen to invite this individual on a date.

(c) Your longest standing audit client is Happy Pte Ltd, which you have been involved in for ten years, as engagement partner. You recently went on an extended cruise with the managing director on his yacht.

**Required**

Comment on the ethical and other professional issues raised by the above matters. Your answer should outline the threat arising, the significance of the threat, any factors you have taken into account, and, if relevant, any safeguards you could apply to eliminate or mitigate the threat.
2.10 Quality control: Independence

The quality control standard for AEs, Singapore Standard on Quality Control (SSQC) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, which we shall look at in detail in Chapter 4, contains a section looking at the AE’s procedures with regard to ethics and, in particular, independence.

**SSQC 1.20**

The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

The policies and procedures should be in line with the fundamental principles, which should be reinforced by:

- The leadership of the AE
- Education and training
- Monitoring
- A process for dealing with non-compliance

**SSQC 1.22**

Such policies and procedures shall require:

(a) Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;

(b) Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and

(c) The accumulation and communication of relevant information to appropriate personnel so that:

   (i) The firm and its personnel can readily determine whether they satisfy independence requirements;

   (ii) The firm can maintain and update its records relating to independence; and

   (iii) The firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.
SSQC 1.23
The firm shall establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures shall include requirements for:

(a) Personnel to promptly notify the firm of independence breaches of which they become aware;

(b) The firm to promptly communicate identified breaches of these policies and procedures to:
   (i) The engagement partner who, with the firm, needs to address the breach; and
   (ii) Other relevant personnel in the firm and, where appropriate, the network, and those subject to the independence requirements who need to take appropriate action; and

(c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

SSQC 1.24
At least annually, the firm shall obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant ethical requirements.

2.10.1 Familiarity threat
Lastly, the SSQC sets out some specific guidance in relation to the threat of overfamiliarity with clients.

SSQC 1.25
The firm shall establish policies and procedures:

(a) Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time, and

(b) Requiring, for audits of financial statements of listed entities, the rotation of the engagement partner and the individuals responsible for engagement quality control review, and where applicable, others subject to rotation requirements, after a specified period in compliance with relevant ethical requirements.

SECTION SUMMARY
Independence is one of the key attributes of the Chartered Accountant. Where circumstances pose a threat to independence the Chartered Accountant must consider the implications. In some cases appropriate safeguards may reduce the threat to an acceptable level.
3 Specific guidance: Confidentiality

SECTION INTRODUCTION

The ISCA Code recognises a duty of confidence and several exceptions to it.

3.1 Duty of confidentiality

Confidentiality is a fundamental principle, defined in Section 1.3 above.

KEY TERM

CONFIDENTIALITY – The principle of confidentiality imposes an obligation on all professional accountants to refrain from:

(a) Disclosing outside the firm or employing organisation confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and

(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

(ISCA Code 140.1)

The key parts of this definition are:

- Do not disclose information without proper authority.
- Do not use information for personal advantage.
- Information may be disclosed if there is a right or duty to do so.

The Chartered Accountant must make the client aware of the duty of confidentiality, and of the fact that it can be overridden where there is a right or duty to disclose.

Maintaining confidentiality means avoiding inadvertent disclosure as much as intentional disclosure. For instance, information must not be disclosed unintentionally when socialising. The ISCA Code 140.6 also notes that the duty of confidentiality continues even after the end of the relationship with the client.

3.2 Exceptions to the rule of confidentiality

Binding though the duty of confidence is, there are nevertheless exceptions to it. The ISCA Code 140.7 identifies three general circumstances where disclosure may be appropriate.

- Disclosure is permitted by law and authorised by the client.
- Disclosure is required by law (eg for legal proceedings).
- There is a professional duty or right to disclose, when not prohibited by law (eg to comply with a quality review by a professional body; to respond to an investigation by a regulatory body; to protect the Chartered Accountant's interests in legal proceedings; to comply with technical standards and ethics requirements).

Disclosure in these circumstances is obligatory. For example, under anti-money laundering legislation, a Chartered Accountant is required to disclose suspected money laundering or terrorism funding (see Chapter 1).
If an auditor reports a serious offence involving fraud or dishonesty to the Minister in good faith, no duty to which an auditor of a company may be subject shall be regarded as having been contravened.

In deciding whether to disclose confidential information, Chartered Accountants should consider the following points:

- Whether it would harm the interests of all parties (including third parties)
- Whether all relevant information is known and substantiated
- The type of communication that is expected
- Whether the parties to whom the communication is addressed are appropriate recipients

**ALERT**

If you are required to make judgments about whether such a disclosure should be made in a given scenario, you should apply the bullet points above to the scenario. This will ensure you have shown evidence of your consideration of all the relevant factors.

3.2.1 Singapore Standard on Auditing (SSA) 250 Consideration of Laws and Regulations in an Audit of Financial Statements

The auditor should look to SSA 250 for guidance when reporting on identified or suspected non-compliance with laws and regulations.

Firstly, the auditor should communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit.

However, if in the auditor's judgment the non-compliance is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practical.

If the auditor suspects that management or those charged with governance are involved, the auditor shall communicate the matter to the next higher level of authority, such as an audit committee, if it exists. Where no higher authority exists or the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

If the auditor concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall consider the effect on the auditor's report. This will be dealt with in Chapter 16.

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Note that although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. The auditor's responsibility to report fraud is covered further in Chapter 7, Section 4.6.

**SECTION SUMMARY**

A Chartered Accountant must not disclose confidential information unless it is permitted by law and authorised by the client, required by law or there is a professional duty or right to disclose.
4 Specific guidance: Conflicts of interest

SECTION INTRODUCTION

AEs should identify potential conflicts of interest as they could result in the ISCA Code being breached. Guidance is given in the ISCA Code Section 220.

4.1 Conflicts between members' and clients' interests

A conflict between members' and clients' interests might arise if a Chartered Accountant competes directly with a client, or has a joint venture or similar arrangement with a major competitor of the client. The rules state that Chartered Accountants and AEs should not accept or continue engagements in which there are, or are likely to be, significant conflicts of interest between Chartered Accountants, AEs and clients.

Chartered Accountants should evaluate the threats arising from a conflict of interest, and unless they are clearly insignificant, they should apply safeguards. The test of whether a threat is significant is whether a reasonable and informed third party, having knowledge of all relevant information, including the safeguards applied, would consider the conflict of interest as likely to affect the judgment of Chartered Accountants and AEs.

4.2 Conflicts between the interests of different clients

AEs are at liberty to have clients who are in competition with each other. However, the AE should ensure that it is not the subject of a dispute between the clients. It must also manage its work so that the interests of one client do not adversely affect another client. Where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued.

4.2.1 Managing conflicts between clients' interests

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. Relationships that ended two or more years earlier are unlikely to create a conflict. Disclosure is the most important 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, or
- 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, or
- 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.

Other safeguards:

- Using separate engagement teams, ie set up information barriers
- Procedures to prevent access of information (such as special passwords)
- Clear guidelines for the respective teams on issues of security and confidentiality
- The use of confidentiality agreements signed by the partners and staff
- Regular review of the safeguards by an independent partner
SECTION SUMMARY
AEs must evaluate the threats arising from a conflict of interest between different clients or between a client and the AE itself.

5 Conflicts in application of the fundamental principles

SECTION INTRODUCTION
The ISCA Code gives some general guidance to members who encounter a conflict in the application of the fundamental principles.

5.1 The problem
The ISCA Code is principles-based and the application of these principles requires a degree of professional judgment. It is possible to have more than one ‘right answer’ to a given situation – more than one reasonable judgment of how the fundamental ethical principles should be applied.

Contrast this to the situation with a rules-based code of ethics as discussed in Section 1. There, applying the rules strictly should result in only one possible outcome. It might not be an outcome that is ethical, eg because it is a result of a loophole, but it will be the only correct outcome (assuming that the rules themselves are not ambiguous). By contrast, a principles-based code may allow for several outcomes that are equally ‘correct’.

What is at issue here is that there may be conflict between different ethical principles. The aim here must be to use judgment to resolve the conflict, or to try to balance the principles involved.

5.2 Matters to consider
When initiating either a formal or informal conflict resolution process, a Chartered Accountant should consider the following, either individually or together with others, as part of the resolution process:

- Relevant facts
- Ethical issues involved – what kinds of issues are these? Would they affect the profession’s reputation? Eg professional ethical issues, personal ethical issues.
- Fundamental principles related to the matter in question – what are the threats? Refer to ISCA Code.
- Established internal procedures – are there procedures for dealing with this sort of situation? Eg discuss with your supervisor, or AE’s legal department.
- Alternative courses of action – have all the consequences been evaluated? Consider laws and regulations, long-term consequences, public consequences.

Having considered these issues, a Chartered Accountant should determine the appropriate course of action that is consistent with the fundamental principles identified. The Chartered Accountant should also weigh the consequences of each possible course of action.

5.2.1 Unresolved conflict
If the matter is unresolved, the Chartered Accountant should consult with other appropriate persons within the AE for help in obtaining resolution.
If a significant conflict cannot be resolved, the Chartered Accountant may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality. For example, a Chartered Accountant may have encountered a fraud, the reporting of which could breach the Chartered Accountant’s responsibility to respect confidentiality. The Chartered Accountant should consider obtaining legal advice to determine whether there is a requirement to report.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, the Chartered Accountant should, where possible, refuse to remain associated with the matter creating the conflict. The Chartered Accountant may determine that, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement or the AE.

SECTION SUMMARY
Professional judgment must be used to resolve any conflicts in the application of fundamental principles.

6 Professional scepticism

SECTION INTRODUCTION
This section looks at professional scepticism and discusses how this relates to independence in an external audit of financial statements. We will examine two recent papers on professional scepticism.

6.1 Relationship with independence

KEY TERMS

Professional scepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
Maintaining professional scepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances
- Over generalising when drawing conclusions from audit observations
- Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof

### 6.2 IAASB Questions and answers on professional scepticism in an audit of financial statements

The importance of professional scepticism in current audit practice is highlighted by a number of papers written on this issue by professional bodies. A Q&A Paper written by the IAASB in February 2012 can be summarised by the following points.

- **What is professional scepticism?**
  It is hard to define, but is ‘fundamentally a mindset’ which is linked to the ethical principles of objectivity and independence. It means ‘being alert’ to evidence that contradicts evidence already obtained, or which casts doubt on the reliability of documents or explanations provided, or which may indicate fraud.

- **Why is professional scepticism important in audits?**
  It is part of the auditor’s ‘skill set’, and is part of professional judgment. It affects decisions about: the procedures to be performed; the sufficiency and appropriateness of evidence obtained; the validity of management’s financial reporting judgments; and the conclusions drawn based on audit evidence.

- **What can AEs do to enhance awareness of professional scepticism’s importance?**
  It is a matter of education, training and experience, as well as the culture of the AE. At a firm-wide level, this means establishing policies and procedures, promoting a quality-oriented culture, and establishing training and CPD schemes.
  At an engagement level, this means that the partner must communicate the importance of quality, and that the audit team is able ‘to raise concerns without fear of reprisals’.

- **At what stage of the audit is professional scepticism necessary?**
  Throughout the audit eg at engagement acceptance, when considering the integrity of management and owners.

- **How does this relate to fraud?**
  The fact that fraud involves deception and concealment makes professional scepticism particularly important in relation to it. ISA 240 emphasises professional scepticism, particularly in the form of ‘an ongoing questioning’ of whether there has been a fraud. There are also areas where there is a required presumption that there is a risk of fraud: revenue recognition, risks of management override of controls as a result of fraud, and accounting estimates.

- **Where else is professional scepticism important, other than fraud?**
  Significant or judgmental areas, such as:
  - Accounting estimates (eg are assumptions reasonable?)
  - Going concern (eg are management’s plans really feasible?)
  - Related party relationships and transactions (eg transactions outside the normal course of business – misappropriation of assets?)
  - Laws and regulations (eg where non-compliance may call the going concern basis of accounting into question)
How can this be evidenced?

Audit documentation should enable an experienced auditor to understand significant decisions made during the audit and any conclusions drawn. As the auditor should be professionally sceptical when making these decisions, the documentation would provide evidence of this, eg it should document the discussions the auditors have about possible non-compliance with laws and regulations, or possible management bias in relation to accounting estimates.

SECTION SUMMARY

Professional scepticism is an attitude of mind linked to the ethical principles of objectivity and independence. It is part of professional judgment.

7 Breach of professional ethics

SECTION INTRODUCTION

ISCA has a complaints procedure to deal with breaches of its ethical code.

7.1 Complaints to ISCA

ISCA takes any breach of its Code of Professional Conduct and Ethics seriously and has in place an investigation and disciplinary process to deal with complaints. Complaints against a member of the Institute may be made by a member of the public, clients, other ISCA members or by the Institute itself.

Before any written complaint is made ISCA emphasises the importance of trying to resolve the matter with the member concerned. Only if this is not successful should a written complaint be lodged. All formal complaints made against a member must:

- Be in writing
- Be supported by relevant documentary evidence
- Provide the full name of the member complained against
- Confirm that an attempt has been made to resolve the matter with the member concerned but was not successfully resolved
- State clearly what the complaint was about
- Provide the name, address and contact details of the complainant
- Be signed by the complainant

7.2 Process

On receipt of the complaint an attempt will be made to try to resolve the issue by conciliation. If this is not possible it will then be treated as a formal complaint and the details and evidence will be sent to the member concerned. The member then has 15 days to respond and advise whether he wishes to be heard by the Investigations Committee. The member is then given 14 days’ notice of the time, date and place of the hearing and is entitled to be heard by the Investigation Committee. The individual may be represented by an advocate and solicitor or an accountant and may wish to call witnesses. The Investigation Committee will report its findings to the Disciplinary Committee.
7.3 Sanctions
The Disciplinary Committee has a range of sanctions available to it including:
- That the member's name be removed from the register such that he is no longer a member
- A fine of a sum not exceeding $5,000

7.4 Complaints to ACRA
Members of the public may also make complaints to ACRA regarding improper or dishonourable conduct by a Chartered Accountant or AE. Examples of matters that could be referred to ACRA include:
- Breach of independence requirements under the ACRA Code
- Failure to exercise adequate professional competence and due care in carrying out audits
- Misappropriation or unauthorised use of funds belonging to the AEs by the Chartered Accountant

7.4.1 Process and sanctions
Complaints should be lodged as soon as possible by preparing and submitting a written complaint, a statutory declaration sworn before a commissioner of oaths or notary public and any supporting evidence to ACRA. The complaint will be reviewed by the Registrar of Public Accountants who will determine whether it merits being referred to a Complaints Committee (CC) or a Disciplinary Committee (DC) for an inquiry.

The CC has up to three months to complete an inquiry but can apply for an extension if required. The CC will review the documents on hand and seek clarifications from the Chartered Accountant or AE concerned. The CC may also request for oral evidence.

Upon completing the inquiry, the CC may:
- Dismiss the complaint and notify the PAOC and all parties involved.
- Recommend to the PAOC to:
  - Issue a warning; or
  - Order a letter of advice; or
  - Make such other order (for example, orders a Chartered Accountant to review their engagements and provide confirmation that they are in compliance with certain areas of the ACRA Code); or
  - Constitute a DC to hold a formal inquiry.

The DC has six months to complete a formal inquiry and has a range of sanctions available including:
- Cancelling the Chartered Accountant's registration
- Suspending the Chartered Accountant or AE for up to two years or restricting the services they can provide
- Imposing penalties of up to $10,000 for a Chartered Accountant and $100,000 for an AE

SECTION SUMMARY
If a member breaches ethical guidance a complaint may be made to ISCA or ACRA.
8 Professional accountants in business

SECTION INTRODUCTION

EP 100 also applies to professional accountants in business.

In addition to specifying ethical requirements for professional accountants performing audit or assurance engagements, the ISCA Code provides ethical requirements for professional accountants in business. These are detailed in Section C of the ISCA Code.

Professional accountants in business are still required to comply with the fundamental principles. Threats to complying with the fundamental principles fall under the same categories as with professional accountants in public practice, that is self-interest, self-review, advocacy, familiarity and intimidation threats. However, the examples of circumstances creating these threats given in the Code and safeguards to eliminate these or reduce them to an acceptable level differ. For example, concern over security of employment or incentive compensation arrangements may create a self-interest threat.

In circumstances where a professional accountant in business believes that unethical behaviour or actions by others will continue to occur within the employing organisation, the professional accountant in business may consider obtaining legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organisation.

Section C of the Code also provides advice to professional accountants in business on how to deal with threats arising in the following areas.

- Conflicts of interest
- Preparing and reporting information
- Acting with sufficient expertise
- Financial interests
- Compensation and incentives linked to financial reporting and decision making
- Inducements

SECTION SUMMARY

Professional accountants in business are required to comply with the fundamental principles in EP 100.
Chapter Roundup

- Public interest in accounting services
  - Integrity
  - Objectivity
  - Professional competence
  - Confidentiality
  - Professional behaviour

- Conflicts of interest
  - Self-interest
  - Self-review
  - Advocacy
  - Familiarity
  - Intimidation

- Exceptions
  - Permitted by law + authorised
  - Required by law
  - Professional right/duty to disclose not prohibited by law

- Fundamental principles
- General threats to fundamental principles
- Example of specific threats
  - Identify threat(s)
  - Evaluate significance of the threat(s)
  - Apply safeguards
  - If no safeguards, decline/discontinue engagement or eliminate interest/activities

- ISCA Code
- Breach
- Resolve with member
- Formal complaint to ISCA
- Conciliation
  - Hearing by Investigations Committee
  - Sanctions

- SSQC1
Quick Quiz

1. Match the fundamental principle to the characteristic.
   (a) Integrity
   (b) Objectivity
     (i) Members should be straightforward and honest in all professional and business relationships.
     (ii) Members should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

2. Name five general threats to independence.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................
   (5) ..........................................

3. Name four relevant safeguards against a financial interest in a client.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................

4. Complete the definition.
   ............................................. are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.

5. Define professional scepticism.
Answers to Quick Quiz

1. (a)(i), (b)(ii)

2. (1) Self-review
   (2) Self-interest
   (3) Familiarity
   (4) Intimidation
   (5) Advocacy

3. (1) Disposing of the interest
   (2) Removing the relevant individual from the assurance team
   (3) Informing the audit committee of the situation
   (4) Independent partner review of work undertaken

4. Contingent fees

5. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
Answers to Questions

2.1 Revision of independence

<table>
<thead>
<tr>
<th>Self-interest</th>
<th>Self-review</th>
<th>Familiarity</th>
<th>Intimidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Undue dependence on an audit client due to fee levels</td>
<td>Auditor prepares the financial statements</td>
<td>Personal relationships with the client</td>
<td>Any threat of/actual litigation by the client</td>
</tr>
<tr>
<td>Overdue fees becoming similar to a loan</td>
<td>Auditor participates in management decisions</td>
<td>Hospitality or gifts</td>
<td>Threat of other services provided to the client</td>
</tr>
<tr>
<td>An actual loan being made to a client</td>
<td>Provision of any other services to the client</td>
<td>Long association with clients</td>
<td>Threat of any services being put out to tender</td>
</tr>
<tr>
<td>Contingency fees being offered</td>
<td></td>
<td></td>
<td>Client refuses to pay fees</td>
</tr>
<tr>
<td>Accepting commissions from clients</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision of lucrative other services to clients</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relationships with persons in associated practices</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relationships with the client</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long association with clients</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beneficial interest in shares or other investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hospitality</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2.2 Financial interests

(a) Teresa is at present a member of the audit team and a member of her immediate family owns a direct financial interest in the audit client. This is unacceptable.

In order to mitigate the risk to independence that this poses on the audit, Stewart Saga needs to apply one of two safeguards:

- Ensure that Teresa's husband disposes of the shares
- Remove Teresa from the engagement team

Teresa should be informed that these are the options and removed from the team while a decision is taken whether to dispose of the shares. Teresa's husband appears to want to keep the shares, in which case, Teresa should be removed from the team immediately.

The AE should inform the audit committee of Recreate of what has happened and the actions they have taken. The partners should consider whether it is necessary to bring in an independent partner to review Teresa's audit work. However, given that Teresa's involvement is subject to the review of the existing engagement partner and she was not connected with the shares while she was carrying out the work, a second partner review is likely to be unnecessary in this case.

(b) The AE has an indirect interest in the parent company of a company it has been invited to tender for by virtue of its employer sponsored retirement scheme having invested in Peter Group.

This is no barrier to the AE tendering for the audit of Paul Ltd.

Should the AE win the tender and become the auditors of Paul Ltd they should consider whether it is necessary to apply safeguards to mitigate against the risk to independence on the audit as a result of the indirect financial interest.

The factors that the partners will need to consider are the materiality of the interest to either party and the degree of control that the AE actually has over the financial interest.
In this case, the AE has no control over the financial interest. An independent employer-sponsored retirement scheme administrator is in control of the financial interest. In addition, the interest is unlikely to be substantial and is therefore immaterial to both parties. Only if the threat is significant should the interest be divested.

It is likely that this risk is already sufficiently minimal so as not to require safeguards. However, if the AE felt that it was necessary to apply safeguards, they could consider the following:

- Notifying the audit committee of the interest
- Requiring Friends Benevolent to dispose of the shares in Peter Group

(c) In this case, Stewart Saga has a direct financial interest in the audit client, which is technically forbidden by ISCA guidance. However, it is a requirement of any AE auditing the company that the share be owned by the auditors.

The interest is not material. The AE should safeguard against the risk by not voting on its own re-election as auditor. The AE should also strongly recommend to the company that it removes this requirement from its constitution as it is at odds with ethical requirements for auditors.

2.3 Advocacy threat

If a Chartered Accountant is paid fees on a contingency basis, then their interests become too closely aligned to that of the client. They will both want the same thing to occur (i.e., the thing the fee is contingent on) and the risk is that the Chartered Accountant will act in the interests of the client to ensure it happens.

2.4 Threats to independence

(a) In relation to Dakota Ltd, there is a threat of self-interest arising, as a member of the audit team has an indirect financial interest in the client.

The relevant factors are as follows:

- The interest is unlikely to be material to the client or Charlie, as the investment is recent and Charlie's interest is in a pool of general investments made by the pension scheme on his behalf.
- Charlie is the audit assistant and does not have a significant role on the audit in terms of drawing audit conclusions or identifying audit risk areas.

The risk that arises to the independence of the audit here is not significant. It would be inappropriate to require Charlie to divest his interest in the audit client. If I wanted to eliminate all elements of risk in this situation, I could simply change the audit assistant assigned to my team, but such a step is not vital in this situation.

(b) In relation to Tilly Ltd, two issues arise. The first is that the AE appears to be providing multiple services to Tilly Ltd, which could raise a self-interest threat. The second is that the second in command assigned to the due diligence assignment wants to engage in a personal relationship with a person connected to the subject of the assignment, which could create a familiarity or intimidation threat.

With regard to the issue of multiple services, insufficient information is given to draw a conclusion as to the significance of the threat. Relevant factors would be matters such as the nature of the services, the fee income and the team members assigned to each. Safeguards could include using different staff for the two assignments. The risk is likely to be significant only if one of the services provided is audit, which is not indicated in the question.

In relation to the second issue, the relevant factors are these:

- The assurance team member has a significant role on the team as second in command.
- The other party is closely connected to a key staff member at the company being reviewed.
- Timing.

In this situation, the AE is carrying out a one-off review of the company, and timing is a key issue. Presently the second in command in the team does not have a personal relationship which would significantly threaten the independence of the assignment. In this situation, the safeguard is to request that
this individual does not take any action in that direction until the assignment is completed. If they refuse, then rotating staff on this assignment should be considered and the individual should be removed from the team.

(c) In relation to Happy Pte Ltd (‘Happy’), there is a risk that my long association and personal relationship with the client will result in a familiarity threat. This is compounded by my acceptance of significant hospitality on a personal level which may result in a self-interest or intimidation threat.

The relevant factors are:

- I have been involved with the client for ten years and have a personal relationship with client staff.
- The company is not a listed company.
- It is an audit assignment.

The risk arising here is significant, but as the client is not listed, it is not insurmountable. However, it would be a good idea to implement some safeguards to mitigate against the risk. I could invite a second partner to provide a pre-issuance review of the audit of Happy, or even consider requesting that I am rotated off the audit of Happy for a period, so that the engagement partner is another partner in my AE. In addition, I must cease accepting hospitality from the directors of Happy, unless the value is trivial and inconsequential.
Auditors have responsibilities to several parties. This chapter explores the various responsibilities and the liability that can arise in respect of them. It also looks at ways of restricting liability, including professional indemnity insurance.

The auditors' responsibility to members and other users of the financial statements in tort and contract can give rise to liability, particularly in the event of negligence. Case law on this matter is complex. It results in auditors being liable to some users and not others. However, auditors' liability is a dynamic issue in that it evolves as cases are brought to court.

The auditor is also generally expected by the entity and its shareholders to conduct the audit with reasonable professional skill and care. This misunderstanding contributes significantly to the 'expectation gap'.

**Topic list**

1 Legal liability
2 Negligence
3 Restricting liability
4 Current issues in auditor liability
5 The expectation gap
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Professional liability</strong></td>
<td></td>
</tr>
<tr>
<td>Recognise circumstances in which professional accountants may have legal liability.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the concept of due care in the performance of work and describe the factors to determine whether or not an auditor is negligent in given situations.</td>
<td>3</td>
</tr>
<tr>
<td>Recognise the auditor's liability to clients and third parties, including those in transnational engagements and non-audit engagements.</td>
<td>2</td>
</tr>
<tr>
<td>Evaluate the practicability and effectiveness of ways in which legal liability may be restricted.</td>
<td>3</td>
</tr>
<tr>
<td>Discuss and appraise the principal causes of audit failure and other factors that contribute to the 'expectation gap' (eg responsibilities for fraud and error).</td>
<td>3</td>
</tr>
<tr>
<td><strong>Communication</strong></td>
<td></td>
</tr>
<tr>
<td>Describe the auditor's responsibility to communicate with those charged with governance and understand the importance of effective two-way communication of specific matters that are required to be communicated to those charged with governance under local and international auditing standards.</td>
<td>2</td>
</tr>
</tbody>
</table>

1 Legal liability

**SECTION INTRODUCTION**

Chartered Accountants may have professional liability under statutory law.

Under certain legislation, notably insolvency legislation, auditors may be found to be officers of the company and could be charged with criminal offences or found liable for civil offences in connection with the winding up of the company.

Auditors may also be found guilty of financial market abuse offences such as insider dealing, since they are privy to inside information and may use this information for their own gain.

Auditors could be found guilty of a criminal offence if they knew or suspected a person was laundering money and they failed to report their suspicions to the proper authority.

**SECTION SUMMARY**

Auditors may be charged with criminal or civil offences in certain situations.
2 Negligence

SECTION INTRODUCTION

Auditors may have professional liability in the tort of negligence.

Negligence is a common law concept. It seeks to provide compensation to a person who has suffered loss due to another person's wrongful neglect. To succeed in an action for negligence, an injured party must prove three things:

(a) A duty of care which is enforceable by law existed.
(b) This duty of care was breached.
(c) The breach caused the injured party loss. In the case of negligence in relation to financial advisers/auditors, this loss must be pecuniary (i.e., financial) loss.

2.1 Who might bring an action for negligence?

The parties likely to want to bring an action in negligence against the auditors, for example, if they have given an inappropriate audit opinion through lack of care, include:

- The company
- Shareholders
- The bank
- Other lenders
- Other interested third parties

A key difference between the various potential claimants is the extent of the proximity between the auditor and the potential claimant, and whether the relationship is sufficiently proximal for the auditor to owe them a duty of care.

2.2 The audit client

KEY POINT

The auditor owes a duty of care to the audit client automatically under law.

The audit client is the company. It is a basic maxim of company law that the company is all of the shareholders acting as a body. In other words, the 'company' cannot be represented by a single shareholder.

\[
\text{COMPANY} = \text{SHAREHOLDERS AS A BODY}
\]

\[
\text{COMPANY} \neq \text{SHAREHOLDER} + \text{SHAREHOLDER}
\]

The company has a contract with the auditor. In the law of many countries, a contract for the supply of a service such as an audit contains a duty of reasonable care implied by statute.
In other words, whatever the express terms of any written contract between the company and the AE, the law always implies a duty of care into it. Therefore, if the company (all the shareholders acting as a body) want to bring a case for negligence, the situation would be as follows.

<table>
<thead>
<tr>
<th>Company's case for negligence</th>
<th>Plaintiff's action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of care exists?</td>
<td>Automatically proven</td>
</tr>
<tr>
<td>Breached?</td>
<td>Must be proven</td>
</tr>
<tr>
<td>Loss arising?</td>
<td>Must be proven</td>
</tr>
</tbody>
</table>

In order to prove whether a duty of care had been breached, the court has to give further consideration to what the duty of 'reasonable' care means in practice.

2.2.1 The auditor's duty of care

Auditors perform their work under the requirements of relevant auditing standards and other legal frameworks. Meeting these requirements does not guarantee, however, that the auditor's duty of care will not be called into question.

CASE STUDY

Re Kingston Cotton Mill 1896

When Lopes L J considered the degree of skill and care required of an auditor he declared:

'... it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution, must depend on the particular circumstances of each case.'

Lopes was careful to point out that what constitutes reasonable care depends very much upon the facts of a particular case. Another criteria by which the courts will determine the adequacy of the auditors' work is by assessing it in relation to the generally accepted auditing standards of the day.

CASE STUDY

The courts will be very much concerned with accepted advances in auditing techniques, demonstrated by Pennycuick J in Re Thomas Gerrard & Son Ltd 1967 where he observed:

'... the real ground on which Re Kingston Cotton Mill... is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896.'

CASE STUDY

Lord Denning in the case of Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd 1958 sought to define the auditor's proper approach to their work by saying:

'... they must come to it with an inquiring mind – not suspicious of dishonesty... – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.'
The auditors have a responsibility to keep themselves abreast of professional developments. Auditing standards are likely to be taken into account when the adequacy of the work of auditors is being considered in a court of law or in other contested situations.

When the auditors are exercising professional judgment they must apply relevant training, knowledge and experience within the context provided from auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement. Obviously, if auditors are to be careful in forming an opinion, they must give due consideration to all relevant matters. Provided they do this and can be seen to have exercised professional judgment in doing so, then their opinion should be above criticism.

However, if the opinion reached by the auditors is one that no reasonably competent auditor would have been likely to reach then they would still possibly be held negligent. This is because however carefully the auditors may appear to have approached their work, it clearly could not have been careful enough, if it enabled them to reach a conclusion which would be generally regarded as unacceptable.

If the auditors' suspicions are aroused, they must conduct further investigations until such suspicions are either confirmed or allayed. Over the years, there have been many occasions where the courts have held that the auditors ought to have been put upon enquiry.

2.3 Third parties

KEY POINT

The auditor only owes a duty of care to parties other than the audit client if one has been established.

‘Third parties’ in this context means anyone other than the company (audit client) who wishes to make a claim for negligence. It therefore includes any individual shareholders in the company and any potential investors. It also includes, importantly, the bank, who is very often a key financier of the company.

The key difference between third parties and the company is that third parties have no contract with the AE. There is therefore no implied duty of care. The situation is therefore as follows.

<table>
<thead>
<tr>
<th>Third party's case for negligence</th>
<th>Plaintiff's action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of care exists?</td>
<td>Must be proven</td>
</tr>
<tr>
<td>Breached?</td>
<td>Must be proven</td>
</tr>
<tr>
<td>Loss arising?</td>
<td>Must be proven</td>
</tr>
</tbody>
</table>

Traditionally the courts have been averse to attributing a duty of care to third parties to the auditor. We can see this by looking at some past cases that have gone to court.

A very important case is Caparo Industries plc V Dickman and Others 1990, which is described here.

CASE STUDY

In 1984, Caparo Industries plc (‘Caparo’) took over Fidelity plc (‘Fidelity’), a manufacturer and vendor of electronic equipment. Both companies were quoted on the London Stock Exchange. Fidelity had not been performing well and its profits, reported in its audited financial statements, were much lower than predicted.

The facts as pleaded were that in 1984 Caparo purchased 100,000 Fidelity shares in the open market. On 12 June 1984, the date on which the financial statements...
(audited by Touche Ross) were published, they purchased a further 50,000 shares. Relying on information in the financial statements, further shares were acquired. On 4 September, Caparo made a bid for the remainder and by October had acquired control of Fidelity. Caparo alleged that the financial statements on which they had relied were misleading in that an apparent pre-tax profit of some £1.3 million (S$2.7m) should in fact have been shown as a loss of over £400,000 (S$840k). The plaintiffs argued that Touche owed a duty of care to investors and potential investors.

The conclusion of the House of Lords hearing of the case in February 1990 was that the auditors of a public company's financial statements owed no duty of care to members of the public at large who relied upon the financial statements in deciding to buy shares in the company. And as a purchaser of further shares, while relying upon the auditor's report, a shareholder stood in the same position as any other investing member of the public to whom the auditor owed no duty. The purpose of the audit was simply that of fulfilling the statutory requirements of the Companies Act. There was nothing in the statutory duties of company auditors to suggest that they were intended to protect the interests of investors in the market. And in particular, there was no reason why any special relationship should be held to arise simply from the fact that the affairs of the company rendered it susceptible to a takeover bid.

In its report *The Financial Aspects of Corporate Governance*, the Cadbury Committee gave an opinion on the situation as reflected in the *Caparo* ruling. It felt that *Caparo* did not lessen auditors' duty to use skill and care because auditors are still fully liable in negligence to the companies they audit and their shareholders collectively. Given the number of different users of financial statements, it was impossible for the House of Lords to have broadened the boundaries of the auditor's legal duty of care.

The decision in *Caparo v Dickman* considerably narrowed the auditor's potential liability to third parties. The judgment appears to imply that members of various such user groups, which could include suppliers, potential investors or others, will not be able to sue the auditors for negligence by virtue of their placing reliance on audited annual financial statements, as their relationship with the auditor is insufficiently proximate.

A more recent court case produced a development in the subject of audit liability. In December 1995, a High Court judge awarded electronic security group ADT £65 million (S$136m) plus interest and costs (£40m or S$84m) in damages for negligence against the former BDO Binder Hamlyn (BBH) partnership.

**CASE STUDY**

The AE had jointly audited the 1988/89 financial statements of Britannia Security Group (BSG), which ADT acquired in 1990 for £105 million (S$220m), but later found to be worth only £40 million (S$84m). Although, under *Caparo*, auditors do not owe a duty of care in general to third parties, the judge found that BBH audit partner Martyn Bishop, who confirmed that the AE stood by BSG's financial statements at a meeting with ADT in the run-up to the acquisition, had thereby taken on a contractual relationship with ADT. This development occurred, apparently, because (post-*Caparo*) solicitors and bankers were advising clients intent on acquisitions to get direct assurances from the target's auditors on the truth and fairness of the financial statements.

BBH appealed this decision; the liable partners, because of a shortfall in insurance cover, were left facing the prospect of coming up with £34 million (S$71m). An out of court settlement was reached with ADT.

A case in 1997 appeared to take a slightly different line, although this case related to some management accounts on which no written report had been issued.
CASE STUDY

In *Peach Publishing Ltd v Slater & Co 1997* the Court of Appeal ruled that Chartered Accountants are not automatically liable if they give oral assurances on accounts to the purchaser of a business.

Prior to the case, Peach Publishing Ltd had purchased ASA Ltd for whom Slater & Co were auditors and Chartered Accountants. The case involved the management accounts of ASA Ltd, which Slater & Co stated were right subject to the qualification that they had not been audited. The Court held that the purpose of giving the assurance was not to take on responsibility to the purchaser for the accuracy of the accounts. The purchaser's true objective in this case was to obtain a warranty from the Chartered Accountant's client, the target. Therefore the Chartered Accountant was not assuming responsibility to the purchaser by giving his client information on which it could decide whether or not to give the warranty. The Court of Appeal also observed that the purchaser should not have relied on the management accounts without having them checked by its advisers.

CASE STUDY

In a further case the Court of Appeal gave guidance on the effect of a disclaimer which stated that the report had been prepared for the client only and no-one else should rely on it. In *Omega Trust Co Ltd v Wright Son & Pepper 1997* (which related to surveyors but the facts of which can be applied to Chartered Accountants), Omega obtained a valuation for a commercial loan but did not reveal to the surveyor that the loan was to be syndicated.

The Court held that the surveyor was entitled to know who his client was and to whom his duty was held. He was entitled to refuse liability to an unknown lender or any known lender with whom he had not agreed.

All this case law raised some problems. In spite of the judgment in *Caparo*, the commercial reality is that creditors and investors (especially institutional ones) do use audited financial statements. The Companies Act (Chapter 50) requires a company to file financial statements with the Registrar. Why is this a statutory requirement? It is surely because the public, including creditors and potential investors, have a need for a credible and independent view of the company's performance and position.

It would be unjust if auditors, who have secondary responsibility for financial statements being prepared negligently, bore the full responsibility for losses arising from such negligence just because they are insured. It would also be unjust if the auditors could be sued by all and sundry. While the profession has generally welcomed *Caparo*, two obvious problems are raised by the decision.

- Is a restricted view of the usefulness of audited financial statements in the profession's long-term interests?
- For private companies there will probably be an increase in the incidence of personal guarantees and warranties given by the directors to banks and suppliers.

Recent developments in the US appear to try to redress the balance of liability by highlighting the responsibilities of management with regard to published financial statements. The Sarbanes-Oxley Act requires chief executive officers and finance officers to certify that the financial statements of listed companies are not misleading and present the company's financial position and results fairly. In addition, they are required to confirm that they are responsible for internal controls and have reported significant control deficiencies to the auditors/audit committee.
The UK has also seen some recent developments. The UK Companies Act 2006 requires the directors’ report to contain a statement to the effect that, in the case of each director:

(a) So far as the director is aware, there is no relevant audit information of which the auditor is unaware.

(b) The director has taken all the steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information.

If the statement in the directors’ report is false, every director who knew it was false or who was reckless as to whether it was false, and failed to take reasonable steps to prevent the report from being approved, commits an offence.

In Singapore, The Accountants Amendment Act 2006 makes it possible for auditors to limit their liability by setting up a Limited Liability Partnership (LLP). We will look at this issue in more detail in Section 4.

**CASE STUDY**

**Ikumene Singapore Pte Ltd and another v Leong Chee Leng (trading as Elizabeth Leong & Co)**

Ikumene Singapore Pte Ltd (‘Ikumene’) was audited by Leong Chee Leng for three years from 1979–1981 and each year she stated that the financial statements were properly drawn up and gave a true and fair view.

In 1983, Far Eastern Bank Ltd (‘the bank’) with whom Ikumene held an overdraft, demanded a payment of $194k. Ikumene was owned 94% by another company. Since Ikumene did not pay the bank the outstanding amount, in 1984 the bank wrote to the other company demanding payment of the $194k plus interest since the other company acted as guarantor of the overdraft.

Ikumene and the other company sued Leong Chee Leng for negligence claiming she had not taken reasonable care.

The judge found Leong Chee Leng negligent in the audit of the financial statements of Ikumene. However, it was held that Leong Chee Leng did not have a duty of care to the other company which guaranteed Ikumene’s bank overdraft.

**2.3.1 Banks and other major lenders**

Banks and other major lenders have generally been excluded from the extent of negligent auditor’s liability by the decision in *Caparo*.

Banks often include clauses in loan agreements referring to audited financial statements and requesting that they have access to audited financial statements on a regular basis or when reviewing the loan facility. In other words, banks may document a ‘relationship’ with the auditors to establish that there is sufficient proximity and that a duty of care exists.

The following Scottish case involved a situation similar to this.

**CASE STUDY**

In *Royal Bank of Scotland v Bannerman Johnstone Maclay and Others 2002* the bank, who provided an overdraft facility to the company being audited, claimed the company had misstated its position due to a fraud and that the auditors were negligent in not discovering the fraud. The auditors claimed that they had no duty of care to the bank. However, the judge determined that the auditors would have known that the bank required audited financial statements as part of the overdraft arrangement and could have issued a disclaimer to the bank. The fact that they had not issued a disclaimer was an important factor in deciding that the auditors did owe a duty of care to the bank.
2.3.2 Assurance services

The AE might be able and prepared to offer assurances to the bank in relation to financial statements, position, internal controls or other matters of interest to a primary lender. If this is the case, and the service is required by the bank, the auditor should seek to create an engagement with the bank itself.

You should bear in mind that providing assurance services to a lender could result in a conflict of interest arising, of course.

**ALERT**

It is vital that you use the right kind of language when answering questions in this area. Your correct use of terms such as duty of care, liability, negligence, proximity and third party can help to demonstrate to the examiner that you are familiar with the subject matter and are simply applying it to the circumstances in the question.

2.4 Disclaimers

The cases above suggest that a duty of care to a third party may arise when a Chartered Accountant does not know that their work will be relied upon by a third party, but only knows that it is work of a kind which is liable in the ordinary course of events to be relied upon by a third party.

A Chartered Accountant may sometimes be informed or be aware, before they carry out certain work, that a third party will rely upon the results. An example is a report upon the business of a client which the Chartered Accountant has been instructed to prepare for the purpose of being shown to a potential purchaser or potential creditor of that business. In such a case a Chartered Accountant should assume that they will be held to owe the same duty to the third party as to their client. The Bannermann case suggests this will also be necessary for audit work. Since the Bannermann case, some AEs have included a disclaimer in their auditor's report, however these are still rare in Singapore.

**CASE STUDY**

The independent auditor's report published in the 2014 annual report and financial statements of Unilever NV contains the following disclaimer.

This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities which can be accessed on our website via www.kpmg.com/uk/auditscopeukco2014b, and are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.


However, there are areas of professional work (for example when acting as an auditor under the Companies Act on behalf of shareholders and no liability limitation agreement is in place), where it is not possible for liability to be limited or excluded. There are other areas of professional work (for example when preparing reports on a business for the purpose of being submitted to a potential purchaser) where although such a limitation or exclusion may be included, its effectiveness will depend on the view which a court may subsequently form of its reasonableness.

2.5 Reducing the risk of litigation

The other aspect of how AEs are trying to deal with litigation is what they are trying to do to reduce the risk of litigation. This strategy has various aspects.

(a) **Client acceptance procedures** are very important, particularly the screening of new clients and the use of engagement letters. The AE should not accept engagements where there is evidence that the client is lacking in integrity (for example, from enquiry of third parties, background searches or
communication with the predecessor auditors). Engagements should also be declined where the AE is lacking the competence and capability to perform the engagement. Acceptance procedures are covered in more detail in Chapter 5.

(b) **Performance of audit work.** AEs should make sure that all audits are carried out in accordance with professional standards and best practice.

(c) **Quality control.** This includes not just controls over individual audits but also stricter ‘whole-firm’ procedures. This is considered in more detail in Chapter 4.

(d) **Issue of appropriate disclaimers.** We discussed above the importance of these.

(e) **Increasing professional scepticism.** AEs should apply professional scepticism during client acceptance and over the entire course of the engagement.

### Question 3.1 Negligence claims

Although auditors can incur civil liability under various statutes it is far more likely that they will incur liability for negligence under the common law, as the majority of cases against auditors have been in this area. Auditors must be fully aware of the extent of their responsibilities, together with steps they must take to minimise the danger of professional negligence claims.

**Required**

(a) Discuss the extent of an auditor’s responsibilities to shareholders and others during the course of their normal audit engagement.

(b) List six steps which auditors should take to minimise the danger of claims against them for negligent work.

### SECTION SUMMARY

The auditor owes a duty of care to the audit client automatically under law. The auditor only owes a duty of care to parties other than the audit client if one has been established.

### 3 Restricting liability

**SECTION INTRODUCTION**

Insurance can restrict the financial impact of claims against the AE.
3.1 Professional indemnity insurance

**KEY TERMS**

**PROFESSIONAL INDEMNITY INSURANCE (PII)** is insurance against civil claims made by clients and third parties arising from work undertaken by the firm.

**FIDELITY GUARANTEE INSURANCE (FGI)** is insurance against liability arising through any acts of fraud or dishonesty by any partner, director or employee in respect of money or goods held in trust by the firm.

It is important that Chartered Accountants have insurance so that if negligence occurs, the client can be compensated for the error by the Chartered Accountant. The appropriate compensation could be far greater than the resources of the AE, such as the case study of BBH mentioned in Section 2.3.

Remember that Chartered Accountants usually trade as partnerships, so all the partners are jointly and severally liable to claims made against individual partners.

3.2 ACRA requirements

All Limited Liability Partnerships must be covered by professional indemnity insurance in accordance with Section 28 of the Accountants Act. The amount covered will be not less than one of the following amounts, whichever is the highest:

- $1 million
- A sum equal to the total of $500,000 for every corporate practitioner in the LLP
- A sum equal to two and a half times the gross income of the LLP in the last completed financial year of the LLP, subject to a maximum sum of $50 million

3.3 Advantages and disadvantages

An advantage to the auditor is that it provides some protection against bankruptcy in the event of successful litigation against the AE. This is particularly important for a partnership, as partners may be sued personally for the negligence of their fellow partners.

A key disadvantage is that the deductible may be high. The deductible represents the amount of loss below which the insurer is not liable to pay and which the insured has to bear the loss. Any loss equal to or below the deductible is borne by the insured. In addition, there may be a cap on the amount that the insurer will pay the insured. Any loss above the cap will have to be borne by the insured.

3.4 Incorporation

Major AEs have used incorporation to reduce personal liability for partners in the event of negligence for some time. For example, imagine a mid-tier AE has incorporated its Singaporean audit practice to become a Public Accounting Corporation. This arrangement creates ‘a firm within a firm’. Being a limited company protects the partners from the crushing effects of any litigation. The other side of incorporation means that the Public Accounting Corporation is subject to the statutory disclosure requirements of companies.

An alternative to incorporation as a company is incorporation as a limited liability partnership.

Limited liability partnership which we will look at briefly below, can be operated in some countries, for example, Singapore, some of the states in the US and the UK.

3.4.1 Limited liability partnerships (LLPs)

The Accountants Amendment Act 2006 enables Chartered Accountants to set up Accounting LLPs through which they may provide public accountancy services. These combine the flexibility and tax status of a partnership with limited liability for members.
The effect of this is that the partnership, but not its members, will be liable to third parties; however, the personal assets of negligent partners will still be at risk. A partner will not be liable for any wrongful acts or omissions of any other partner.

Limited liability partnerships could be formed from 6 April 2006. Several prominent professional partnerships have incorporated as LLPs.

LLPs need to comply with the Limited Liability Partnerships Act and the Accountants Act. To be an LLP, the entity needs to be registered under the Limited Liability Partnerships Act and to obtain approval to be an accounting LLP, the entity needs approval under the Accountants Act.

Limited liability partnerships are set up by similar procedures to those for incorporating a company. An incorporation document is sent to the Registrar of Companies. The Registrar will issue a certificate of incorporation to confirm that all statutory requirements have been fulfilled.

In a similar way to traditional partnerships, relations between partners will be governed by internal partner agreements, or by future statutory regulations.

Each member of the partnership will still be an agent of the partnership unless he has no authority to act and an outside party is aware of this lack of authority.

### 3.5 Advantages and disadvantages of different structures

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<th>Advantages</th>
<th>Disadvantages</th>
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<td>Partnership</td>
<td>• Less regulation than for companies</td>
<td>• Joint and several liability</td>
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<td></td>
<td>• Financial statements not on public record</td>
<td>• Personal assets at risk</td>
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<td>Incorporation</td>
<td>• Limited liability</td>
<td>• Public filing of audited financial statements</td>
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<td>• Management must comply with the Companies Act</td>
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<td>LLP</td>
<td>• Protection of personal assets</td>
<td>• Public filing of audited financial statements</td>
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<td>• Limited liability of members</td>
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<td>• Similar tax effect of partnership</td>
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<td>• Flexible management structures</td>
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### SECTION SUMMARY

Incorporation or LLPs limit the liability of individual partners in the event of a negligence claim.
4 Current issues in auditor liability

SECTION INTRODUCTION

Auditor liability is an important practical issue.

EXAMPLES OF CASE STUDIES IN SINGAPORE

PlanAssure PAC v Gaelic Inns Pte Ltd

Gaelic Inns Pte Ltd was a company incorporated in Singapore that ran a chain of bars. PlanAssure PAC was an AE of CPAs that were engaged to perform the audit for the year-ends 2001, 2002 and 2003.

The group finance manager of Gaelic Inns Pte Ltd carried out a ‘teeming and lading fraud’ between 2001 and 2004 in which she delayed banking cash into the bank account and used the cash for her own use. An identical amount of money would later be paid into the bank from subsequent cash sales.

The group finance manager was caught in May 2004 only after she had misappropriated over $1 million. Gaelic Inns Pte Ltd recovered almost $9,000 from the finance manager and $100,000 from their own insurers.

In July 2005, Gaelic Inns sued PlanAssure for negligence in failing to detect the theft during the three audits. The High Court found that the auditor had failed to discharge their duty of care and were liable for the amount of $775,266.02.

The Court of Appeal found that PlanAssure had failed to investigate the possibility of fraud given the unusually large amount of unlodged cash deposits. However, the quantum of liability was reduced by 50% because the Court was of the opinion that the directors and management of Gaelic Inns had themselves been negligent by not reviewing the bank accounts and not even looking at the monthly bank reconciliation. This amounted to contributory negligence.

JSI Shipping (S) Pte Ltd v Teofoongwongcloong

JSI Shipping (S) Pte Ltd was the Singapore subsidiary company of an American freight-forwarding company. It had two directors, one based in Singapore and the other based in the US.

Teofoongwongcloong were CPAs who audited JSI for the financial years 1999, 2000 and 2001. All three years had unqualified auditor's reports.

The Singapore based director had overall control and responsibility for the day to day operations in Singapore and was engaged in a scheme to take some of the profits for his own use. This was discovered only after one of the staff ‘whistle blew’ to the US director (managing director).

Another AE was engaged to conduct a special audit and they found that the Singapore based director had misappropriated funds of $1.808 million, had an overpayment of salary of $18,000 and had received non-approved allowances and benefits of $174,000.

The High Court accepted that an auditor has to use reasonable skill, care and caution and found that the auditor had conducted all three audits without breach of duty or negligence.
The Court of Appeal reversed the trial judge's findings on liability and held the auditors liable for negligence. However, the auditors were only liable for 50% of the losses as the judge found that JSI were 'contributorily negligent by reason of its own patent failure to safeguard its own interest...'.

**United Project Consultants Pte Ltd v Leong Kwok Onn (‘trading as Leong Kwok Onn & Co’)**

United Project Consultants Pte Ltd (UPC) employed Leong Kwok Onn to act as auditor and tax agent from 1983 to 2000. During this period, the directors of UPC did not declare all the fees due to them to the Inland Revenue Authority of Singapore (IRAS) and thus underpaid their taxes. In 1998, the IRAS queried UPC about their director's fees. The investigation that followed resulted in a penalty of $1.707 million having to be paid by UPC which was the same as the tax underpaid.

UPC launched a case against Leong Kwok Onn claiming that he should have informed them of the consequences of providing the incorrect information to the IRAS. They lost the original claim but successfully won an appeal.

The appeal found irrefutable evidence that from 1993, Leong Kwok Onn had actual knowledge that some, if not all, the directors of UPC were underreporting their director's fees to the IRAS. The appeal also concluded that as Leong Kwok Onn was hired as a professional to ensure the correct filing of UPC's tax returns, Leong Kwok Onn had a duty to warn UPC of any inaccuracies in filing of tax returns he had acquired any knowledge of.

The appeal concluded that Leong Kwok Onn was in breach of his duties as a professional tax agent. Whilst the loss prior to 1993 was a result of the failings of UPC, any losses after were due to the failure of Leong Kwok Onn's duty as tax agent.

The appeal noted that UPC's loss was precisely the kind of loss that Leong Kwok Onn was engaged to prevent. Leong Kwok Onn was ordered to pay the proportion of the fine to UPC that related to the period from 1993 to 1998.

Even with PII and other means of restricting liability there has been great concern throughout the audit profession globally at the remaining risks to AEs' survival in the face of claims which might exceed their insurance cover.

The profession has lobbied for further protection in the form of proportionate liability or capping liability.

**KEY TERMS**

**Proportionate Liability** allows claims arising from successful negligence claims to be split between the auditors and the directors of the client company, the split being determined by a judge on the basis of where the fault was seen to lie. This would require the approval of shareholders.

**Capping Liability** sets a maximum limit on the amount that the auditor would have to pay out under any claim.

### 4.1 Protecting against liability

In a case for liability, the judge would determine the scope and duty of care of an auditor and would assess whether the conduct of the auditor fell below the reasonable standard.
In the case of *JSI Shipping (S) Pte Ltd v Teofoongwongcloong*, the Court of Appeal identified that the courts will use the following documents to assess whether the auditor has fallen below a reasonable standards of care:

- The Singapore Standards on Auditing
- The Singapore Auditing Practice Standards
- The Singapore Standards on Review Engagements
- The Singapore Standards on Assurance Engagements

It would be difficult to prove that an auditor had not exercised due care and attention if they complied completely with all the relevant standards.

**CASE STUDY**

Akai Holdings Limited (Akai) was an electronics company listed on the Hong Kong Stock Exchange. Following Akai being placed under compulsory liquidation, the liquidator Borelli Walsh sued E&Y for negligence and breach of duty in the audit of Akai’s financial statements for the years 1997 to 1999. Borelli Walsh accused E&Y of falsifying audit evidence to shield itself from a large negligence claim. In 2009, E&Y agreed to make an undisclosed payment to the Borelli Walsh.

4.2 Ongoing debate

The Companies Act (Chapter 50) Section 391 covers the power to grant relief and states:

If in any proceedings for negligence, default, breach of duty or breach of trust against a person to whom this section applies it appears to the court before which the proceedings are taken that he is or may be liable in respect thereof but that he has acted honestly and reasonably and that, having regard to all the circumstances of the case including those connected with his/her appointment, he ought fairly to be excused of the negligence, default or breach the court may relieve him/her either wholly or partly from his/her liability on such terms as the court sees fit.

In the case of JSI Shipping, the Court of Appeal used Section 391 of the Companies Act (Chapter 50) to find contributory negligence by the Managing Director and held the company liable for 50% of the loss.

The Court of Appeal acknowledged that Section 391 provided some guidance as to when it would willing to use it in future.

‘In our view, we agree that the Court should not hesitate, in a proper case, to relieve a person from a harsh and oppressive consequence arising from the strict application of the law, have particularly in an instance where the person had acted honourably, fairly and in good faith as judged by the standards of other of a similar professional background.’

This is an important development as it emphasises the need for directors to also provide due care and attention in their duties. It indicates that if the directors are negligent then liability may be split.

4.3 Network firms

Several AEs have moved towards network models over recent years. This is where member firms are part of a larger structure, often sharing a name (or using a similar name) and professional resources. As part of a global network, member firms have been able to sell services based on the value and reputation of their global brand name. However, in recent liability cases, some network firms have claimed the network is not liable for negligence in an individual member firm even though they appear to be operating under the same brand.
CASE STUDY

In 2009, BDO Seidman, a member firm of the global network BDO International, faced audit negligence claims to the sum of $500 million over the audit of ES Bankest, a company owned by the Portuguese bank Banco Espirito Santo. Auditors from BDO Seidman had been accused of being grossly negligent in audits between 1998 and 2002. BDO International had claimed that they should not be held liable as member firm audits are conducted independently.

It is possible that the network model may disappear or be modified in future years. The current situation where network firms advertise under one brand and then claim they are separate firms when things go wrong may not be sustainable given the outcome of current legal activity.

CASE STUDY

In 2009, a major fraud was exposed at Satyam, an Indian IT services company when the company's then chairman Ramalinga Raju admitted falsifying the financial statements.

The auditors of Satyam were PW India, an affiliate of PricewaterhouseCoopers. PW India failed to externally confirm material bank balances and where external bank confirmations had been received, large differences were not followed up.

PW India were fined US$7.5 million by the Securities and Exchange Commission (SEC) in the US since Satyam shares were traded on the New York Stock Exchange as well as Indian markets. In addition, two former partners at PW India were jailed for seven years.

5 The expectation gap

SECTION INTRODUCTION

The ‘expectation gap’ can be narrowed either by educating the users of audited financial statements, or by extending the auditor’s role.

The definition of ‘expectation gap’ in relation to audited financial statements has been developed over time. No exact definition exists in Singaporean legislation or standards although many academics internationally have proposed their own definitions.

SSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements sets out the current position on the auditor’s responsibility to consider fraud. There remains a debate as to whether this is sufficient as the area of fraud is a key part of the expectation gap between what users of auditors’ reports believe to be the purposes of the audit compared with the actual nature of the assurance reported to them by auditors.

The issue of the expectation gap is consistently in and out of the financial press. In recent years, there has been a focus on the role of auditors in evaluating whether a company is a going concern. In the US, the collapse of Lehman Brothers brought with it accusations from some quarters that its auditor, Ernst & Young (EY), had failed to discharge its responsibilities as auditor.

A recent example of such coverage relates to auditors EY and their audit client, the Olympus Corporation. A scandal was precipitated in October 2011 when Olympus’s recently appointed chief executive was ousted from his position after having exposed what was described as a loss-hiding arrangement of
fraudulent financial reporting. A succession of auditors had issued unmodified reports throughout this period. An internal Olympus enquiry into the fraud concluded that the scheme had been too well-concealed for the auditors to detect it:

‘The masterminds of this case were hiding the illegal acts by artfully manipulating experts' opinions…’

 Reuters report, at http://www.webcitation.org/65x0p5rgR

High profile cases such as these have brought up the question of the extent to which auditors should be responsible for detecting fraud, and how this differs from the way that the responsibilities of the auditor are perceived.

5.1 Narrowing the expectation gap

Logically, the expectation gap could be narrowed in two ways.

1 Educating users – the auditor’s report as outlined in SSA 700 *Forming an Opinion and Reporting on Financial Statements* includes an explanation of the auditor’s responsibilities. It is not clear that any further information would help, and it might even have the effect of bringing the value of the audit into question. One suggestion is that auditors could highlight circumstances where they have had to rely on directors’ representations.

Suggestions for expanding the auditor’s role have included:

- Requiring auditors to report to boards and audit committees on the adequacy of controls to prevent and detect fraud.
- Encouraging the use of targeted forensic fraud reviews.
- Increasing the requirement to report suspected frauds.

2 Extending the auditor’s responsibilities – research indicates that extra work by auditors with the inevitable extra costs is likely to make little difference to the detection of fraud because:

- Most material frauds involve management.
- More than half of frauds involve misstated financial reporting but do not include diversion of funds from the company.
- Management fraud is unlikely to be found in a financial statement audit.
- Far more is spent on investigating and prosecuting fraud in a company than on its audit.

New and revised SSAs on auditor reporting issued by ISCA in July 2015 go some way to addressing the expectation gap. Amongst other things, these require a more prominent display of the auditor’s opinion, auditor reporting on Key Audit Matters for listed companies and an improved description of the auditors’ responsibilities. Chapter 16 covers this in more detail.

**SECTION SUMMARY**

The expectation gap is the difference between what auditors do and what the users of financial statements expect them to do. Potentially, it could be narrowed by educating the users of financial statements or extending the responsibilities of the auditor.
Chapter Roundup

Audit liability

- Restricting Liability
- Duty of care?
- Duty of care breached?
- Loss arising?
- Disclaimers

- PII
- FGI
- Incorporation
- LLPs
Quick Quiz

1 What three matters must an injured party satisfy to the court in an action for negligence?
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................

2 Name four aspects of litigation avoidance.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................

3 Professional indemnity insurance is insurance against liability arising through any acts of fraud or dishonesty by partners in respect of money held in trust by the firm.
   True □
   False □
Answers to Quick Quiz

1. (1) A duty of care existed
   (2) Negligence occurred
   (3) The injured party suffered pecuniary loss as a result

2. (1) Client acceptance procedures
   (2) Performance of audit work in line with SSAs
   (3) Quality control
   (4) Disclaimers

3. False – That is fidelity guarantee insurance. Professional indemnity insurance is insurance against civil claims made by clients and third parties arising from work undertaken by the firm.
3.1 Negligence claims

(a) Responsibility under statute

Auditors of limited companies have a responsibility, imposed upon them by statute, to form and express a professional opinion on the financial statements presented by the directors to the shareholders. They must report upon the truth and fairness of such statements and the fact that they comply with the law. In so doing, the auditor owes a duty of care to the company imposed by statute. But such duty also arises under contract and may also arise under the common law (law of tort).

Responsibility under contract

The Companies Act does not state expressly the manner in which the auditor should discharge their duty of care; neither is it likely that this would be clearly spelt out in any contract setting out the terms of an auditor's appointment (eg the engagement letter). Although the articles of a company may extend the auditor's responsibilities beyond those envisaged by the Companies Act, they cannot be used so as to restrict the auditor's statutory duties, neither may they place any restriction upon the auditor's statutory rights which are designed to assist them in the discharge of those duties.

The comments of Lopes L J when considering the degree of skill and care required of an auditor in *Re Kingston Cotton Mill 1896* are still relevant.

'... It is the duty of an auditor to bring to bear on the work he has to perform the skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.'

Clearly, with the advent of auditing standards, a measure of good practice is now available for the courts to take into account when considering the adequacy of the work of the auditor.

Responsibility in tort

The law of tort has established that a person owes a duty of care and skill to 'our neighbours' (common and well-known examples of this neighbour principle can be seen in the law of trespass, slander, libel and so on). In the context of the auditor, the extent to which the auditor owes a duty of care and skill to third parties who rely on financial statements upon which they have reported, but with whom they have had no direct contractual or fiduciary relationship, has changed.

Liability to third parties

In *Caparo Industries plc v Dickman & Others 1990*, it was held that the auditors of a public company's financial statements owed no duty of care to members of the general public who relied upon the financial statements in deciding to buy shares in the company. Furthermore as a purchaser of more shares, a shareholder placing reliance on the auditor's report stood in the same position as any other investing member of the public to whom the auditor owed no duty. This decision appeared to radically reverse the tide of cases concerning the auditor's duty of care. The purpose of the audit was simply that of meeting the statutory requirements of the Companies Act. There was nothing in the statutory duties of an auditor to suggest that they were intended to protect the interests of investors in the market. In particular, there was no reason why any special relationship should be held to arise simply from the fact that the affairs of the company rendered it susceptible to a take-over bid.

The case between BDO Binder Hamlyn and ADT seems to have moved the argument on. In this case it was argued that proximity between a prospective investor and the auditor of a company could be created if the investor asked the auditor whether they stood by their last audit. An appeal is likely in this case as the auditor involved face a large shortfall in the proceeds of an insurance claim. The Scottish Bannerman case suggests that judges may be more likely to impute a duty of care to the auditors if they were aware that the bank made use of audited financial statements and did not disclaim liability to them.
(b) In order to provide a means of protection for the auditor arising from the comments in (a) above, the following steps should be taken.

(i) Agreements concerning the duties of the auditor should be:
   (1) Clear and precise
   (2) In writing
   (3) Confirmed by a letter of engagement, including matters specifically excluded

(ii) Audit work should be:
   (1) Relevant to the system of internal control, which must be ascertained, evaluated and tested. Controls cannot be entirely ignored: for the auditor to have any confidence in an accounting system there must be present and evident the existence of minimum controls to ensure completeness and accuracy of the records
   (2) Adequately planned before the audit commences
   (3) Reviewed by a senior member of the AE to ensure quality control of the audit and to enable a decision to be made on the form of auditor's report

(iii) Any queries arising during the audit should be:
   (1) Recorded on the current working papers
   (2) Cleared and filed

(iv) A management letter should be:
   (1) Submitted to the client or the Board of Directors in writing immediately following an audit
   (2) Seen to be acted upon by the client

(v) All members of an AE should be familiar with:
   (1) The standards expected throughout the AE
   (2) The standards of the profession as a whole by means of adequate training, which should cover the implementation of the AE's audit manual and the recommendations of the professional accountancy bodies

(vi) Professional Indemnity Insurance (PII) should be taken out to cover the AE against possible claims.
PART C
PRACTICE MANAGEMENT
The role performed by Chartered Accountants performing statutory audits represents an activity of significant public interest. Quality independent audits are crucial both to users and to the audit profession as a whole. Failing to pay attention to audit quality damages the reputation of the AE and may lead to loss of clients and thus fees, as well as an increased risk of litigation and associated professional insurance costs. Although there are two specific standards giving guidance on how Chartered Accountants should perform their work with satisfactory quality, these standards deal with quality at a general level. These standards are SSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements, and SSA 220 Quality Control for an Audit of Financial Statements.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
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<tbody>
<tr>
<td>Quality control</td>
<td>3</td>
</tr>
<tr>
<td>Explain the principles and purpose of quality control of audit and other</td>
<td></td>
</tr>
<tr>
<td>assurance engagements under the regulatory framework.</td>
<td></td>
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<tr>
<td>Select and justify quality control procedures that are applicable to a given</td>
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<td>firm and audit engagement.</td>
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<td>Assess whether an engagement has been planned and performed in</td>
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<tr>
<td>accordance with professional standards and public oversight requirements.</td>
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</table>

ESSENTIAL READING

- ACRA Practice Monitoring Programme: Seventh Public Report August 2013
- A Framework for Audit Quality: Key Elements that create an Environment for Audit Quality
- Audit Practice Bulletin No 1 of 2011 Engagement Quality Control Review
- Audit Practice Bulletin No 1 of 2012 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (Part 1) – Leadership Responsibilities for Quality within the Firm
- Audit Practice Bulletin No 2 of 2012 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (Part 2) – (a) relevant ethical requirements and (b) acceptance and continuance of client relationships and specific engagements
- Audit Practice Bulletin No 3 of 2012 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (Part 3) – Human Resources
- Audit Practice Bulletin No 1 of 2013 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (Part 4) – (a) engagement performance and (b) monitoring
- Audit Practice Bulletin No 3 of 2016 Compliance with Continuing Professional Education Requirements for Renewal of Certificate of Registration by Public Accountants
- Singapore Standard on Quality Control (SSQC) 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements
- SSA 220 Quality Control for an Audit of Financial Statements
1 Principles and purpose

SECTION INTRODUCTION

Audit quality is not defined in law or through regulations, and neither do auditing standards provide a simple definition. It is often a matter of conducting an audit in line with the spirit as well as the literal interpretation of professional guidance.

ALERT

Issues relating to quality control can be linked with almost any area of the syllabus, from ethics and auditor liability covered in Part B to any of the specific areas covered in Part D of this Textbook. You could be asked to suggest quality control procedures that an AE should implement in specific circumstances; to review an AE’s procedures and assess their adequacy; or to assess procedures planned or performed, and evidence obtained, for a specific engagement.

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an appropriate professional opinion supported by the necessary evidence and judgments.

Many principles contribute to audit quality including good leadership, professional scepticism, technical competence, ethical values and appropriate client relationships, proper working practices and effective quality control and monitoring review processes.

The standards SSQC 1 Quality Control for Firms that Perform Audits of Financial Statements and Other Assurance and Related Services Engagements and SSA 220 Quality Control for an Audit of Financial Statements provide guidance to AEs on how to achieve these principles.

In February 2014 the IAASB issued a non-authoritative publication called A Framework for Audit Quality: Key Elements that create an Environment for Audit Quality. This publication describes the input, process and output factors that contribute to audit quality at the engagement level, the public accounting entity level and the national level as well as relevant interactions and contextual factors. The objectives of the Framework for Audit Quality include:

- Raising awareness of the key elements of audit quality
- Encouraging key stakeholders to explore ways to improve audit quality
- Facilitating greater dialogue between key stakeholders on the topic

1.1 Benefiting from the Framework for Audit Quality

The primary responsibility for performing a quality audit rests with the auditors. However, audit quality is best achieved in an environment where there is support from, and appropriate interactions among, participants in the financial reporting supply chain.

The IAASB expects that the Framework will generate discussion, and positive actions to achieve a continuous improvement to audit quality. It encourages stakeholders to use it including AEs, those charged with governance, public sector organisations, regulators, oversight bodies, national standards setters and academics. Stakeholders are encouraged to challenge themselves about whether there is more they can do to increase audit quality in their particular environments.
1.2 Elements of the Framework for Audit Quality

The *Framework for Audit Quality* identifies the following as elements that contribute to maximising the likelihood of a quality audit being consistently performed:

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Inputs</th>
<th>Categorised at the engagement, firm and national level and involve auditors:</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>• Exhibiting appropriate values, ethics and attitudes</td>
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<td></td>
<td></td>
<td>• Being sufficiently knowledgeable, skilled, experienced, and having sufficient time allocated to them to perform the audit work</td>
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<tr>
<td>Processes</td>
<td></td>
<td>Categorised at the engagement, and firm and national levels</td>
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<tr>
<td></td>
<td></td>
<td>Quality audits involve auditors applying a rigorous audit process and quality control procedures that comply with laws, regulations and applicable standards</td>
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<tr>
<td>Outputs</td>
<td></td>
<td>Categorised at the engagement, and firm and national levels including output from:</td>
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<td></td>
<td>• The auditor</td>
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<td>• The audit firm</td>
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<td></td>
<td>• The entity</td>
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<tr>
<td></td>
<td></td>
<td>• Audit regulators</td>
</tr>
<tr>
<td>Interactions</td>
<td></td>
<td>Described as effective interactions between:</td>
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<tr>
<td></td>
<td></td>
<td>• Auditors</td>
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<td></td>
<td></td>
<td>• Management</td>
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<td></td>
<td>• Those charged with governance</td>
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<tr>
<td></td>
<td></td>
<td>• Users</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Regulators</td>
</tr>
<tr>
<td>Contextual factors</td>
<td></td>
<td>Interactions include both formal and informal communications</td>
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<tr>
<td></td>
<td></td>
<td>• Business practices and commercial law</td>
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<tr>
<td></td>
<td></td>
<td>• Laws and regulations relating to financial reporting</td>
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<tr>
<td></td>
<td></td>
<td>• The applicable financial reporting framework</td>
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<tr>
<td></td>
<td></td>
<td>• Corporate governance</td>
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<tr>
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<td>• Information systems</td>
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<td>• Financial reporting timetable</td>
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<td>• Broader cultural factors</td>
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<td>• Audit regulation</td>
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<td>• Litigation environment</td>
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<td>• Attracting talent</td>
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<td>• Financial reporting timetable</td>
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SECTION SUMMARY

Quality control is a requirement of professional standards.
2 Quality control at a firm level

SECTION INTRODUCTION
The Singapore Standard on Quality Control (SSQC 1) helps AEs establish quality standards for their business.

2.1 Purpose of SSQC 1

SSQC 1.11
The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
(b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

All quality control policies and procedures should be documented and communicated to the AE's personnel.

We have already considered the sections of this standard relating to ethics in Chapter 2 and those relating to client acceptance will be covered in Chapter 5 of this Textbook. We shall now consider the requirements of the rest of the standard, which fall into the following areas:

- Firm and leadership responsibilities for quality within the AE
- Human resources
- Engagement performance (see also below, the requirements of SSA 220)
- Monitoring

2.2 Firm and leadership responsibilities for quality within the AE

SSQC 1.13
Personnel within the firm responsible for establishing and maintaining the firm's system of quality control shall have an understanding of the entire text of this SSQC, including its application and other explanatory material, to understand its objective and to apply its requirements properly.

AEs are required to ensure that the appropriate training is provided to ensure there is complete understanding of the objectives and procedures under SSQC 1. The standard stipulates further that some AEs may need to apply additional procedures (beyond SSQC 1) to ensure that the objectives are met.

The standard requires that the AE implements policies such that the internal culture of the AE is one where quality is considered to be essential. Such a culture must be inspired by the leaders of the AE, who must promote this culture by the example of 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 AE may appoint an individual or group of individuals to oversee quality in the AE. Such individuals must have:

- Sufficient and appropriate experience
- The ability to carry out the job
- The necessary authority to carry out the job
ACRA's Seventh Practice Monitoring Programme (PMP) Public Report published in August 2013 noted that leadership is critical for quality as it sets the tone at the top. Where the leadership of the AE sets audit quality as a key priority and demonstrate their commitment, it has a profound influence on the behaviour and work ethics of staff to focus on the similar. Commendable measures observed to have been implemented by AEs in this respect include:

- Clearer linkage between partner compensation and audit quality, for example requiring the consideration of feedback obtained from the AE's quality control function on the partner's performance
- Reviewing engagement partner and engagement workloads to enable quality work, for example, setting a maximum number of listed clients with the same year-end to be handled by one partner
- Increasing the amount of resources allocated to quality control functions such as training, internal review and monitoring

2.3 Human resources

The AE's overriding desire for quality will necessitate policies and procedures on ensuring excellence in its staff, to provide the AE with 'reasonable assurance that it has sufficient personnel with the competence, capabilities and commitment to ethical principles necessary to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the AE or engagement partners to issue reports that are appropriate in the circumstances'.

These will cover the following issues:

- Recruitment
- Performance evaluation
- Capabilities
- Competence
- Career development
- Promotion
- Compensation
- The estimation of personnel needs

The AE is responsible for the ongoing excellence of its staff, through continuing professional development, education, work experience and coaching by more experienced staff.

Practical measures the AE can take in this area are given in ACRA's Seventh Practice Monitoring Programme (PMP) Public Report and include:

- Greater transparency on career progression to motivate staff, for example feedback to be given to staff on the level of competence required to be demonstrated in order to progress to the next level
- Clear, structured and objective measures for assessing staff performance in engagement feedback and staff performance evaluation forms
- Linking performance evaluation and audit quality, for example by rewarding staff who have performed well in the AE's monitoring reviews
- Greater staff engagement and communication, for example via staff surveys (noting that a survey only identifies issues and any response determines the effectiveness of the engagement process)
- Identifying and fulfilling the training needs of staff, for example by being responsive to the results of internal or external quality reviews
2.3.1 Continuing professional development

In October 2016 ACRA published Audit Practice Bulletin No 3 of 2016 Compliance with Continuing Professional Education Requirements for Renewal of Certificate of Registration by Public Accountants. To renew their registrations annually, public accountants are required to provide details of their CPE hours attained and declare if they have met the prescribed CPE requirements in their registration renewal forms. The bulletin shares the key observations from a compliance check of the CPE declarations of selected public accountants. A similar compliance check was carried out and reported on in Audit Practice Bulletin No 1 of 2014 and it was found that CPE compliance has improved since this previous check.

The bulletin concludes that ACRA will continue to conduct regular CPE compliance checks and stringent enforcement actions will be taken against non-compliant public accountants found in future checks. All public accountants are strongly advised to exercise due care to ensure compliance with CPE requirements and the accuracy of the required information declared.

2.3.2 Assignment of engagement teams

The assignment of engagement teams is an important matter in ensuring the quality of an individual assignment.

This responsibility is given to the audit engagement partner. The AE should have policies and procedures in place to ensure that:

- Key members of client staff and those charged with governance are aware of the identity of the audit engagement partner
- The engagement partner has appropriate capabilities, competence and authority to perform the role
- The engagement partner is aware of his responsibilities as engagement partner

The engagement partner should ensure that he assigns staff of sufficient capabilities, competence and time to individual assignments so that he will be able to issue an appropriate audit opinion.

2.4 Engagement performance

The AE should take steps to ensure that engagements are performed correctly, that is, in accordance with standards and guidance. AEs often produce a manual of standard engagement procedures to give to all staff so that they know the standards they are working towards. These may be in an electronic format.

Ensuring good engagement performance involves a number of issues:

- Direction
- Consultation
- Supervision
- Resolution of disputes
- Review

Many of these issues will be discussed in the context of an individual audit assignment (see Section 3 below).

SSQC 1.34

The firm shall establish policies and procedures designed to provide it with reasonable assurance that:

(a) Appropriate consultation takes place on difficult or contentious matters
(b) Sufficient resources are available to enable appropriate consultation to take place
(c) The nature and scope of, and conclusions resulting from, such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted
(d) Conclusions resulting from consultations are implemented
This may involve consulting externally, for example with other AEs, or the related professional body (ISCA), particularly when the AE involved is small.

When there are differences of opinion on an engagement team, a report should not be issued until the dispute has been resolved. This may involve the intervention of the quality control reviewer.

**KEY TERMS**

An **engagement quality control review** is a process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is for audits of financial statements of listed entities, and those other engagements, if any, for which the firm has determined an engagement quality control review is required.

An **engagement quality control reviewer** is a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.

The AE should have policies and procedures to determine when an engagement quality control reviewer will be necessary for an engagement. This will include all audits of financial statements for listed companies. When required, such a review must be completed before the report is signed.

The AE must also have standards as to what constitutes a suitable quality control review:

- The nature, timing and extent of such a review
- The criteria for eligibility of reviewers
- The documentation requirements

<table>
<thead>
<tr>
<th>Quality control reviews</th>
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<tr>
<td><strong>Nature, timing and extent</strong></td>
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(SSQC 1.12)
### Quality control reviews

<table>
<thead>
<tr>
<th>Eligibility</th>
<th>The reviewer must have sufficient technical expertise and be objective towards the assignment. The following should be considered:</th>
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<tr>
<td></td>
<td>- The technical qualifications required to perform the role including necessary experience and authority. For example the quality control reviewer for an audit of the financial statements of a listed entity is likely to be an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of listed entities.</td>
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<tr>
<td></td>
<td>- The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity. Such consultations avoid identification of differences of opinion at a late stage. Where the nature and extent of consultations become significant the reviewer's objectivity may be compromised unless care is taken.</td>
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<td>- Policies and procedures designed to maintain the reviewer's objectivity. As a result the reviewer should not:</td>
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<td>-- Be selected by the engagement partner</td>
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<td></td>
<td>-- Participate in the engagement</td>
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<td></td>
<td>-- Make decisions for the engagement team</td>
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<td>-- Be subject to other considerations that would threaten objectivity</td>
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<td></td>
<td>- Where the reviewer's objectivity is impaired a replacement should be found.</td>
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</table>

| Documentation | Documentation showing that the AE's requirements for a review have been met, that the review was completed before the report was issued and a conclusion that the reviewer is not aware of any unresolved issues. |

The requirements are more stringent for listed companies where the review may include the following:

- The engagement team's evaluation of the AE's independence in relation to the specific engagement
- Significant risks identified during the engagement and the responses to those risks
- Judgments made, particularly with respect to materiality and significant risks
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached
- The appropriateness of the report to be issued

ACRA's Seventh Practice Monitoring Programme (PMP) Public Report noted that there is still room for improvement in providing the necessary level of review and supervision in engagements. Instances where deficiencies were detected in basic areas could have been avoided had a more diligent review been carried out by both the engagement partner and engagement quality control reviewer.

### 2.5 Monitoring

SSQC 1 states that AEs must have policies in place to ensure that their quality control procedures are:

- Relevant
- Adequate
- Operating effectively
In other words, they must monitor their system of quality control. Monitoring activity should be reported on to the management of the AE on an annual basis.

There are two types of monitoring activity:

- An ongoing evaluation of the system of quality control. An ongoing evaluation might include such questions as, ‘have we kept up to date with regulatory requirements?’.
- Periodic inspection of a selection of completed engagements. A periodic inspection cycle would usually fall over a period such as three years, in which time at least one engagement per engagement partner would be reviewed.

For monitoring activity to be effective, there must be a well-organised and conducted review programme. This includes having the scope, objective, and timelines clearly defined prior to the commencement of each review.

AE staff monitoring the system are required to evaluate the effect of any deficiencies found. These deficiencies might be one-offs. The AE will be more concerned with systematic or repetitive deficiencies that require corrective action. When evidence is gathered that an inappropriate report might have been issued, the AE may want to take legal advice.

**Corrective action**

- Remedial action with an individual
- Communication of findings with the training department so they can ensure improvements are made to the AE's policies and procedures related to education and training
- Changes in the quality control policies and procedures to correct any weaknesses or lack of understanding
- Disciplinary action, if necessary, especially if an individual repeatedly fails to comply with the AE’s policies and procedures

### SECTION SUMMARY

An AE needs to establish and maintain a system of quality control that includes policies and procedures addressing six areas. These are leadership responsibilities for quality within the AE, human resources, engagement performance, monitoring, ethical requirements and client acceptance. The first four of these areas are dealt with in this section. Ethics has been covered in Chapter 2 and you will learn about client acceptance in the next chapter.

### 3 Quality control on an individual audit

**SECTION INTRODUCTION**

SSA 220 requires AEs to implement quality control procedures over individual audit engagements.

The requirements concerning quality control on individual audits are found in SSA 220 *Quality Control for an Audit of Financial Statements*. This SSA applies the general principles of SSQC 1 we looked at in the previous section on individual audit.
SSA 220.6
The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and applicable legal and regulatory requirements; and
(b) The auditor's report issued is appropriate in the circumstances.

The burden of this falls on the audit engagement partner, who is responsible for the audit and the ultimate conclusion.

3.1 Leadership responsibilities
The engagement partner is required to set an example with regard to the importance of quality.

SSA 220.8
The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

This emphasises the importance to audit quality of:

- Performing work that complies with professional standards and applicable legal and regulatory requirements
- Complying with the AE's quality control policies and procedures
- Issuing auditor's reports that are appropriate
- The engagement team's ability to raise concerns without fear of reprisals

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement also emphasise the fact that quality is essential in performing audit engagements.

3.2 Ethical requirements

SSA 220.9
Throughout the audit engagement, the engagement partner shall remain alert, through observation and making enquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.

This includes the ISCA Code of Professional Conduct and Ethics, with its fundamental principles and all the other detailed requirements. For example, while in principle the provision of other services is allowed, the threat of self-review and its impact on the independence of the audit process must be considered.

The SSA also contains some detailed guidance about independence in particular.

SSA 220.11
The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence.
(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement.
(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law and regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.
3.3 Acceptance/continuance of client relationships and specific audit engagements

The partner is required to ensure that the requirements of SSQC 1 in respect of accepting and continuing with the audit are followed. If the engagement partner obtains information that would have caused that partner to decline the audit in the first place he should communicate that information to the AE so that swift action may be taken. He must document conclusions reached about accepting and continuing the audit.

3.4 Assignment of engagement teams

As discussed in the previous section, this is also the responsibility of the audit engagement partner. He must ensure that the team is appropriately qualified and experienced as a unit.

3.5 Engagement performance

Several factors are involved in engagement performance, as discussed above (Section 2.4).

3.5.1 Direction

The partner directs the audit. The partner is required by SSA 300 Planning an Audit of Financial Statements to hold a meeting with the audit team to discuss the audit, in particular the risks associated with the audit. SSA 220 suggests that direction includes informing members of the engagement team of:

(a) Their responsibilities (including objectivity of mind and professional scepticism)
(b) Responsibilities of respective partners where more than one partner is involved in the conduct of the audit engagement
(c) The objectives of the work to be performed
(d) The nature of the entity's business
(e) Risk-related issues
(f) Problems that may arise
(g) The detailed approach to the performance of the engagement

3.5.2 Supervision

The audit is supervised overall by the engagement partner, but more practical supervision is given within the audit team by senior staff to more junior staff, as is also the case with audit engagement review (see Section 3.5.3 below). It includes:

- Tracking the progress of the audit engagement
- Considering the capabilities and competence of individual members of the team, and whether they have sufficient time and understanding to carry out their work
- Addressing significant issues arising during the audit engagement and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement
3.5.3 Review
Audit engagement review includes consideration of whether:
- The work has been performed in accordance with Singapore Standards on Auditing and regulatory and legal requirements
- Significant matters have been raised for further consideration
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- There is a need to revise the nature, timing and extent of work performed
- The work performed supports the conclusions reached and is appropriately documented
- The evidence obtained is sufficient and appropriate to support the auditor's report
- The objectives of the engagement procedures have been achieved

Before the auditor's report is issued, the engagement partner must ensure that sufficient and appropriate audit evidence has been obtained to support the audit opinion. The audit engagement partner need not review all audit documentation, but may do so. He should review critical areas of judgment, significant risks and other important matters.

3.5.4 Consultation
The partner is also responsible for ensuring that if difficult or contentious matters arise the team takes appropriate consultation on the matter and that such matters and conclusions are properly recorded.

If differences of opinion arise between the engagement partner and the team, or between the engagement partner and the quality control reviewer, these differences should be resolved according to the AE's policy for such differences of opinion.

3.5.5 Quality control review
Under Singapore Standard on Quality Control (SSQC) 1, the AE is required to establish policies and procedures to maintain the objectivity of the engagement quality control reviewer. Such policies and procedures provide that the engagement quality control reviewer:
- Where practical, is not selected by the engagement partner
- Does not otherwise participate in the engagement during the period of review
- Does not make decisions for the engagement team
- Is not subject to other considerations that would threaten the reviewers objectivity

The audit engagement partner is then responsible for discussing significant matters arising with the reviewer and for not issuing the auditor's report until the quality control review has been completed.

A quality control review should include:
- Discussion of significant matters with the engagement partner
- Review of financial statements and the proposed report
- Review of selected audit documentation relating to significant audit judgments made by the audit team and the conclusions reached
- Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the auditor's report is appropriate

In addition to the above a quality control review for a listed entity will also include a review of:
- The engagement team's evaluation of the AE's independence towards the audit
- Whether appropriate consultations have taken place on differences of opinion/contentious matters and the conclusions drawn
- Whether the audit documentation selected for review reflects the work performed in relation to significant judgments/supports the conclusions reached
Other matters relevant to evaluating significant judgments made by the audit team are likely to be:

- The significant risks identified during the engagement and the responses to those risks (including assessment of, and response to, fraud)
- Judgments made, particularly with respect to materiality and significant risks
- Materiality of corrected and uncorrected misstatements identified during the audit
- Matters to be communicated with management/those charged with governance

SSA 220.25

The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) The procedures required by the firm’s policies on engagement quality control review have been performed;
(b) The engagement quality control review has been completed on or before the date of the auditor’s report; and
(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

3.6 Monitoring

An audit engagement partner is required to consider the results of monitoring of the AE’s (or network firm’s) quality control systems and consider whether they have any impact on the specific audit they are conducting.

Question 4.1

You are an audit senior working for the AE Khanna Smith, a firm of Chartered Accountants. You are currently carrying out the audit of Queenstown Manufacturing Ltd (Queenstown), a manufacturer of waste paper bins. You are unhappy with Queenstown’s inventory valuation policy and have raised the issue several times with the audit manager. The audit manager has dealt with the client for a number of years and does not see what you are making a fuss about. The audit manager has refused to meet you on site to discuss these issues.

The former engagement partner to Queenstown retired two months ago. As the audit manager had dealt with Queenstown for so many years, the other partners have decided to leave the audit of Queenstown in their capable hands.

Required

Comment on the situation outlined above.

3.7 Quality control regulations

The regulation of audit is the same for all AEs regardless of size. However, it is logical to see that it will impact on large and small AEs differently.

For example, a large AE may have international quality control procedures. If not, it will certainly have national and regional ones. In order to meet some of the quality control requirements, small, single-partner AEs may need to make extensive use of external experts.
SECTION SUMMARY

Firm-wide quality control involves procedures regarding direction, supervision, review, consultation and dispute resolution.

It is the engagement partner's responsibility to ensure that quality control procedures are applied to an individual audit so that it complies with Singapore Standards on Auditing and the audit opinion is appropriate.
Chapter Roundup

Quality control policies and procedures

AEs need to ensure they do not draw the wrong conclusion on assurance

Why?
- Professional negligence claims
- Disciplinary proceedings
- Loss of reputation and consequences
- AE collapse

How?

Engagement Performance
SSA 220

Standards give guidance under the following headings:

- Leadership
- Ethics
- Acceptance/continuance
- HR
- Engagement performance
- Monitoring

Direction
Supervision
Review
Consultation
Engagement Quality Control Review
Disputes
Quick Quiz

1. The objective of an AE applying SSQC 1 is to:
   'Establish and maintain a system of ............... ............... to provide it with ....................... assurance that
   (a) The AE and its personnel comply with .................. and ......................... and ........................ requirements and
   (b) ........................ issued by the AE or engagement partners are ................ in the circumstances.'

2. List five issues relating to good engagement performance that should be addressed in an AE’s procedures manual.
   (1) ..........................................
   (2) ..........................................
   (3) ..........................................
   (4) ..........................................
   (5) ..........................................

3. Who reviews audit work in an audit of financial statements?
1. Quality control, reasonable
   (a) Singapore Standards on Auditing, regulatory, legal
   (b) Reports, appropriate

2. (1) Direction
    (2) Supervision
    (3) Review
    (4) Consultation
    (5) Resolution of disputes

3. Audit work is generally reviewed by the staff member who is more senior on the team than the person who did the work. The partner must carry out a review to ensure there is sufficient and appropriate evidence to support the audit opinion. It might also be necessary under the AE’s quality control policies to obtain a quality control review by a suitable person outside the audit team. This will be necessary if the audit is of a listed entity.
Answers to Questions

4.1 Quality control issues

Several quality control issues are raised in the scenario:

Engagement partner

An engagement partner is usually appointed to each audit engagement undertaken by the AE, to take responsibility for the engagement on behalf of the AE. Assigning the audit to the experienced audit manager is not sufficient.

The lack of an audit engagement partner also means that several of the requirements of SSA 220 about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit are not in place.

Conflicting views

In this scenario the audit manager and senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the manager refusing to discuss the issue with the senior.

SSA 220 requires that the audit engagement partner takes responsibility for settling disputes in accordance with the AE's policy in respect of resolution of disputes as required by SSQC 1. In this case, the lack of engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the AE's policy under SSQC 1. At worst, it indicates that the AE does not have a suitable policy concerning such disputes as required by SSQC 1.
PAEs need to grow like any other business, which means attracting new clients and increasing revenue from existing clients. PAEs may also need to end client relationships for a variety of reasons, such as independence issues or the client being too high risk. Audit clients may also look for new auditors for their own reasons including fees being too high or changes mandated by an overseas parent company.

Section 210 of the ISCA Code provides guidance on a change in auditor.

SSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements sets out some basic requirements for all PAEs accepting engagements.
### Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
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</thead>
<tbody>
<tr>
<td><strong>Appointment and reappointment of auditors</strong></td>
<td></td>
</tr>
<tr>
<td>Discuss the reasons why entities change their statutory auditors/professional accountants.</td>
<td>2</td>
</tr>
<tr>
<td>Recognise and explain the factors to be considered when a firm is invited to submit a proposal or fee quote for an audit or other professional engagement.</td>
<td>2</td>
</tr>
<tr>
<td>Identify the information to be included in a proposal.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the matters to be considered and the procedures that an audit firm/professional accountant should carry out before accepting and/or continuing a specified client/engagement including:</td>
<td></td>
</tr>
<tr>
<td>- Client acceptance and continuance;</td>
<td></td>
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<tr>
<td>- Engagement acceptance and continuance;</td>
<td></td>
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<tr>
<td>- Establish whether the preconditions for an audit are present;</td>
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<tr>
<td>- Communicating with the predecessor auditor; and</td>
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<tr>
<td>- Agreeing the terms of engagement.</td>
<td></td>
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<tr>
<td>Recognise the key issues that underlie the agreement of the scope and terms of an engagement with a client including the full scope of a statutory audit.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Advertising, publicity, obtaining professional work and fees</strong></td>
<td></td>
</tr>
<tr>
<td>Recognise situations in which specified advertisements are acceptable.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the restrictions on practice descriptions and the names of public accountancy entities.</td>
<td>2</td>
</tr>
<tr>
<td>Outline the determinants of fee setting and justify the basis on which fees and commissions may and may not be charged for services.</td>
<td>3</td>
</tr>
<tr>
<td>Discuss the ethical and other professional issues, for example, lowballing, involved in establishing and negotiating fees and other types of remuneration for a specified assignment.</td>
<td>3</td>
</tr>
</tbody>
</table>

### ESSENTIAL READING

- Singapore Standard on Quality Control 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements
- ACRA Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities
- ACRA Practice Direction No. 4 of 2015 Resignation of Auditors of Public Interest Companies or their Subsidiaries in Relation to Sections 205AB to 205AF of the Companies Act, Chapter 50
- ISCA Code of Professional Conduct and Ethics
- SSA 210 Agreeing the Terms of Audit Engagements
1 Change in auditors

SECTION INTRODUCTION
Common reasons for companies changing their auditor include the size of the audit fee, audit rotation, personality clashes, the auditor not seeking re-election or a change in the size of company.

1.1 Why do companies change their auditor?
The following diagram shows some of the more common reasons that companies might change their auditors.

- Perceived not to be value for money
- Perceived to be too high
- Audit fee
- Client falls below exemption limit
- Client's business expands beyond AE’s capacity
- Size
- Personality: Client falls out with audit staff or partner
- AE does not seek re-election
- Disagreement with the client
- Another client is in competition
- AE has other ethical reasons
- Not wanting to reduce fee
- Audit rotation: relationship ended for independence reasons
- Another client is in competition

1.2 Audit fee
The setting and negotiation of fees is covered later in this chapter. Here we shall explore some of the fee-related reasons why companies change their auditors from a client perspective.

1.2.1 Perceived to be too high or not value for money
Clients look at cost versus benefit for all services procured. The client may conclude that the cost of the audit outweighs the benefit they receive. This is particularly the case in a voluntary audit situation.

Audit clients have their own pressures to meet budgets and achieve profit expectations. The audit fee is an expense like any other and entities will seek to reduce their expenses by obtaining the same service at a lower cost if possible. It is possible that a company could be paying its AE a fee that it considers reasonable for an audit, but it just believes that another AE could give it a better audit for a similar fee.

1.2.2 AE not wanting to reduce fee
A situation may occur where an AE cannot demand a high enough audit fee from the client to cover the costs of the audit. In order not to make a loss, the AE may choose not to offer itself for re-election.
1.3 The auditor does not seek re-election

Another key reason for the auditor changing is that the auditor chooses not to stand for election for another year. The reasons for this may be as follows.

1.3.1 The AE does not have the necessary resources

It is possible for an AE to lack the resources to continue to provide an audit service to a particular client. Such a situation might occur where the client company grows rapidly and so requires a larger audit team. The AE may not have enough skilled staff to carry out a quality audit in line with all legal and regulatory requirements. Similarly, a client may acquire a subsidiary company overseas and the AE might not have an office in that country. The AE might feel that the risk from relying on the work of other auditors it too great and thus not seek re-election.

1.3.2 Disagreement with the client

An AE might disagree with a client for a number of reasons, such as a disagreement over the accounting policies used or the estimate of a provision. Disagreements over significant matters could result in the AE losing confidence in the competence of management. The AE might be reluctant to seek re-election if the disagreement cannot be resolved.

1.3.3 AE wants to focus on a specific industry of audit clientele

Clients may prefer to use an auditor who understands their industry. An AE who specialises in one industry or business area may find that this attracts new clients to the AE. An AE looking to grow its business by specialising in one area of business may not seek re-election at clients that operate in industries outside that area.

1.3.4 AE has ethical reasons

The ISCA Code of Ethics and Professional Conduct has many guidelines which must be adhered to by the AE. If the AE can identify a potential breach in any area of the ISCA Code where safeguards cannot be applied to reduce the threat to an acceptable level, the AE may choose not to seek re-election. For example, an increase in the audit fee at a client may take the audit fee above 15% of the AE’s annual total fees. The ISCA Code requires safeguards to be applied in such a situation, to reduce the threat to an acceptable level. If after applying such safeguards, the threat is still considered to be significant, the AE will not be able to stand for re-election as auditor.

Reviewing the requirements of the ISCA Code that you studied in Chapter 2 may be useful for further examples of ethical reasons, such as overdue fees, financial interests or close relationships.

1.3.5 There is a conflict of interest

A conflict of interest might arise between two existing audit clients at the AE. For example, an AE may act as auditor for two companies, one of which is taking legal action against the other. Although the use of safeguards might result in the threat to the fundamental principles being reduced to an acceptable level, the AE may decide it is preferable not to seek re-election as auditor of one of the audit clients.

1.3.6 AE has reason to doubt the integrity of the client

The AE may feel that management is not acting with integrity, for example the AE suspects the client of being involved with child labour or being responsible for excessive pollution. The AE might not seek re-election to avoid being associated with the client’s unethical behaviour.
Question 5.1

Negotiation over the level of the audit fee is common practice in Asia.

Required

Outline the reasons why an AE may not be willing to compromise during such negotiations and reduce its fee when requested. (You do not need to address the fact that an AE needs to cover the costs associated with carrying out the audit in order not to make a loss on the audit.)

1.4 Size of the company

This can be a major reason for a change in auditors. There are two key reasons, one of which has been touched on already:

- Client experiences rapid growth to the point where the audit is no longer practicable for the AE
- Client restructures its business in such a way that it no longer needs a statutory audit

In the first instance, the auditor may no longer be able to provide the audit for several reasons:

- Insufficient staff available
- Time might be too short to complete the audit
- Low fee level so unable to recover costs

In the second instance, the client may choose not to have an audit. In either situation, there is little that the auditor can do.

IMPORTANT

The Companies Act describes the concept of a ‘small company’ to determine audit exemption. To qualify for audit exemption as a ‘small company’, a company must be a private company that meets at least two of the following three criteria for each of the previous two financial years.

- Total annual revenue not more than $10 million
- Total assets not more than $10 million
- Total number of employees not more than 50

1.5 Other reasons

These reasons may have been touched on in relation to the other reasons given above. We shall consider them briefly here.

1.5.1 Personality

Due to the nature of an audit, auditors are essentially in the people business. On rare occasions, individual personalities can sour a relationship to the point that the parties part ways. It should be stressed this is expected to be a rare occurrence.

1.5.2 Audit rotation

Rotation of audit staff and audit partner was discussed in Chapter 2 as a safeguard to audit independence. However, the partners in an AE may sometimes conclude that the AE as a whole has been associated too long with a client, and therefore give up the audit.
1.6 Legal issues

There are a number of legal requirements relating to the change of auditor. A brief summary is provided below:

1.6.1 Appointment and reappointment of auditor

The company must appoint an auditor at each general meeting. This auditor will hold office until the conclusion of the next annual general meeting at which point the existing auditor may be reappointed or replaced.

When a company is first incorporated the directors must appoint an auditor within three months of incorporation. These auditors will hold office until the conclusion of the first annual general meeting. Directors may also appoint the auditor to fill a casual vacancy.

1.6.2 Removal of the auditor

An auditor of a company may be removed from office by resolution of the company at a general meeting of which special notice has been given. Where a notice of a resolution to remove an auditor is received by the company a copy of the notice must be sent to the auditor concerned and the Registrar immediately. The auditor within seven days of receipt of this notice make representations in writing and request that they be sent to the members.

Where the auditor is removed at the general meeting a new auditor may be appointed immediately by a resolution passed by a majority of not less than three quarters of the members entitled to vote. Alternatively the meeting may be adjourned until a later date (not earlier than 20 days and not later than 30 days) at which point a new auditor will be appointed by ordinary resolution.

1.6.3 Resignation of the auditor

Resignation procedures for auditors are dependent on whether the company being audited is a public interest company or non-public interest company. The definition of what constitutes a public interest company is covered in Chapter 2 of this Textbook.

The auditors of a non-public interest company may resign before the end of the term of office for which they were appointed by giving the company a notice of resignation in writing. The resignation will take effect at the end of the day on which notice is given, or a later date if this is specified in the notice.

Auditors of public interest companies and their subsidiary companies resigning prior to the end of their term, will need ACRA's consent to resign. This will ensure that companies are not left without an auditor.

In May 2015, ACRA published Practice Direction No. 4 of 2015 Resignation of Auditors of Public Interest Companies or their Subsidiaries in Relation to Sections 205AB to 205AF of the Companies Act, Chapter 50. This Practice Direction provides some broad guidelines as to when ACRA may give consent to auditors to resign in this situation along with practical details of the application process.

Auditors of public interest companies and their subsidiary companies must also notify the company concerned of the reason for their resignation. This must be circulated by the company to all its shareholders with fourteen days of being received.

In either case, unless the resigning auditor is not the sole auditor or the company's financial statements do not require auditing, the company must hold a general meeting as soon as practical to appoint a new auditor.
2 Tendering

SECTION INTRODUCTION
When approaching a tender, it is important to consider both fees and practical issues.

2.1 Approach
An AE puts together a tender if:
- It has been approached by a prospective client
- The partners have decided that they are capable of doing the work for a reasonable fee

When approached to tender, the auditor has to consider whether he wants to do the work. You should be aware of all the ethical considerations that would go into this decision from Chapter 2, for example, threats to independence from close personal relationships or the provision of non-audit services to the client. The auditor will also have to consider:
- Fees
- Practical issues

2.2 Fees

2.2.1 Setting and negotiating fees
The ISCA Code (Section 240) states that the Chartered Accountant may quote whatever fee is appropriate in the circumstances. The fact that this may be higher or lower than another professional is not in itself unethical.

In order to arrive at the proposed fee amount the auditor will need the following information: an exact description of the work required; a timeline of the work and the deadline; information on the business, its systems and infrastructure.

The first stage of setting the fee is to ascertain what the job will involve. The job should be broken down into its respective parts, for example, audit and tax, or if it is a complex audit, what aspects of the job would be undertaken by what level of staff.

The second stage is closely linked with the first, therefore. It involves ascertaining which staff, or which level of staff, will be involved and in what proportions they will be involved.

Once estimates have been made of how long the work will take and what level of expertise is needed in each area, the AE's standard charge out rates can be applied to that information, and a fee estimated.

Clearly, it is commercially vital that the estimates of time and costs are accurate, or the AE will be seeking to undertake the work at a loss. There are situations when an audit might be tendered at a loss in order to achieve a larger goal. For example, in order to win a global audit, the AE needs a "foot in the
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5: Obtaining and accepting professional appointments | PART C PRACTICE MANAGEMENT

doors’. In one country, an AE might tender for a particular piece of work at a loss in order to get a foot in the door with that company and possibly win the audit for all subsidiary companies worldwide. The ‘greater good’ of having the global audit would outweigh the loss on one individual audit.

2.2.2 Commissions

ISCA members may offer a referral fee or commission (and by implication receive a referral fee or commission) for introducing clients. However, they should only do so if there are appropriate safeguards such as making full disclosure to the relevant parties.

Commissions could be a self interest threat to objectivity – refer back to Chapter 2 for more information on this.

2.2.3 Contingent fees

Contingent fees could be used for certain types of non-assurance engagements. They may however give rise to self-interest threats and threats to objectivity. The significance of these threats should be evaluated and if they are considered significant, safeguards should be applied as necessary.

An AE must not provide professional services on a contingent basis to an audit client when that client is a listed entity or public company (except where such remuneration is provided for under the provisions of law). Contingent fees were also discussed in Chapter 2.

2.2.4 Lowballing

Problems can arise when auditing firms appear to be charging a fee level that is unsustainably low, or at least less than the ‘market rate’ for the audit. The practice of undercutting, usually at tender for the audit of large companies, has been called lowballing. In other cases, the audit fee has been reduced even though the auditors have remained the same. The problem here is that, if the audit is being performed for less than it is actually worth, then a self-interest threat to professional competence and due care is created. This is because the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

The following factors need to be taken into account when negotiating the audit fee.

(a) The audit is perceived to have a fluctuating ‘market price’ as any other commodity or service. In a recession, prices would be expected to fall as companies aim to cut costs everywhere, and as auditors chase less work (supply falls). AEs are also reducing staffing levels and their own overhead costs should be lower.

(b) Companies (especially groups of companies) can reduce external audit costs through various legitimate measures:

(i) Performing more work in-house such as having an internal audit function perform a detail review of internal controls
(ii) Reducing the number of different AEs used worldwide
(iii) Selling off subsidiary companies leaving a simplified group structure to audit
(iv) The tender process itself simply makes auditors more competitive
(v) Exchange rate fluctuations in audit fees

(c) Auditing firms have increased productivity, partly through the use of more sophisticated information technology techniques in auditing.

It is not improper to secure work by quoting a lower fee; however, the issue of professional competence and due care must be considered.
2.2.5 Practical issues

The AE will have to consider the practical points arising from the approach. Common considerations include:

- Does the proposed timetable for the work fit with the current work plan?
- Does the AE have suitable personnel (number of staff and appropriate skill level) available?
- Where will the work be performed and is it accessible/cost-effective?
- Are (non-accounting) specialist skills necessary?
- Will staff need further training to do the work?
- If so, what is the cost of that further training?

2.3 Content of an audit proposal

An audit proposal, or tender, does not have a set format. The prospective client will indicate the format that they want the tender to take. This may be merely in document form, or could be a presentation by members of the AE.

Although each tender will be tailored to the individual circumstances, there are some matters which are likely to be covered in every one. These are set out below.

<table>
<thead>
<tr>
<th>Matters to be included in audit proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The fee, and how it has been calculated</td>
</tr>
<tr>
<td>• An assessment of the needs of the prospective client</td>
</tr>
<tr>
<td>• An outline of how the AE intends to meet those needs</td>
</tr>
<tr>
<td>• The assumptions made to support that outline</td>
</tr>
<tr>
<td>• The proposed approach to the engagement</td>
</tr>
<tr>
<td>• A brief outline of the AE</td>
</tr>
<tr>
<td>• An outline of the key staff involved</td>
</tr>
</tbody>
</table>

SECTION SUMMARY

A tender document is produced when the auditor is approached by a prospective client. It is tailored to the individual circumstances of the client.

3 Acceptance

SECTION INTRODUCTION

SSQC 1 sets out what an AE must consider and document in relation to accepting or continuing an engagement.

3.1 Ethical requirements

There are a number of ethical procedures associated with accepting engagements.
LINK

Procedures before accepting nomination

(a) Ensure that there are no ethical issues which are a barrier to accepting nomination
(b) Ensure that the auditor is professionally qualified to act and that there are no legal or technical barriers
(c) Ensure that the existing resources are adequate in terms of staff, expertise and time
(d) Obtain references for the directors if they are not known personally to the AE
(e) Consult the previous auditors to ensure that there are no professional reasons behind the vacancy which the new auditors ought to know

Procedures after accepting nomination

(a) Ensure that the outgoing auditors' removal or resignation has been properly conducted in accordance with the Companies Act (Chapter 50)
   The new auditors should see a valid notice of the outgoing auditors' resignation, or confirm that the outgoing auditors were properly removed
(b) Ensure that the new auditors' appointment is valid. The new auditors should obtain a copy of the resolution passed at the general meeting appointing them as the company's auditors
(c) Set up and submit a letter of engagement to the directors of the company (see Section 4.4 for more details)

3.2 Requirements of SSQC 1

We touched on the bulk of the requirements of SSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements in Chapter 4. However, it also sets out standards and guidance in connection with the acceptance and continuance of client relationships and specific engagements which we shall consider here.

SSQC 1.26 and 1.27

The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:

(a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so
(b) Can comply with relevant ethical requirements, and
(c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity.

Such policies and procedures shall require:

(a) The firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.
(b) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement.
(c) If issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, the firm to document how the issues were resolved.
The AE should carry out the following steps:

**STEP 1** Obtain relevant information.

**STEP 2** Identify issues.

**STEP 3** If resolvable issues exist, resolve them and document that resolution.

### 3.2.1 Obtain information

The standard outlines three general sources of information:

- The communications auditors must make with the previous auditors according to the ISCA Code
- Other relevant communications, for example with other parties in the AE, bankers or legal counsel
- Searches on relevant databases

In deciding whether to continue an engagement with an existing client, or to accept a new engagement with an existing client, the AE should also consider significant matters that have arisen in the course of the previous/existing relationship, for example, expansion into a business area in which the AE has no experience.

**Communication with previous auditor**

Section 210 of the ISCA Code provides ethical guidance regarding a change in professional appointment. A summary is provided below:

- An auditor who is considering tendering for an audit currently held by another auditor should determine whether there are any reasons why the appointment should not be accepted.
- In Singapore the prospective auditor must enter into direct communication with the existing auditor and enquire whether there is any professional or other reason why the appointment should not be accepted. If there are reasons the existing Chartered Accountant should provide details.
- The prospective auditor will ordinarily need to obtain the client's permission in writing to initiate discussion with the existing auditor.
- On receipt of the request by the prospective auditor the existing auditor is required to reply in writing advising on whether there are any reasons why the appointment should not be accepted. Permission from the client to provide details should be obtained.
- If the existing auditor is unable to obtain permission to communicate from the client the prospective auditor should be informed.
- If the prospective auditor does not receive a written reply within a reasonable time he should try to send a final letter by registered post stating that he assumes that there are no professional or other reasons why the appointment should not be accepted.
Anti-money laundering

As we discussed in Chapter 1, Chartered Accountants are now required to carry out specific client identification procedures when accepting new clients. These are covered in EP 200 Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore Section 4.

‘Know your customer’ (KYC) or ‘customer due diligence’ (CDD) is an important part of being in a position to comply with the law on anti-money laundering, because knowledge of the client is at the bottom of 'suspicion' in the context of making reports about anti-money laundering.

EP 200 requires the following CDD measures to be taken:

(a) Identifying the client;
(b) Identifying the beneficial owner;
(c) Verifying that client's identity using reliable, independent source documents, data or information, and taking reasonable measures to verify the identity of the beneficial owner, such that the professional firm is satisfied that it knows who the beneficial owner is. For legal persons and arrangements, this shall include professional firms understanding the ownership and control structure of the client;
(d) Understanding and, as appropriate, obtaining information on the purpose and intended nature of the business relationship; and
(e) Conducting ongoing due diligence on any continuing business relationship and scrutiny of transactions (if any) undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the professional firm's knowledge of the client, their business and risk profile, including, where necessary, the source of funds.

It is important from the outset of a relationship with a new client to obtain KYC/CDD information, such as:

- Expected patterns of business
- The business model of the client
- The source of the client's funds

In situations where politically exposed persons (PEPs) are involved or there is a higher risk of money laundering or terrorist financing, enhanced CDD measures will be required.

3.2.2 Identify issues

Here is a list of matters that the auditors might consider in relation to accepting a client.

<table>
<thead>
<tr>
<th>Matters to consider</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Integrity of a client</strong></td>
<td>The identity and business reputation of the client's principal owners, key management, related parties and those charged with governance.</td>
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<tr>
<td></td>
<td>Nature of the client's operations, including its business practices.</td>
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<td></td>
<td>Information concerning the attitude of the client's principal owners, key management, those charged with governance towards matters such as aggressive interpretation of accounting standards/internal control environment.</td>
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<td></td>
<td>Whether the client is aggressively concerned with maintaining the AE's fees as low as possible.</td>
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<tr>
<td></td>
<td>Indications of an inappropriate limitation in the scope of work.</td>
</tr>
<tr>
<td></td>
<td>Indications that the client might be involved in money laundering or other criminal activities.</td>
</tr>
<tr>
<td></td>
<td>The reasons for the proposed appointment of the AE and non-reappointment of the previous AE.</td>
</tr>
</tbody>
</table>
Matters to consider

<table>
<thead>
<tr>
<th>Competence of the AE</th>
<th>Do AE personnel have knowledge of relevant industries/subject matters?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Do AE personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively?</td>
</tr>
<tr>
<td></td>
<td>Does the AE have sufficient personnel with the necessary capabilities and competence?</td>
</tr>
<tr>
<td></td>
<td>Are experts available, if needed?</td>
</tr>
<tr>
<td></td>
<td>Are individuals meeting the criteria and eligibility requirements to perform the engagement quality control review available where applicable?</td>
</tr>
<tr>
<td></td>
<td>Is the AE able to complete the engagement within the reporting deadline?</td>
</tr>
</tbody>
</table>

In addition, the AE needs to consider whether acceptance would create any conflicts of interest.

3.2.3 Resolve issues

SSQC 1.28

The firm shall establish policies and procedures on continuing an engagement and the client relationship addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of:

(a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities, and

(b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Such procedures might include discussions with client management and those charged with governance, and, if required, discussions with the appropriate regulatory authority.

Question 5.2

You are a partner in an AE of Chartered Accountants. You have just successfully tendered for the audit of Lunch Pte Ltd, a chain of sandwich shops across Singapore. The tender opportunity was received cold, that is, the company and its officers are not known to the AE. The company has just been incorporated and has not previously had an audit. You are about ready to accept nomination as statutory auditors.

Required

(a) Explain the procedures you should carry out prior to accepting nomination as statutory auditors.

(b) In the course of your acceptance procedures you received a reference from a business contact of yours concerning a director of Lunch Pte Ltd. There are five directors at the company. It stated that your business contact had done some personal tax work for the director in question ten years previously, and had found the director to be difficult to keep in contact with and slow to provide information. Your contact suspected the director of being less than entirely truthful when it came to their tax affairs. As a result of this distrust, your contact had ceased to carry out work for this director.

Comment on the effect this reference would have on accepting nomination as statutory auditors.
 ALERT
You can see from the answer to the above question that there are no easy answers to ethical questions. You might be asked questions in the exam similar to the one above as part of a scenario highlighting several ethical issues. It is not enough just to state the rules at this level; you must explain what the practical issues are and try to draw conclusions based on the facts you know.

3.3 Client screening
Many AEs use a client acceptance checklist to assist them in making the decision and ensuring that SSQC 1 requirements are met.

3.4 Group audits
The acceptance or continuance of a group audit has extra requirements which are detailed in SSA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors). SSA 600 places special emphasis on the need for the group auditor to determine whether or not to accept the appointment. This is particularly important because it is possible for it to be straightforward to audit the parent company, but impossible to obtain sufficient appropriate evidence about the rest of the group.

The acceptance and continuance of group audits is covered further in Chapter 11, Section 3.4.

SECTION SUMMARY
As part of the acceptance process the auditor must consider the integrity of the client, whether the AE is competent to do the work, and whether the AE meets the ethical requirements in relation to the work.

4 Terms of the engagement

SECTION INTRODUCTION
The terms of the engagement are normally set out in a letter of engagement.

4.1 SSA 210 Agreeing the Terms of Audit Engagements
SSA 210 Agreeing the Terms of Audit Engagements sets out best practice concerning this issue.

SSA 210.3
The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
(a) Establishing whether the preconditions for an audit are present, and
(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.
KEY TERM

The **preconditions for an audit** are the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management, and, where appropriate, those charged with governance to the premise on which an audit is conducted.

(SSA 210.4)

4.2 Preconditions for an audit

The auditor needs to carry out tests to ensure that the preconditions for an audit outlined above are met.

**SSA 210.6**

In order to establish whether the preconditions for an audit are present, the auditor shall determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable.

SSA 210 then goes on to require the auditor to ensure that management acknowledges and understands its responsibilities:

**SSA 210.6**

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

(ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;

(iii) To provide the auditor with:

- Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documents and other matters;

- Additional information that the auditor may request from management for the purpose of the audit

- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence

This will all be confirmed in the engagement letter.

If any of these conditions does not exist (e.g., the framework used is unacceptable or management does not acknowledge its responsibilities), the auditor shall not accept the audit unless legally required to do so.

In addition, the auditor should not accept the engagement if those charged with governance impose a limitation on the scope of the auditor's work likely to result in a disclaimer of opinion, again, unless the auditor is required by law or regulation to accept the audit.

4.3 Clarifying the agreement

It is important when entering into a contract to provide services to ensure that both parties fully understand their respective responsibilities and what the agreed services are. Misunderstanding could lead to a breakdown in the relationship, and eventually result in legal action being undertaken.

4.4 Engagement letter

Auditors will outline the basis for the audit agreement in their tender to provide services. However, once they have accepted nomination, it is vital that the basis of their relationship is discussed with the new client and laid out in contractual form. This is the role of the engagement letter.
Matters which SHALL be clarified in the engagement letter

- Objective and scope of the audit
- Auditor's responsibilities
- Management's responsibilities
- Identification of applicable financial reporting framework
- Expected form and contents of reports to be issued by the auditor and statement that there may be circumstances when a report may differ from this

Matters which MAY be clarified in the engagement letter

- More detail on the scope of the audit including references to law, auditing and other standards the auditor follows
- Form of other audit communications
- Limitation of audit and internal controls and resulting risk that material misstatements may not be detected
- Composition of the audit team and other practical arrangements
- Expectation the management will provide written representations
- Agreement of management to make draft financial statements and other documents available in good time
- Agreement of management to inform the auditors of facts that may affect the financial statements before the date of the auditor's report
- Basis on which fees are computed and billing arrangements
- A request for management to acknowledge receipt of audit engagement letter and agree to its terms
- Arrangements concerning the use of experts or other auditors
- Arrangements concerning the use of internal auditors and other entity staff
- Arrangements to be made with predecessor auditors (in the case of a new audit)
- Any restrictions of the auditor's liability
- References to any other agreements between parties
- Any obligations to provide working papers to other parties

An auditor shall not agree to a change in the terms of the engagement letter where there is no reasonable justification for doing so. If the terms of the engagement are changed, this should be recorded. If the auditor is unable to agree to a change and is not permitted by management to continue the original audit engagement, the auditor shall withdraw from the engagement (where possible under law and regulation) and consider whether there is an obligation to report the circumstances to other parties.

A request to change the terms of the audit engagement may result from:

- A change in the circumstances affecting the need for the service
- A misunderstanding as to the nature of an audit as originally requested
- A restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances

A change in circumstances or a misunderstanding may be considered a reasonable basis for requesting a change in the audit engagement.
A change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. For example, where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified or disclaimer of opinion.

In practice, the auditors and the new client will meet to negotiate the terms of the audit agreement which the auditor will later clarify in the engagement letter.

**Question 5.3**

SSA 210 *Agreeing the Terms of Audit Engagements* lists a series of matters which shall be referred to in an engagement letter. What are they?

### 4.4.1 Recurring audits

In a recurring audit, the auditor is not required to send a new letter for each audit, but must ensure that the client still understands the existing terms. The following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms.

- Any indication that the entity misunderstands the objective and scope of the audit
- Any revised or special terms of the audit engagement
- A recent change of senior management
- A significant change in ownership
- A significant change in nature or size of the entity’s business
- A change in legal or regulatory requirements
- A change in the financial reporting framework adopted in the preparation of the financial statements
- A change in other reporting requirements

It may be necessary to revise the terms in the event of new circumstances arising.

**SECTION SUMMARY**

The auditor must agree terms of the audit engagement with relevant personnel at the client and must ensure that preconditions for an audit exist in order to agree to those terms.

### 5 Other matters to note

**SECTION INTRODUCTION**

ISCA provides ethical guidance on the issue of advertising.
5.1 ISCA/ACRA guidance

ISCA gives guidance about advertising in the *Code of Professional Conduct and Ethics*. In general, ISCA allows Chartered Accountants to advertise their work. This is subject to the following general principle:

<table>
<thead>
<tr>
<th>ISCA Code of Professional Conduct and Ethics (Section 250.2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A professional accountant in public practice shall not bring the profession into disrepute when marketing professional services. The professional accountant in public practice shall be honest and truthful and not:</td>
</tr>
<tr>
<td>• Make exaggerated claims for services offers, qualifications possessed or experience gained</td>
</tr>
<tr>
<td>• Make disparaging references or unsubstantiated comparisons to the work of another</td>
</tr>
</tbody>
</table>

ACRA provides identical guidance in its *Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities* (ACRA Code). Chapter 2 explained how the ACRA Code and ISCA Code are identical, bar some terminology differences.

5.1.1 Examples of advertising for professional services

- Websites detailing services offered
- Event sponsorship
- Provision of speakers at professional seminars and conferences enabling the AE to have their logo seen, hand out leaflets and technical materials and network with participants

SECTION SUMMARY

Advertising of services by Chartered Accountants is allowed under ethical guidance.
Chapter Roundup

Change in auditor
- Why
  - Audit fee
  - Auditor not seeking re-election
  - Size
  - Personality
  - Rotation
- Legal issues
  - Appointment/reappointment of auditor
  - Removal of auditor
  - Resignation of auditor
- Ethical guidance
  - ISCA Code Section 210
- Advertising, fees and tendering
  - Setting fees
  - Contingent fees
  - Lowballing
  - Commission

Acceptance/Continuance of engagements
- Obtain information
- Identify issues
  - Integrity
  - Competence
- Resolve issues

Anti-money laundering procedures
Client screening

How do AEs confirm the scope of the engagement?
- Engagement letter
  - Clarifies:
    - Scope
    - Objective
    - Responsibilities
    - Applicable framework
    - Form and content of reports
Quick Quiz

1. Name three reasons why an auditor might not seek re-election.
2. Explain the ethical guidance regarding the advertisement of professional services by Chartered Accountants.
3. List six practical issues that an auditor should consider when approaching a tender.
4. Draw a diagram showing the key stages in a tender, explaining what happens at each stage.
5. List three sources of information about a new client given in SSQC 1.
6. According to SSQC 1, when considering whether to accept an engagement with a new or existing client, the auditors must consider whether a ........................................... ........................................... arises.
7. List five matters which may be referred to in an engagement letter.
1. Any from the following.
   - Ethical reasons (eg fees from one client form too large a percentage of AE's income)
   - Conflict of interest between two clients
   - Disagreement with the client, for example over accounting policy
   - AE wants to focus on a specific industry of audit clientele
   - AE does not have the necessary resources
   - AE has reason to doubt the integrity of the client

2. The Chartered Accountant should not bring the profession into disrepute. The Chartered Accountant should be honest and truthful and should not make exaggerated claims for services offers, qualifications possessed or experience gained or make disparaging references to unsubstantiated comparisons to the work of another.

3. (1) Does the timetable fit with current work plan?
   (2) Are suitable personnel available?
   (3) Where will work be performed? Is it cost effective?
   (4) Are specialist skills needed?
   (5) Will staff need further training?
   (6) If so, what is the cost?

4. AUDITOR CONSIDERS IF IT IS POSSIBLE TO UNDERTAKE WORK AT A REASONABLE FEE

   ARRANGE TO OBTAIN INFORMATION PRIOR TO TENDER

   OBTAIN KNOWLEDGE OF THE BUSINESS AND THE SERVICE REQUIRED

   ALLOCATE POTENTIAL STAFF TO WORK PLAN AND CALCULATE FEE BY REFERENCE TO STANDARD CHARGE OUT RATES

   THIS COULD BE IN THE FORM OF:
   - Letter
   - Report
   - Presentation

5. (1) Communications with existing/previous auditors
   (2) Communications with other third parties (eg bankers/legal counsel)
   (3) Relevant databases

6. Conflict of interest

7. Any five from the following:
   - Objective and scope of the audit
   - Auditor's responsibilities
   - Management's responsibilities
   - Identification of applicable financial reporting framework
- Expected form and contents of reports to be issued by the auditor and statement that there may be circumstances when a report may differ from this
- More detail on the scope of the audit including references to law, auditing and other standards the auditor follows
- Form of other audit communications
- Limitation of audit and internal controls and resulting risk that material misstatements may not be detected
- Composition of the audit team and other practical arrangements
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- Arrangements to be made with predecessor auditors (in the case of a new audit)
- Any restrictions of the auditor's liability
- References to any other agreements between parties
- Any obligations to provide working papers to other parties
Answers to Questions

5.1 Audit fee negotiations

(a) Profit element
AEs are business entities, and it will be important to an AE not simply to cover costs in performing an audit, but to make a profit doing so as well.

(b) Quality audit
The AE needs to charge a fee which is commensurate with the time needed to perform the audit properly and in accordance with quality control and auditing standards. If the fee is negotiated too low, there is a chance that quality will be affected, if the audit team feel that the audit needs to be rushed.

(c) Intimidation threat
The auditor should charge an audit fee that is suitable and comparable to competitor audit fees, or there is a risk that independence in relation to the audit will be lost, that is, if the auditor feels under pressure to lower the audit fee to a level which is clearly inappropriate for the services provided, but does so anyway, then it would appear that the audit would be affected both by the auditor's self-interest (in failing to negotiate a suitable fee due to fear of losing the client) and by the possible intimidation of the audit client management (in forcing the AE to accept inappropriately low fees). Both these threats to independence would be without safeguard if the AE had in effect been forced to accept a fee level that they were not happy with.

(d) Perception of audit
Ideally, audit clients view the audit as a value-adding exercise, rather than just an expense that is legally required. This impacts the negotiation of fees because if clients see the value that is being brought to the business, then they may understand why a lower fee is not appropriate.

5.2 Accepting nomination

(a) The following procedures should be carried out:

(i) Ensure that I and my audit team are professionally qualified to act and consider whether there are ethical barriers to my accepting nomination.

(ii) Review the AE's overall work programme to ensure that there are sufficient resources to enable my AE to carry out the audit.

(iii) Obtain references about the directors as they are not known personally by me or anyone else in my AE.

(b) The auditor must use their professional judgment when considering the responses they get to references concerning new clients. The guidance cannot legislate for all situations so it does not attempt to do so. In the circumstance given above there is no correct answer, so in practice an auditor would have to make a justifiable decision which they would then document.

Matters to be considered

The reference raises three issues for the auditor considering accepting nomination:

(i) The issue that the director has been difficult to maintain a relationship with in the past
(ii) The issue that the director was slow to provide information in the past
(iii) The suspicion of a lack of integrity in relation to the director's tax affairs

The auditor must consider these in the light of several factors:

(i) The length of time that has passed since the events
(ii) What references which refer to the interim time say
(iii) The difference between accepting a role of auditing a company and personal tax work
(iv) The director's role in the company and therefore the audit
(v) The amount of control exercised by the director
   – Relationships with other directors
   – Influence

At this stage the auditor should not be considering how highly they value the opinion of the referee. That should have been considered before they sent the reference. At this stage they should only be considering the implications of the reference for their current decision.

Auditing a company is different from auditing personal affairs in terms of obtaining information and contacting personnel. In this case, the key issue is the question over the integrity of the director.

As we do not have information about interim references and details of the business arrangements it is difficult to give a definite answer to this issue. However, the director is likely to only have limited control over decisions of the entity being one of five directors, which might lead to the auditor deciding that the reference was insufficient to prevent them accepting nomination. If the director were the finance director, the auditor would be more inclined not to take the nomination.

5.3 Engagement letter

The SSA includes the following matters in Paragraphs 10 and A24 to A25:

- The objective of the audit of financial statements
- Management's responsibility for the financial statements and auditor's responsibility
- The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres
- The form of any reports or other communication of results of the engagement
- The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable
- Arrangements regarding the planning and performance of the audit
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit
- Request for the client to confirm the terms of engagement by acknowledging receipt of the engagement letter
- Description of any other letters or reports the auditor expects to issue to the client
- Basis on which fees are computed and any billing arrangements
- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit
- Arrangements concerning the involvement of internal auditors and other client staff
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit
- Any restriction of the auditor's liability when such possibility exists
- A reference to any further agreements between the auditor and the client
PART D
PERFORMING THE STATUTORY AUDIT
Audit planning is an important part of the audit process because it sets the direction for the audit based on an assessment of the risks relevant to the entity. In order to be able to assess the risks of material misstatement the auditor is required to obtain an understanding of the entity and its environment. Information will be sought regarding the industry in which the business operates and the different business processes within the entity itself. The auditor will use a number of techniques including:

- Inquiries of management
- Analytical procedures
- Observation and inspection
- Audit team discussion
- Prior period knowledge

Having identified the risks the auditor will evaluate the risks to determine whether they could result in a material misstatement and the likelihood of this occurring (we will consider risk in more detail in Chapter 7). Notice therefore that the stages of audit planning often take place simultaneously rather than being performed in a sequence. Many of the same procedures will be adopted to both obtain an understanding of the business and identify risk.

Materiality considerations are also important at the planning stage. The calculation of materiality should be based on experience and judgment and will assist the auditor in determining the nature, timing and extent of audit procedures to include in the audit plan.

Finally, we look at how the audit strategy and audit plan help with planning an initial audit engagement before outlining some topical issues regarding financial reporting that the auditor should consider when planning any audit.

### Topic list

1. Revision: overview of audit planning
2. Understanding the entity
3. Materiality
4. Planning an initial audit engagement
5. Current financial reporting issues
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
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<tbody>
<tr>
<td><strong>Code of Professional Conduct and Ethics</strong></td>
<td></td>
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<tr>
<td>Discuss the importance of auditors' independence and professional scepticism in</td>
<td>3</td>
</tr>
<tr>
<td>planning and performing an audit.</td>
<td></td>
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<tr>
<td><strong>Planning, materiality and assessing the risk of misstatement</strong></td>
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<tr>
<td>Define materiality and performance materiality and demonstrate how it should be</td>
<td>2</td>
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<tr>
<td>applied in accordance with professional auditing standards.</td>
<td></td>
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<tr>
<td>Identify and explain the importance of understanding the entity and its</td>
<td>3</td>
</tr>
<tr>
<td>environment, including internal controls in risk assessment.</td>
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</tr>
<tr>
<td>Explain the planning procedures specific to an initial audit engagement.</td>
<td>2</td>
</tr>
<tr>
<td>Apply the further considerations and audit procedures relevant to initial</td>
<td>2</td>
</tr>
<tr>
<td>engagements.</td>
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ESSENTIAL READING

- SSA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Singapore Standards on Auditing
- SSA 300 Planning an audit of financial statements
- SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- SSA 320 Materiality in Planning and Performing an Audit
- SSA 450 Evaluation of Misstatements Identified During the Audit
- SSA 510 Initial audit engagements – opening balances

1 Revision: overview of audit planning

SECTION INTRODUCTION

Auditors must plan their work well to ensure an efficient and effective audit.

1.1 SSA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Singapore Standards on Auditing

SSA 200.11

In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the SSAs, in accordance with the auditor's findings.
The key requirements for the auditor to obtain reasonable assurance and to express an opinion are:

- Ethics: comply with relevant ethical requirements ie the ACRA Code and ISCA Code
- Professional scepticism: plan and perform an audit with professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated
- Professional judgment: exercise professional judgment in planning and performing an audit
- Sufficient appropriate audit evidence and audit risk: obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level
- Conduct of an audit in accordance with SSAs: comply with all SSAs relevant to the audit

1.1.1 Professional scepticism

As we have seen in Chapter 2, the ability to exercise professional scepticism is one of the key attributes of the auditor. It is defined as follows:

**KEY TERM**

**PROFESSIONAL SCEPTICISM** – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence.

Professional scepticism is necessary to the critical assessment of audit evidence. Adopting an attitude of professional scepticism includes being alert to the following:

- Audit evidence that contradicts other audit evidence obtained
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence
- Conditions that may indicate possible fraud
- Circumstances that suggest the need for audit procedures in addition to those required by the SSAs

Maintaining professional scepticism throughout the audit reduces the risk of overlooking unusual circumstances, over-generalising when drawing conclusions and using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating results.

Whilst the auditor is not expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, a belief that they are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less than persuasive audit evidence.

1.1.2 IAASB Q&A paper: Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions

Issued in August 2010, this IAASB Question & Answer paper deals with significant unusual or highly complex transactions, including significant transactions outside the normal course of business and those occurring at or near the period end, which may by nature carry a higher risk of material misstatement, and thus merit heightened attention by auditors. The IAASB emphasises the importance of the auditor exercising professional judgment and scepticism. The auditor is required to consider the susceptibility of the financial statements to material misstatement by fraud, which includes consideration of fraud risk factors (eg significant complex transactions, which may pose questions of 'substance over form' and fraudulent financial reporting). The auditor then needs to design audit procedures that gather sufficient appropriate audit evidence in relation to these risks.
1.1.3 Professional judgment

The ability to apply professional judgment is another key skill that an auditor must develop. This is defined by SSA 200 as follows:

**KEY TERM**

**PROFESSIONAL JUDGMENT** – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about courses of action that are appropriate in the circumstances of the audit engagement. (SSA 200.13)

Professional judgment is essential to the proper conduct of an audit as interpretation of the relevant ethical requirements and the SSAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience of the facts and circumstances. It is particularly necessary when making decisions about:

- Materiality and audit risk
- The nature, timing and extent of audit procedures
- Evaluating whether sufficient appropriate audit evidence has been obtained
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework
- The drawing of conclusions based on the audit evidence obtained

1.2 SSA 300 Planning an Audit of Financial Statements

SSA 300 *Planning an Audit of Financial Statements* states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner.

The SSA refers to two documents, the overall audit strategy and the audit plan, to be included in the audit documentation. The overall audit strategy sets out in general terms how the audit is to be carried out. Considerations in establishing the overall audit strategy are listed in the Appendix to SSA 300 and include:

- Characteristics of the engagement
- Reporting objectives, timing of the audit and nature of communications
- Significant factors, preliminary engagement activities and knowledge gained on other engagements
- Nature, timing and extent of resources

The audit plan details specific procedures to be carried out to implement the strategy and complete the audit. This includes the nature, timing and extent of planned risk assessment procedures and planned further audit procedures at the assertion level. Any significant changes made, and the reasons for the changes, during the audit engagement to the overall audit strategy or the audit plan will also have to be included in the audit documentation.

In the case of a smaller entity the strategy is likely to be a brief memorandum and the audit plan a series of tailored standard audit programmes.

**SECTION SUMMARY**

Planning an audit involves establishing the overall strategy and developing an audit plan. The auditor must demonstrate professional judgment and apply professional scepticism throughout.
2 Understanding the entity

SECTION INTRODUCTION

Auditors must obtain an understanding of the entity and its environment in order to be able to assess the risks of material misstatement.

2.1 Objective

The objective of SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment is as follows:

SSA 315.3

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

SSA 315 emphasises gaining an understanding of the entity first, and then using this knowledge and insight to work out where the highest risks of material misstatement might be.

Understand the entity, in order to...

Identify and assess risks of material misstatement

Design and perform audit procedures

Provide a frame of reference for judgments

2.2 What do we need to get an understanding of?

The SSA sets out a number of areas of the entity and its environment that the auditor should gain an understanding of.

<table>
<thead>
<tr>
<th>Areas to gain an understanding of</th>
<th>Industry, regulatory and other external factors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nature of the entity</td>
</tr>
<tr>
<td></td>
<td>Selection, application and reasons for changes of accounting policies</td>
</tr>
<tr>
<td></td>
<td>Objectives, strategies and related business risks</td>
</tr>
<tr>
<td></td>
<td>Measurement and review of the entity's financial performance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The entity's internal control</th>
<th>Control environment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Risk assessment process</td>
</tr>
<tr>
<td></td>
<td>Information system</td>
</tr>
<tr>
<td></td>
<td>Control activities</td>
</tr>
<tr>
<td></td>
<td>Monitoring</td>
</tr>
<tr>
<td>(The components of internal control will be looked at again in more detail in Chapter 7)</td>
<td></td>
</tr>
</tbody>
</table>
2.3 How do we get this understanding?

The SSA sets out ways of getting this understanding:

<table>
<thead>
<tr>
<th>Methods of obtaining an understanding of the entity</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inquiries of management, appropriate individuals within the internal audit function and others within the entity</td>
<td>Inquiry of IT staff about IT system failures</td>
</tr>
<tr>
<td></td>
<td>Inquiry of in-house legal counsel about any ongoing litigation</td>
</tr>
<tr>
<td></td>
<td>Inquiry of the internal audit function of any identified control deficiencies or risks</td>
</tr>
<tr>
<td>Analytical procedures (on both financial and non-financial data)</td>
<td>Calculating ratios for example the relationship between sales and square metre of selling space</td>
</tr>
<tr>
<td>Observation and inspection</td>
<td>Reading internal control manuals, business plans and strategies</td>
</tr>
<tr>
<td>Audit team discussion of the susceptibility of the financial statements to material misstatement</td>
<td>More experienced members of the audit team passing knowledge to new team members</td>
</tr>
<tr>
<td>Prior period knowledge (but should check that it is still relevant)</td>
<td>Whether past misstatements have been corrected on a timely basis</td>
</tr>
<tr>
<td></td>
<td>Deficiencies in controls documented in prior period audit files</td>
</tr>
</tbody>
</table>

The auditors shall perform risk assessment procedures including the top three procedures. The engagement partner and other key engagement team member should also discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. Obtaining an understanding of the entity is a continuous dynamic process of gathering, updating and analysing information throughout the audit. The auditor may use prior period knowledge, but must carry out procedures to ensure that if there have been any changes in the year, the prior period knowledge is still valid.

Understanding the entity enables the auditor to identify areas of the business which might impact upon the audit. The auditor needs to understand who the client is, what they do and how they do it, any specific laws or regulations surrounding their business and the integrity and competence of client personnel. Once the auditor can understand this, they will be able to perform an effective risk assessment.

For example, for a client owning a chain of restaurants, understanding the entity will include the auditor gaining some basic knowledge of food hygiene regulations. This knowledge and understanding allows the auditor to identify the risk that if the client fails to comply with the regulations, they may be shut down by the authorities. For each risk identified, SSA 315.26 requires the auditor to take the following steps:

**STEP 1** Identify risks throughout the process of obtaining an understanding of the entity and its environment.

**STEP 2** Assess whether the identified risks relate more pervasively to the financial statements as a whole and potentially affect assertions.
Relate the identified risk to what can go wrong at the assertion level, and assess the controls that the auditor intends to test.

Consider the likelihood of misstatement and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Throughout this process the size of the entity being audited must be considered. For example, in a small entity there is likely to be limited segregation of duties. This may be compensated for by increased management oversight, however this in turn increases the risk of override of controls by management.

**CASE STUDY**

The audit team at Ockey Ltd has been carrying out procedures to obtain an understanding of the entity. In the course of making enquiries about the inventory system, they have discovered that Ockey Ltd designs and produces tableware to order for a number of stores. It also makes a number of standard lines of tableware, which it sells to a number of wholesalers. By the terms of its contracts with the stores, it is not entitled to sell leftover inventory designed for them to wholesalers. Ockey Ltd regularly produces 10% more than the stores have ordered, in order to ensure that they meet requirements when the stores do their quality control check. Certain stores have more stringent control requirements than others and regularly reject some of the inventory.

The knowledge above suggests two risks, one that the company may have obsolete inventory, and another that if their production quality standards are not sufficiently high then they risk losing customers.

We shall look at each of these risks in turn and relate them to the assertion level.

**Inventory**

If certain inventory items are obsolete due to the fact that they were produced in excess of the customer's requirement and there is no other available market for it, then there is a risk that inventory as a whole in the financial statements will not be carried at the appropriate value. Given that inventory is likely to be a material balance in the statement of financial position of a manufacturing company, and the value could be up to 10% of the total value, this has the capacity to be a material misstatement.

The factors that will contribute to the likelihood of these risks causing a misstatement are matters such as:

- Whether management regularly review inventory levels and scrap items that are obsolete
- Whether such items are identified and scrapped at the inventory count
- Whether such items can be put back into production and changed so that they are saleable

**Losing customers**

The long-term risk of losing customers is that in the future the company will not be able to continue as a going concern (we will consider going concern in Chapter 12). A further risk is of customer disputes leading to sales returns which may not be recognised, in which case sales and receivables could be overstated. However, it
Some risks identified may be significant risks.

**KEY TERM**

A **SIGNIFICANT RISK** is an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. (SSA 315.4)

The following factors indicate that a risk might be significant:

- Risk of fraud
- Risk related to significant economic, accounting or other developments
- The degree of subjectivity in the measurement of financial information related to the risk
- Unusual transactions or significant transactions outside the normal course of business
- Significant transactions with a related party
- Complexity of the transactions

Routine, non-complex transactions are less likely to give rise to significant risk than unusual transactions or matters of director's judgment because the latter are likely to have more management intervention, complex accounting principles or calculations, greater manual intervention or there is less opportunity for control procedures to be followed.

When the auditor identifies a significant risk, he/she should evaluate the design and implementation of the entity's controls relevant to the risk. Failure by management to implement controls over this significant risk is an indicator of a significant deficiency in internal control.

### 2.4 Documentation requirements

The auditor shall include in the audit documentation:

- The discussion among the audit team concerning the susceptibility of the financial statements to material misstatements, including any significant decisions reached
- Key elements of the understanding gained of the entity including the elements of the entity and its control specified in the SSA as mandatory, the sources of the information gained and the risk assessment procedures carried out
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level
- Significant risks identified and related controls evaluated

### 2.5 IAASB ISA 315 (Revised) Exposure Draft

In July 2018, the IESBA published an **exposure draft for ISA 315 (Revised)** which sought comments on the following proposed improvements to this auditing standard.

- Consistent and effective identification and assessment of the risk of material misstatement by auditors.
- Modernisation of ISA 315 to meet business needs, focusing on the use of IT and data analytics as part of the audit.
• Improving the applicability of the ISA across a broader range of entities.
• Focus on professional scepticism during risk identification and assessment.

Further details of the exposure draft can be found here: https://www.ifac.org/publications-resources/exposure-draft-isa-315-revised-identifying-and-assessing-risks-material

SECTION SUMMARY
The auditor identifies and assesses the risks of material misstatements through understanding the entity and its environment. Special audit consideration must be given to significant risks.

3 Materiality

SECTION INTRODUCTION
Materiality considerations are important in both planning and performing the audit. An item might be material due to its nature, value or impact on the users of the financial statements as a group.

3.1 Materiality in Planning and Performing an Audit
Materiality issues are dealt with in two standards:
• SSA 320 Materiality in Planning and Performing an Audit
• SSA 450 Evaluation of Misstatements Identified During the Audit

KEY TERMS

MATERIALITY – Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

(SSA 320.2)

PERFORMANCE MATERIALITY means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

(SSA 320.9)

The application of materiality to an audit can be summarised in three key stages:

STEP 1
Make a preliminary judgment about materiality.

Determining materiality for the audit as a whole is a matter of professional judgement, based on the specific circumstances of the audited entity, and on the needs of the users of financial statements.
Determine performance materiality.

This will be less than the level determined in step 1, and can be applied to particular classes of transactions, account balances or disclosures.

Accumulate non-trivial misstatements identified during the audit and compare totals to the preliminary judgment about materiality.

The initial determination of materiality should be reviewed during the course of the audit and revised where necessary.

In accordance with SSA 320 Steps 1 and 2 would normally be performed as part of the planning process. (Step 3 is covered in SSA 450 and is normally performed as part of the review stage. See Section 3.4 below.) The assessment of materiality and performance materiality at this stage should be based on the most recent and reliable financial information and will help to determine an effective and efficient audit approach.

Materiality assessment will help the auditors to decide:

- How many and what items to examine
- Whether to use sampling techniques
- What level of misstatement is likely to lead to a modified audit opinion

The resulting combination of audit procedures should help to reduce audit risk to an appropriately low level.

Materiality criteria

<table>
<thead>
<tr>
<th>An item might be material due to its</th>
<th>Nature</th>
<th>Value</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Given the definition of materiality as an item that would affect the users of the financial statements, some items might by their nature affect users. Examples include transactions related to directors, such as remuneration or contracts with the company.</td>
<td>Some items will be significant in the financial statements by virtue of their size, for example, if the company had bought a piece of land with a value which comprised three quarters of the asset value of the company, that would be material. That is why materiality is often expressed in terms of percentages (of assets, of profits).</td>
<td>Some items may by chance have a significant impact on financial statements, for example, a proposed journal which is not material in itself could convert a profit into a loss. The difference between a small profit and a small loss could be material to some users.</td>
</tr>
</tbody>
</table>

The auditor can also set different materiality levels for particular classes of transactions, account balances or disclosures of the financial statements, according to their judgment of the audit risk that is particular to that area. This is an application of the idea that some items are material by nature, since it allows the auditor to set a lower level of materiality for these riskier areas of the audit.

The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by:

- The auditor's understanding of the entity, updated during the performance of the risk assessment procedures
- The nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period
Example: Performance materiality

You are planning the audit of a manufacturing client, Links Pte Ltd for the year ending 31 December 20X4. Materiality has been set at $250k. Your AE's rulebook states that performance materiality must be set at no more than 75% of materiality.

Performance materiality for accounts payable for the year ending 31 December 20X3 was set at 70% of materiality or $175k. In the 20X3 audit, three errors of $35k each were found. They were not considered material and the auditor's report was not modified.

When setting performance materiality for the current year audit you consider that there may be errors of $35k again this period. If there were five errors of this size, then the aggregate of these misstatements would be material. You decide to lower performance materiality to $150k for accounts payable for the 20X4 audit as you judge the cumulative risk to be high.

3.2 Guidelines for materiality

It is clear from the points made about materiality criteria that materiality is judgmental, and an issue that auditors must be aware of when approaching all their audit work. However, generally accepted guidelines on materiality exist. It is helpful to have some guidelines to bear in mind. Reasons for this are:

- The guidelines give the auditor a framework within which to base his thoughts on materiality.
- The guidelines provide a benchmark against which to assess the quality of auditing, for example, in the event of litigation or disciplinary action.

Refer to the following table for examples of percentages that can be used to determine materiality.

<table>
<thead>
<tr>
<th>Benchmark</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>5</td>
</tr>
<tr>
<td>Gross profit</td>
<td>(\frac{1}{2} \text{–} 1)</td>
</tr>
<tr>
<td>Revenue</td>
<td>(\frac{1}{2} \text{–} 1)</td>
</tr>
<tr>
<td>Total expenses</td>
<td>(\frac{1}{2} \text{–} 1)</td>
</tr>
<tr>
<td>Total assets</td>
<td>1–2</td>
</tr>
<tr>
<td>Net assets</td>
<td>2–5</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>5–10</td>
</tr>
<tr>
<td>Issues related to directors</td>
<td>100</td>
</tr>
</tbody>
</table>

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. Account must be taken of the relationship between the percentage chosen and the benchmark such that a percentage applied to a profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example an auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages however may be deemed appropriate depending on the circumstances.

The percentage guidelines of assets and profits that are commonly used for materiality must be handled with care. The auditor must bear in mind the focus of the company being audited.

In some companies, profit after tax is the key figure in the financial statements, as the level of dividend is the most important factor in the financial statements.

Some companies are driven by assets rather than the need for profits. In such examples, net assets or total assets are more likely to be the benchmark used for materiality setting. In some companies, say charities, costs are the driving factor, and therefore expenses will be used for materiality setting.

While guidelines are helpful to auditors when assessing materiality, they must always keep in mind the nature of the business they are dealing with. Materiality must be tailored to the business and the
anticipated users of financial statements. Refer back to the definition of materiality and consider all the elements of it.

### 3.2.1 Revision as audit progresses

The auditor will revise the materiality level during the audit if he/she becomes aware of information that would have caused a different materiality level to have been set in the first place. Changes must be documented.

If the auditor concludes that a lower materiality than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

**Question 6.1**

You are the manager responsible for the audit of Albreda Ltd. The draft consolidated financial statements for the year ended 31 March 20X2 show revenue of $42.2 million (20X1 $41.8 million), profit before taxation of $1.8 million (20X1 $2.2 million) and total assets of $30.7 million (20X1 $23.4 million).

In March 20X2, the management board announced plans to cease offering 'home delivery' services from the end of the month. These sales amounted to $0.6 million for the year to 31 March 20X2 (20X1 $0.8 million). A provision of $0.2 million has been made at 31 March 20X2 for the compensation of redundant employees (mainly drivers).

**Required**

Comment upon the materiality of the home delivery sales and provisions on compensation of redundant employees for the year ended 31 March 20X2.

### 3.3 Documentation

The auditor must document:

- Materiality for the financial statements as a whole
- Materiality for particular balances, classes of transactions or disclosures
- Performance materiality
- Any revisions to the above

### 3.4 Evaluating material misstatements

**SSA 450.A1**

Misstatements may result from:

(a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(b) An omission of an amount or disclosure;

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;

(d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate;

(e) An inappropriate classification, aggregation or disaggregation, of information; and

(f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.
SSA 450 Evaluation of Misstatements Identified During the Audit provides more specific guidance on the documentation and communication of misstatements identified.

**SSA 450.5**
The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.

‘Clearly trivial is not another expression for “not material”.’ Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SSA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.

All misstatements (other than those that are clearly trivial) must be communicated on a timely basis to management with a request that they are corrected. If management does not correct them, then the auditor is obliged to communicate the individual uncorrected misstatements to those charged with governance, together with the effect on the audit opinion. Finally, for those misstatements that remain uncorrected, management and, where appropriate, those charged with governance, must provide written representations that they believe that the effects of the misstatements (individually and in aggregate) are immaterial. The materiality level for accumulated misstatements is set as a percentage of materiality.

**SSA 450.15**
The auditor shall include in the audit documentation:

(a) The amount below which misstatements would be regarded as clearly trivial
(b) All misstatements accumulated during the audit and whether they have been corrected
(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion

3.4.1 IASB Practice Statement on materiality

In September 2017, IASB issued a practice statement designed to assist an entity's management when deciding on how best to present financial information about the entity that would be useful to shareholders, lenders and other stakeholders looking to provide the entity with resources. The focus is on clear and concise communication, individually and in aggregate.

**WEBSITE**
IASB Practice Statement (PS) 2 'Making materiality judgements' can be found on the IASB website.


**SECTION SUMMARY**

A preliminary assessment of materiality and performance materiality is made during the planning process. This is reviewed throughout the audit and revised if necessary. Current best practice requires a systematic process to produce financial information that is useful to all stakeholders.
4 Planning an initial audit engagement

SECTION INTRODUCTION
An initial audit engagement will often involve more work at the planning stage than a recurring audit engagement. An initial audit engagement is an engagement in which the financial statements for the prior period were not audited, or the financial statements for the prior period were audited by a predecessor auditor.

Auditors must make special considerations at the planning stage when they are auditing an entity for the first time, whether because the entity has never required an audit before, or whether the entity has simply changed auditor.

First-time audits generally require a little more work than recurring engagements because there are specific risks in relation to an auditor's relative lack of knowledge of new audit clients.

Guidance on first-time audits is provided in SSA 510 Initial Audit Engagements: Opening Balances.

4.1 Audit strategy and audit plan
For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Arrangements to be made with the predecessor auditor, eg to review their working papers
- Any major issues discussed with management, eg relating to the application of SFRS(I), and how these issues affect the audit strategy and plan
- The audit procedures necessary to audit opening balances in accordance with SSA 510 Initial Audit Engagements – Opening Balances (see Chapter 10)
- Any other procedures required by the AE for initial engagements, eg review of the audit strategy by another senior partner within the AE

It is likely that more audit work will need to be performed in order to lower detection risk, ie the risk that the auditors procedures do not detect a material misstatement (and thus audit risk) to the required level. This may result in a higher audit fee being charged for an initial engagement, since fees should relate to the amount of time spent on the engagement.

4.2 Understanding the entity
SSA 315 requires the auditor to obtain an understanding of the entity and its environment in order to identify and assess the risks of material misstatement. In the case of a first-time audit engagement this will tend to require more work, because the auditor will have less knowledge regarding the client.

4.3 Other considerations
Detection risk may be higher for an initial audit engagement, as the auditor may not have the knowledge to design and perform procedures to obtain sufficient appropriate audit evidence.

Materiality is likely to be set at a lower level for initial engagements. As the auditors are not familiar with the entity's internal controls, they should consider using a more conservative threshold. Using a lower level of materiality increases the likelihood of detecting less than material misstatements, which could be indicative of a pervasive failure in internal controls.
Question 6.2

Planning and understanding the business

You have been informed by the senior partner of your AE that you are to be in charge of the audit of a new client, Peppermint Chews, for the year ended 31 December 20X4. The senior tells you that the company is engaged in the manufacture and wholesaling of sweets and confectionery, with revenue of approximately $10,000,000 and a workforce of about 150. The company has one manufacturing location, sells mainly to the retail trade but also operates 10 shops of its own. The senior partner asks you to draw up an outline audit plan for the assignment showing when you anticipate visits to the client will be made and what kind of work will be carried out during each visit. The deadline for your auditor's report is 28 February 20X5.

Required

Draw up an outline plan for the audit of Peppermint Chews for the year ended 31 December 20X4, including:

(a) Approximate timing in the company's year of each stage of the audit of this new client. State why you have selected the approximate timing

(b) The objective of each stage

(c) The kind of work that will be carried out at each stage.

SECTION SUMMARY

The purpose and objective of planning the audit remain the same whether the audit is an initial audit or a recurring engagement. For an initial audit engagement planning activities may need to be expanded.

5 Current financial reporting issues

SECTION INTRODUCTION

ACRA has carried out a review of selected financial statements to identify areas for directors of companies in Singapore to be aware of when asked to comment on their own companies’ financial reporting.

5.1 Financial Reporting Practice Guidance 1 of 2018 – Areas of review focus for FY2017 financial statements under ACRA’s financial reporting surveillance programme

In order to maintain the quality of financial reporting in Singapore, ACRA has published this practice guidance for directors to use when reviewing the financial statements of their companies. Such information is also useful to AEs when planning the audit of these companies. The following is a list of points identified from reviewing a selection of financial statements prepared in 2018.

- An overview of the current economic outlook for Singapore
- A reminder of new accounting standards that will require adequate levels of disclosure (eg SFRS(I) 9, 15 and 16 on financial instruments, revenue and leases respectively)
• Reinforcement of the importance to investors of disclosing significant judgements for the assessment of going concern
• An overview of the problems faced by directors when conducting impairment testing
• The need for greater scepticism when reviewing significant transactions where gains or losses are recognised (such as the disposal of a subsidiary with an obligation to reacquire the sold interest in 12 months' time – regardless of the legal form, what is the substance of such a transaction?)
• The need for greater scrutiny of the control demonstrated by various parties when choosing between equity and consolidation accounting
• A reminder of the complexities associated with accounting for business acquisitions
• Examples of inappropriate classifications within statements of cash flows which may be affecting key indicators used by investors (such as foreign currency translation)
• A reminder to disclose adequately any complex or subjective judgements when preparing financial statements to ensure meaningful reporting

WEBSITE
Financial Reporting Practice Guidance 1 of 2018 can be found on the ACRA website. 
https://www.acra.gov.sg/uploadedFiles/Content/Publications/Practice_Guidance/Practice%20Guidance_Areas%20of%20Review%20Focus%202017.pdf

SECTION SUMMARY
The matters identified by ACRA will be of benefit to company directors but understandably will also benefit their auditors as well, especially when considered as part of the planning stage to understand the entity.
Chapter Roundup

Understanding the entity and its environment SSA 315

What?

Why?

To identify risk of material misstatement in the financial statements

How?

Significant risks

Audit Planning

SSA 300 Planning an Audit of Financial Statements

Audit Strategy
Audit Plan

Planning issues

Materiality

SSA 320 SSA 450

Topical issues

Financial statements as a whole

Performance Materiality

Revise as audit progresses
Quick Quiz

1. What is the purpose of an audit strategy document?

2. Which of the following procedures might an auditor use in gaining an understanding of the entity?
   (a) Inquiry
   (b) Recalculation
   (c) Analytical procedures
   (d) CAATs
   (e) Observation and inspection

3. Name three factors which might indicate a significant risk.

4. What is performance materiality?
Answers to Quick Quiz

1. The audit strategy document sets out in general terms how the audit is to be carried out.

2. (a), (c), (e)

3. Any three from the following:
   - Risk of fraud
   - Relationship with recent developments
   - Degree of subjectivity in the financial information
   - The fact that it is an unusual transaction
   - Transaction with a related party
   - Complexity of the transaction

4. Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
6.1 Materiality

Home delivery sales

The appropriate indicator of materiality with regard to the home delivery sales is revenue, as the home delivery sales form part of the total revenue of the company.

$0.6 million is 1.4% of the total revenue for 20X2 (see Working 1).

An item is generally considered to be material if it is in the region of ½ –1% of revenue, so the home delivery services are material.

Provision

The appropriate indicators of materiality with regard to the provision are total assets and profit, as the provision affects both the statement of financial position (it is a liability) and the statement of profit or loss and other comprehensive income (it is a charge against profit).

$0.2 million is 0.65% of total assets in 20X2 (see Working 2). As an item is generally considered to be material if it is in the region of 1–2% of total assets, the provision is not material to the statement of profit or loss and other comprehensive income.

However, $0.2 million is 11% of profit before tax for 20X2 (see Working 3 below). An item is considered material to profit before tax if it is in the region of 5%. Therefore, the provision is material to the statement of financial position.

<table>
<thead>
<tr>
<th>Working 1</th>
<th>Working 2</th>
<th>Working 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0.6 million</td>
<td>$0.2 million</td>
<td>$0.2 million</td>
</tr>
<tr>
<td>$42.2 million</td>
<td>$30.7 million</td>
<td>$1.8 million</td>
</tr>
<tr>
<td>× 100% = 1.4%</td>
<td>× 100% = 0.65%</td>
<td>× 100% = 11%</td>
</tr>
</tbody>
</table>

6.2 Planning and understanding the business

Initial visit

(a) Timing. As this is a new client, this visit should take place as soon as possible after the terms of engagement have been agreed with and accepted by the directors of Peppermint Chews.

(b) Objective. To build up a background knowledge of the company to assist in the more detailed planning of audit work that will be required at a later stage.

(c) Audit work. We shall obtain details of the following:

(i) The history and development of the company
(ii) The nature of the commercial environment within which the company operates
(iii) The nature of the company's products and manufacturing processes
(iv) The plan of organisation within the company
(v) The accounting and internal control systems operating within the company
(vi) The accounting and other records of the company and how they are maintained

The above will be obtained using techniques such as interview, observation, reviewing client's systems documentation, and so on.

We shall not at this stage carry out detailed tests of controls on the company's systems, but we should perform risk assessment analytics and carry out 'walk-through' tests to gain confirmation that the systems outlined to us in theory appear to operate that way in practice.

Interim visit(s)

(a) Timing. As this is the first audit of Peppermint Chews, it may, in view of the extra work involved, be necessary to have more than one interim visit. If we decided that only one such visit would be
needed, however, then ideally it should take place reasonably close to the year-end, in, say, October 20X4. If it were decided that more than one visit were needed, then perhaps the first interim visit could take place in September 20X4.

(b) Objective. The purpose of interim audits is to carry out detailed tests on a client's accounting and internal control systems to determine the reliance that may be placed thereon.

(c) Audit work. Following the initial visit to the client, we should have completed our documentation of the client's systems using narrative notes and flowcharts. We should also have assessed the strengths and weaknesses of the systems and determined the extent to which we wish to place reliance on them.

Given effective controls, we shall select and perform tests designed to establish compliance with the system. We shall therefore carry out an appropriate programme of tests of controls. The conclusion from the results may be either:

(i) That the controls are effective, in which case we shall only need to carry out restricted substantive procedures; or

(ii) That the controls are ineffective in practice, although they had appeared strong on paper, in which case we shall need to carry out more extensive substantive procedures.

After carrying out tests of controls, it is normal practice, as appropriate, to send management a letter identifying any deficiencies, making recommendations for improvements, and obtaining their responses.

Final visit

(a) Timing. This may well be split into a pre-final visit in December 20X4 and a final audit early in 20X5, or it could be a continuous process.

(b) Objective. We should visit the client prior to the year-end to assist in the planning of the final audit so as to agree with the client detailed timings such as year-end inventory count and trade receivables circularisation, preparation of client schedules, finalisation of financial statements and so forth.

The objective of the final audit is to carry out the necessary substantive procedures, these being concerned with substantiating the figures in the accounting records and, eventually, in the financial statements themselves. The completion of these tests, followed by an overall review of the financial statements, will enable us to decide whether we have obtained 'sufficient appropriate audit evidence to be able to draw reasonable conclusions' so that we are in a position to express an opinion on the company's financial statements, the expression of an opinion in their auditor's report being the primary objective of the audit.

(c) Audit work. The audit work to be carried out at this final stage would include the following:

(i) Consideration and discussion with management of known problem areas
(ii) Attendance at inventory count
(iii) Verification of assets and liabilities/income and expenditure
(iv) Following up interim audit work
(v) Carrying out review of events after the reporting period
(vi) Analytical procedures
(vii) Obtaining representations from management
(viii) Reviewing financial statements
(ix) Drafting the auditor's report
Once the auditor has an understanding of the entity and its environment (Chapter 6), the next step is to identify and assess risks in order to plan the audit approach. Assessed risk falls into two categories:

- Business risk associated with the client which may form a part of the inherent risk and therefore impacts on the audit
- Specific assignment risk, known as audit risk, which is made up of the risk of material misstatement (inherent risk and control risk) and detection risk

A risk-based audit approach directs the greatest audit effort at the areas in which the financial statements are most likely to be misstated. Analytical procedures are useful tools in risk assessment. Chapter 6 covered their use at the planning stage of the audit as a means to understand the business, this chapter covers their use in identifying audit risk.

Having assessed the risks of material misstatement, the auditor must then design and perform further audit procedures in response to those risks. The result must be audit work that will be sufficient and appropriate to support the audit opinion.

<table>
<thead>
<tr>
<th>Topic list</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Risk</td>
</tr>
<tr>
<td>2 Analytical procedures</td>
</tr>
<tr>
<td>3 Responses to audit risk</td>
</tr>
<tr>
<td>4 Fraud and error</td>
</tr>
</tbody>
</table>
### Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning, materiality and assessing the risk of misstatement</td>
<td></td>
</tr>
<tr>
<td>Identify and explain the importance of understanding the entity and its environment, including internal controls in risk assessment.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and explain material and significant audit risks (broken into risks of material misstatement and detection risks) for a given assignment.</td>
<td>3</td>
</tr>
<tr>
<td>Discuss and apply the use of analytical procedures in the planning of an assignment.</td>
<td>3</td>
</tr>
<tr>
<td>Explain how the result of planning procedures determines the relevant audit strategy.</td>
<td>2</td>
</tr>
<tr>
<td>Fraud and error</td>
<td></td>
</tr>
<tr>
<td>Compare and contrast the respective responsibilities of management and auditors relating to fraud and error.</td>
<td>3</td>
</tr>
<tr>
<td>Describe the matters to be considered and procedures to be carried out in response to risks of misstatements arising from fraud and error.</td>
<td>3</td>
</tr>
</tbody>
</table>

#### ESSENTIAL READING
- SSA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Singapore Standards on Auditing
- SSA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
- SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- SSA 330 The Auditor's Responses to Assessed Risks
- SSA 520 Analytical Procedures
- Audit Practice Bulletin No 1 of 2016 Identifying, Assessing and Responding to Risks of Material Misstatement in the Financial Statements

### 1 Risk

#### SECTION INTRODUCTION

The auditor must consider both the risk of material misstatement (inherent risk and control risk) and detection risk as part of planning the audit.
1.1 Audit risk

**KEY TERM**

*RISK OF MATERIAL MISSTATEMENT* is risk that the financial statements are materially misstated prior to audit. This consists of two components: inherent risk and control risk. (SSA 200.13)

The material misstatement could involve:

- Misstatements of the amounts recorded in the statement of comprehensive income or statement of financial position
- Misstatements of, or omissions from, the disclosure notes

**SSA 200.5**

As the basis for the auditor's opinion, SSAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

In accordance with SSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, the way the auditor does this is by carrying out risk assessment procedures. A risk assessment helps the auditor to ensure the key areas more susceptible to material misstatement are adequately investigated and tested during the audit. It also helps the auditor identify low risk areas where reduced testing may be appropriate, ensuring time is not wasted by over testing these areas.

As we saw in Chapter 6, risk assessment procedures must include:

- Inquiries of management and any existing internal audit function
- Analytical procedures
- Observation and inspection
Further audit procedures are then performed to respond to the risk assessment as we will see in Section 3 of this chapter.

**KEY TERMS**

**Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk. (Risk of material misstatement breaks down into inherent risk and control risk.)

**Inherent risk** is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

**Control risk** is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

**Detection risk** is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

(SSA 200.13)

The auditor shall identify and assess the risk of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

1.1.1 Inherent risk

Inherent risk is the risk that items will be misstated due to characteristics of those items. Inherent risk may, for example, be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures. The auditors must use their professional judgment and the understanding of the entity they have gained to assess inherent risk.

<table>
<thead>
<tr>
<th>Financial statement level considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Integrity and attitude to risk of directors and management</strong></td>
</tr>
<tr>
<td>Aggressive selection of alternative accounting policies, an ongoing</td>
</tr>
<tr>
<td>IeAS investigation for tax offences</td>
</tr>
<tr>
<td><strong>Management experience and knowledge</strong></td>
</tr>
<tr>
<td>Loss of company knowledge from changes in management or whether appropriately</td>
</tr>
<tr>
<td>qualified financial management are recruited</td>
</tr>
<tr>
<td><strong>Unusual pressures on management</strong></td>
</tr>
<tr>
<td>Tight reporting deadlines, or market or financing expectations</td>
</tr>
<tr>
<td><strong>Nature of business</strong></td>
</tr>
<tr>
<td>Technological obsolescence or over-dependence on single product</td>
</tr>
<tr>
<td><strong>Industry factors</strong></td>
</tr>
<tr>
<td>Competitive conditions, regulatory requirements, technology</td>
</tr>
<tr>
<td>developments, changes in customer demand</td>
</tr>
<tr>
<td><strong>Information technology</strong></td>
</tr>
<tr>
<td>Lack of supporting documentation, concentration of expertise in a few people,</td>
</tr>
<tr>
<td>potential for unauthorised access</td>
</tr>
</tbody>
</table>
### Factors affecting individual account balances or transactions

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement accounts prone to misstatement</td>
<td>Accounts which require adjustment in previous period or require high degree of estimation</td>
</tr>
<tr>
<td>Complex accounts</td>
<td>Accounts which require expert valuations or are subjects of current professional discussion</td>
</tr>
<tr>
<td>Assets at risk of being lost or stolen</td>
<td>Cash, inventory, portable non-current assets (e.g., laptop computers)</td>
</tr>
<tr>
<td>Quality of accounting systems</td>
<td>Strength of individual departments (sales, purchases, cash etc.) eg inherent risk will be lower where few issues have been identified in the past</td>
</tr>
<tr>
<td>High volume transactions</td>
<td>Accounting system may have problems coping e.g., where system was not designed initially to cope with this level of transactions</td>
</tr>
<tr>
<td>Unusual transactions</td>
<td>Transactions involving large amounts, with unusual names, i.e., names that do not appear to be associated with the normal business activity, not settled promptly (particularly important if they occur at period-end)  Transactions that do not go through the system, that relate to specific creditors or debtors or are processed by certain individuals</td>
</tr>
<tr>
<td>Staff</td>
<td>Staff changes or indications that staff morale is low</td>
</tr>
</tbody>
</table>

Obviously there is no formula to distinguish between low, medium and high inherent risk. The auditor assesses which of the above factors exist and the extent of their potential impact. Using professional judgment, the auditor assigns a risk level to each factor and plans the audit procedures accordingly to ultimately reduce detection risk and audit risk to an acceptable level.

### 1.1.2 Control risk

Control risk is the risk that client controls fail to detect, prevent or correct material misstatements. A preliminary assessment of control risk at the planning stage of the audit is required to determine the level of controls testing and substantive testing to be carried out.

Control risk can be assessed as lower when a company has an efficient and effectively operating internal control system. Professional judgment is used in the assessment of how efficiently and effectively the internal controls work throughout the year. Appendix 1 of SSA 315 contains a summary of the components of a good system of internal controls. These components are categorised under the following 5 areas:

#### Control environment

**KEY TERM**

The **CONTROL ENVIRONMENT** includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity. The control environment is a component of internal control.

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- Communication and enforcement of integrity and ethical values. These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
Commitment to competence. Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

Participation by those charged with governance. Attributes of those charged with governance such as: their independence from management; their experience and stature; the extent of their involvement and the information they receive, and the scrutiny of activities; and the appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

Management's philosophy and operating style. Characteristics such as: management's approach to taking and managing business risks; management's attitudes and actions toward financial reporting; and management's attitudes toward information processing and accounting functions and personnel.

Organisational structure. The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

Assignments of authority and responsibility. Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

Human resource policies and practices. Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Entity's risk assessment process. The entity should have a process for identifying risks that may affect its financial reporting, assessing these risks and then responding to them. Examples of risks that might affect financial reporting include:

- Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- Corporate restructuring. Restructuring may be accompanied by staff reduction and changes in supervision and segregation of duties that may change the risk associated with internal control.
- New personnel. New personnel may have a different focus on or understanding of internal control.
- New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.
- New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- New business models, products or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information system. The quality of the information generated by the system affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

**Control activities**, which include:

- Performance reviews. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance.
- Information processing. The two broad groupings of information systems control activities are application controls and general IT controls. Application controls apply to the processing of individual applications. Examples include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. Examples of general IT controls include program change controls, controls that restrict access to programs or data (e.g., passwords), controls over the implementation of new releases of packaged software applications and controls over systems software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- Physical controls, e.g., the physical security of assets, authorisation for access to computer programs and data files, and the periodic counting and comparison with amounts shown on control records, e.g., comparing the results of cash, security and inventory counts with accounting records
- Segregation of duties.

**Monitoring of controls.** An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management’s review of internal auditors’ evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time.

### 1.1.3 Detection risk

Detection risk is the risk that the audit procedures may not detect misstatements, whether individually or in aggregate, that are material to the financial statements. Detection risk could be reduced to zero if an auditor tested every transaction, balance and line item. However, this is usually not practical and the audit is performed using sampling.

### 1.1.4 The audit risk model

Audit risk can be represented by the audit risk model:

\[
\text{Audit risk} = \text{Inherent risk} \times \text{Control risk} \times \text{Detection risk}
\]

The model shows that audit risk has two major components. One is dependent on the entity, and is the risk of material misstatement arising in the financial statements (inherent risk and control risk). The other is dependent on the auditor, and is the risk that the auditor will not detect material misstatements in the financial statements (detection risk).

Auditors will want their overall audit risk to be at an acceptable level, or it will be too risky to carry out the audit. For example, if the chance of the auditors giving an inappropriate opinion and being sued is high, it might be better not to do the audit at all.
It is not in the auditors’ power to affect inherent or control risk. These are risks integral to the client, and the auditor cannot change the level of these risks. The auditors therefore manage overall audit risk by managing detection risk, the only element of audit risk they have control over. The more audit work the auditors carry out, the lower detection risk becomes, although it can never be entirely eliminated due to the inherent limitations of audit. The auditors will decide what level of overall risk is acceptable and then determine a level of audit work so that detection risk is at such a level to achieve the required level of overall audit risk.

It is important to understand that there is not a standard level of audit risk which is generally considered by auditors to be acceptable. This is a matter of audit judgment and so will vary between AEs and from audit to audit.

### CASE STUDY

**Audit risk model**

You are a partner in an AE. Today, you are looking at the audit risk associated with the audit of a new client, TAP. You have been given the following information about TAP.

- TAP is a registered charity that raises money for projects building wells in Africa through musical entertainment. The entertainers consists of volunteers who put on a variety of music and dance shows, the proceeds of which are put towards building the wells.
- A large proportion of TAP’s revenue comes from box office receipts which are taken by the theatre at which they are performing. The theatres usually waive their standard terms for use of the premises and merely take a 10% commission on ticket receipts to cover light and heat and other such expenses. Revenue usually comes in after every booking in the form of a lump sum cheque from the theatre, together with a breakdown of takings and commission.
- TAP also receives donations towards the work. These come from a variety of sources:
  - Cash donations from buckets passed around at the interval of each performance
  - Cash donations on the (rare) occasion that the team does street performances
  - Cash donations made over the phone or by post by interested donors
- TAP has not been audited previously.
- The charity owns an office where the administration is carried out.
- The charity employs an administrator who organises bookings, handles publicity and co-ordinates all the finances.

In considering the audit risk for your AE you noted the following.

**Inherent risk**

Inherent risk is high as inherent risks exist in the following areas.

1. **Cash.** The charity operates with a high number of cash and cheque transactions. A substantial part of their revenue comes from cash donations which are difficult to verify. Also, it is likely that many of the expenses which TAP incurs are also cash expenses. Cash is risky for audit purposes because it is susceptible to loss, miscounting or misappropriation.
2. **Charity.** The theatre company is a charity, and is therefore subject to a high degree of regulation. Charities are classified as public interest entities (PIEs)
which means that higher standards of financial reporting are expected. This raises the risk for our audit.

(iii) Accounting specialist. The charity employs an administrator, but there is no mention of a Chartered Accountant. It is unclear who is going to draft the financial statements (which must comply with the requirements of the Charities Act) but it does not appear that a specialist exists to undertake this job. This increases the risk of a material misstatement.

(iv) Completeness of revenue. As the charity appears to have no control over the primary collection of revenue from box office receipts, there is a risk that revenue is understated and that the theatres have not accounted properly.

(v) Expenditure. The charity expenses may be well-recorded, or they may be difficult to substantiate – this is not clear. It may also be difficult to substantiate payments made to build wells in Africa. We currently have no knowledge about how that aspect of the charity operates. It will be important to check that expenditure is made in accordance with the trust deed. Some essential administrative expense will not necessarily be conducive to the aims of the charity. We must ensure that it is all analysed correctly.

Control risk
There currently appear to be no controls over cash in the charity. Control risk is high. There is also a lack of segregation of duties; the administrator is responsible for all the finances.

Detection risk
This is a first-year audit, so there is little knowledge of the business at present. It is also the first ever audit of the charity, so the comparatives are unaudited. We must make this clear in our auditor's report, and we will need to undertake more detailed work on the opening balances. As the shows are based at different locations, we may find audit evidence difficult to obtain, if it has not been properly returned to the administrative offices.

Conclusion on audit risk
This appears to be a high-risk first-year audit. The nature, timing and extent of audit procedures designed will need to reduce detection risk and thus audit risk to a level acceptable to the AE.

1.1.5 Risk-based auditing
Risk-based auditing refers to the development of auditing techniques that are responsive to risk factors in an audit. As discussed above, the auditors apply judgment to determine what level of risk pertains to different areas of a client's system and devise appropriate audit tests.

This approach should ensure that the greatest audit effort is directed at the areas in which the financial statements are at higher risk of being misstated, so that the chance of detecting misstatements is improved and time is not spent on unnecessary testing of 'safe' areas.

This approach reflects two factors.

(a) The growing complexity of the business environment increases the danger of fraud or misstatement. Factors such as the developing use of computerised systems and the growing internationalisation of business are relevant here.

(b) Pressures are increasingly exerted by audit clients for the auditors to keep fee levels down while an improved level of service is expected.
Risk-based auditing is best illustrated by a small case study.

**CASE STUDY**

**Risk-based auditing**

Your AE has a client which is a small manufacturing company. This company owns the land and buildings in its statement of financial position, which it depreciates over 50 years (buildings only) and has always been valued at cost.

The other major item in the statement of financial position is inventory.

Looking at these two items from the point of view of the AE, the following conclusions can be drawn.

1. There is only a small chance that the audit engagement partner will draw an inappropriate conclusion about land and buildings. The accounting treatment of the land and buildings is straightforward and there are no contentious issues. The cost of the land and buildings is based on fact (not judgment) and sufficient appropriate evidence should be available to support this. Similarly it should be relatively straightforward to recalculate accumulated depreciation.

2. In a manufacturing company, inventory is likely to be far more complex. There may be a significant number of lines to count and value, the quantity will change all the time, inventory may grow obsolete. The chance of the audit engagement partner drawing an inappropriate conclusion about inventory is higher than the risk in connection with land and buildings.

The auditors will have to do less work to render audit risk acceptable for land and buildings than on inventory. The audit risk (or risk-based) approach will mean doing less work on land and buildings than on inventory.

1.2 Business risk

**IMPORTANT**

SSA 315 requires the auditor to consider business risks and to adapt the audit plan accordingly.
**KEY TERMS**

**BUSINESS RISK** is a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. (SSA 315.4)

It can generally be split into three components:

**FINANCIAL RISKS** are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.

**OPERATIONAL RISKS** are the risks arising with regard to operations, for example, the risk that a major supplier will be lost and the company will be unable to operate.

**COMPLIANCE RISK** is the risk that arises from non-compliance with the laws and regulations that surround the business. The compliance risk attaching to environmental issues, for example, is discussed in Chapter 17.

<table>
<thead>
<tr>
<th>Risk</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial risk</td>
<td>Entity is not a going concern</td>
</tr>
<tr>
<td></td>
<td>Interest rate changes</td>
</tr>
<tr>
<td></td>
<td>Exchange rate fluctuations</td>
</tr>
<tr>
<td>Operational risk</td>
<td>Loss of orders</td>
</tr>
<tr>
<td></td>
<td>Physical damage to assets</td>
</tr>
<tr>
<td></td>
<td>Loss of key staff</td>
</tr>
<tr>
<td>Compliance risk</td>
<td>Non-compliance with laws and regulations, eg the Companies Act, environmental legislation, taxation or accounting standards</td>
</tr>
</tbody>
</table>

It is possible for some business risks to overlap into more than one category. For instance, exposure to foreign exchange movements is a financial risk, but it can also be an operational risk if the currency conversion moves against the entity and makes its products more expensive.

**1.2.1 Objectives, strategies and related business risks**

The auditor shall obtain an understanding of the entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement. In order to do this the auditor may consider the following matters.

<table>
<thead>
<tr>
<th>Matter to consider</th>
<th>Example of potential related business risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry developments</td>
<td>The entity does not have the personnel or expertise to deal with the changes in the industry</td>
</tr>
<tr>
<td>New products and services</td>
<td>There is increased product liability</td>
</tr>
<tr>
<td>Expansion of the business</td>
<td>The demand has not been accurately estimated</td>
</tr>
<tr>
<td>New accounting requirements</td>
<td>Incomplete or improper implementation, or increased costs</td>
</tr>
<tr>
<td>Regulatory requirements</td>
<td>There is increased legal exposure</td>
</tr>
<tr>
<td>Current and prospective financing requirements</td>
<td>The loss of financing due to the entity’s inability to meet requirements</td>
</tr>
</tbody>
</table>
7: Risk assessment

<table>
<thead>
<tr>
<th>Matter to consider</th>
<th>Example of potential related business risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of IT (covered in detail in Chapter 18)</td>
<td>Systems and processes are incompatible</td>
</tr>
<tr>
<td>The effects of implementing a strategy particularly any effects that will lead to new accounting requirements</td>
<td>Incomplete or improper implementation</td>
</tr>
</tbody>
</table>

1.2.2 The entity's risk assessment process

The auditor will need to identify the business risks at the entity being audited. SSA 315 requires the auditors to consider an entity's process for assessing its own business risks.

SSA 315.15

The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;
(b) Estimating the significance of the risks;
(c) Assessing the likelihood of their occurrence; and
(d) Deciding about actions to address those risks.

This process is called the entity's risk assessment process and most, but not all, entities will have one. Where such a process exists, and the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.

If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

So, in addition to considering the entity's risk assessment, the auditors may need to use their own methods to identify business risks. The techniques and models used by the auditor to identify key business risks are likely to parallel those used by management. There are various tools used to do this that you may have come across before. They are listed and briefly described below.

- SWOT analysis – considers the internal and external factors affecting the position of the business (strengths, weaknesses, opportunities, threats)
- The five forces model – examines the forces affecting an industry's competitive environment (customers, suppliers, competitors, new entrants, substitutes)
- The PEST analysis – considers the impact of external forces upon the company (PEST is Political, Economic, Social, Technological)
- Porter's value chain – relates a company's resource profile to its strategic performance in obtaining competitive advantage

1.3 Financial statement implications

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. The auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.
The following table illustrates some potential business risks and demonstrates how these could have an impact on the financial statements and therefore the audit.

<table>
<thead>
<tr>
<th>Potential business risk</th>
<th>Immediate financial statement implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic pressures causing reduced unit sales and eroding margins</td>
<td>Inventory values (SFRS(I) 1-2)</td>
</tr>
<tr>
<td></td>
<td>Going concern</td>
</tr>
<tr>
<td>Economic pressures resulting in demands for extended credit</td>
<td>Receivables recoverability</td>
</tr>
<tr>
<td>Product quality issues related to inadequate control over supply chain and transportation damage</td>
<td>Inventory values – net realisable value and inventory returns</td>
</tr>
<tr>
<td>Customer dissatisfaction related to inability to meet order requirements</td>
<td>Going concern</td>
</tr>
<tr>
<td>Customer dissatisfaction related to invoicing errors and transportation damage</td>
<td>Receivables recoverability</td>
</tr>
<tr>
<td>Unacceptable service response call rate related to poor product quality</td>
<td>Going concern</td>
</tr>
<tr>
<td></td>
<td>Litigation – provisions and contingencies</td>
</tr>
<tr>
<td></td>
<td>Inventory – net realisable value</td>
</tr>
<tr>
<td>Out of date IT systems affecting management’s ability to make informed decisions</td>
<td>Pervasive</td>
</tr>
</tbody>
</table>

**ALERT**

You must be able to distinguish between audit risk and business risk. In an exam question there may be some risks that are both business risks and audit risks. You should be able to approach the question from the perspective of an auditor in identifying and explaining risks.
Question 7.1

Fragrant Flowers Pte Ltd is a small company offering garden landscaping and maintenance services to parks and businesses. It is partly owned by three business associates, Mr Rose, Mr Carnation and Ms Tulip, who each hold 10% of the shares. The major shareholder is the parent company, Poppy Ltd. This company owns shares in 20 different companies, which operate in a variety of industries. One of them is a garden centre, and Fragrant Flowers Pte Ltd regularly trades with it. Poppy Ltd is in turn owned by a parent, YYY Holdings Ltd.

The management structure at Fragrant Flowers Pte Ltd is simple. Of the three non-corporate shareholders, only Mr Rose has any involvement in management. He runs the day to day operations of the company (marketing, sales, purchasing etc) although the company employs 25 landscape gardeners to actually carry out projects. The accounts department employs a purchase clerk and a sales clerk, who deal with all aspects of the function. The sales clerk is Mr Rose's daughter, Doreen. Mr Rose authorises and produces the payroll. The company ledgers are kept on Mr Rose's personal computer. Two weeks after the year-end, the sales ledger records were severely damaged by a virus. Doreen has a single printout of the balances as at year-end, which shows the total owed by each customer.

Fragrant Flowers Pte Ltd owns the equipment which the gardeners use and they pay them a salary and a bonus based on a percentage of salary. Mr Rose is remunerated entirely on a commission basis relating to sales and, as a shareholder he receives dividends annually, which are substantial.

Fragrant Flowers Pte Ltd does not carry any inventory. When materials are required for a project, they are purchased on behalf of the client and charged directly to them. Most customers pay within the 60 day credit period, or take up the extended credit period which Fragrant Flowers Pte Ltd offers. However, there are a number of accounts that appear to have been outstanding for a significant period.

Doreen and her father do not appear to have a very good working relationship. She does not live at home and her salary is not significant. However, she appears to have recently purchased a sports car, which is not a company car.

The audit partner has recently accepted the audit of Fragrant Flowers Pte Ltd. You have been assigned the task of planning the first audit.

Required

Identify and explain the audit risks relevant to Fragrant Flowers Pte Ltd.

SECTION SUMMARY

Auditors must assess the risk of material misstatements arising in financial statements and carry out procedures in response to assessed risks.
2 Analytical procedures

SECTION INTRODUCTION

Analytical procedures are a useful tool in performing risk assessments.

Guidance on analytical procedures is given in SSA 520 Analytical Procedures.

Analytical procedures must be used as follows:

- Risk assessment procedures (in accordance with SSA 315)
- Forming an overall conclusion near the end of the audit (in accordance with SSA 520)

Analytical procedures may also be used as substantive procedures.

Analytical procedures consist of comparing items, for example, current year financial information with prior year financial information, and analysing predictable relationships, for example, the relationship between receivables and credit sales.

2.1 Use of analytical procedures generally

Analytical procedures provide valuable insights when assessing risks and planning the audit. Analytical procedures are also covered in Chapter 13 when looking at reviews and assurance engagements and Chapter 14 on prospective financial information.

2.2 Practical techniques

Broadly, two types of analytical procedures are commonly used by auditors: standard ratio calculations and trend analysis.

<table>
<thead>
<tr>
<th>Commonly used ratios</th>
<th>Payables and purchases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit margins, in total and by product, area and months/quarter (if possible)</td>
<td>Inventory and cost of sales</td>
</tr>
<tr>
<td>Receivables ratio (average collection period)</td>
<td>Non-current assets and depreciation, repairs and maintenance expense</td>
</tr>
<tr>
<td>Inventory turnover ratio (inventory divided into cost of sales)</td>
<td>Intangible assets and amortisation</td>
</tr>
<tr>
<td>Current ratio (current assets to current liabilities)</td>
<td>Loans and interest expense</td>
</tr>
<tr>
<td>Quick or acid test ratio (liquid assets to current liabilities)</td>
<td>Investments and investment income</td>
</tr>
<tr>
<td>Gearing ratio (debt capital to equity capital)</td>
<td>Receivables and receivables expense</td>
</tr>
<tr>
<td>Return on capital employed (profit before tax to total assets less current liabilities)</td>
<td>Receivables and sales</td>
</tr>
</tbody>
</table>

Related accounts useful in trend analysis

- Payables and purchases
- Inventory and cost of sales
- Non-current assets and depreciation, repairs and maintenance expense
- Intangible assets and amortisation
- Loans and interest expense
- Investments and investment income
- Receivables and receivables expense
- Receivables and sales
Ratios mean very little when used in isolation. They should be calculated for previous periods and for comparable companies.

In addition to looking at the more usual ratios the auditors should consider examining other ratios that may be relevant to the particular client's business, such as revenue per passenger mile for an airline operator client, or fees per partner for a professional office.

### 2.2.1 Key ratios: profitability

**LEARN**

\[
\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Total assets less current liabilities}} \times 100\%
\]

\[
\text{Capital employed} = \frac{\text{Shareholders' equity plus non-current liabilities}}{(\text{or total assets less current liabilities})}
\]

Return on capital employed (ROCE) is a measure of how efficiently a company is using its capital to generate profits. The higher the ROCE, the more efficiently capital is being used. It is a useful ratio to apply in capital intensive industries, such as utilities.

There are three main analytical procedures which can be performed on ROCE.

(a) The change in ROCE from one year to the next can be examined.

(b) The ROCE being earned by other companies, if this information is available, can be compared with the ROCE of this company.

(c) A comparison of the ROCE with current market borrowing rates may be made.

ROCE differs from return on equity (ROE) which is a measure of how efficiently the company is using shareholders' equity to generate profits.

\[
\text{ROE} = \frac{\text{Profit before interest and taxation}}{\text{Shareholders'equity}} \times 100\%
\]

You also need to be familiar with profit margin and asset turnover, which both tie in with the ROCE. The relationship between the three ratios can be shown mathematically.

**LEARN**

\[
\text{Profit margin} \times \text{Asset turnover} = \text{ROCE}
\]

\[\therefore \frac{\text{PBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Capital employed}}\]

It is common to think that a high profit margin is good, and a low asset turnover means sluggish trading. In broad terms, this is so. But there is a trade-off between profit margin and asset turnover, and you cannot look at one without allowing for the other.

(a) A high profit margin means a high profit per every dollar of sales. However, if sale prices were high to begin with, this would imply a low volume of sales, indicating a low asset turnover.

(b) A high asset turnover ratio would imply a high volume of sales, a trade-off could be that sales prices have to be kept down, which may result in lower profit margins.
2.2.2 Revision of key ratios: debt

**LEARN**

Debt ratio = \( \frac{\text{Total debt}}{\text{Total assets}} \times 100\% \)

There is no absolute guide to the maximum safe debt ratio, but as a very general guide, you might regard 50% as a safe limit to debt. In practice, many companies operate successfully with a higher debt ratio than this, but 50% is nonetheless a helpful benchmark. In addition, if the debt ratio is over 50% and getting worse, the company's debt position will be worth looking at more carefully.

**LEARN**

Gearing = \( \frac{\text{Total debt}}{\text{Total equity}} \times 100\% \)

As with the debt ratio, there is no absolute limit to what a gearing ratio ought to be. A company with a gearing ratio of more than 50% is said to be high-gereared (whereas low gearing means a gearing ratio of less than 50%). A high-gereared company is likely to face difficulty in the future when it wants to borrow even more, unless it can also boost its shareholders' capital, either with retained profits or by a new share issue.

**LEARN**

Interest cover ratio = \( \frac{\text{Profit before interest and tax}}{\text{Interest expenses}} \)

A low interest cover would indicate the company is having difficulty financing its debts. As a result there is an increased risk that there will be little or no profits available to distribute by way of dividend.

**LEARN**

Current ratio = \( \frac{\text{Current assets}}{\text{Current liabilities}} \)  
Quick ratio = \( \frac{\text{Current assets less inventory}}{\text{Current liabilities}} \)

Both the current ratio and the quick ratio offer an indication of the company's liquidity position, but the absolute figures should not be interpreted too literally. It is often theorised that an acceptable current ratio is 1.5 and an acceptable quick ratio is 0.8, but these should only be used as a guide.

Finally, you should also be comfortable with the ratios of the cash operating cycle – receivables days, payables days, inventory holding period.
2.2.3 Revision of key ratios: shareholders' investment ratios

**LEARN**

Dividend cover is a ratio of: \( \frac{\text{Earnings per share}}{\text{Dividend per (ordinary) share}} \)

It shows the proportion of profit for the year that is available for distribution to shareholders that has been paid (or proposed) and what proportion will be retained in the business to finance future growth. A dividend cover of 2 times would indicate that the company had paid 50% of its distributable profits as dividends, and retained 50% in the business to help to finance future operations. Retained profits are an important source of funds for most companies, and so the dividend cover can in some cases be quite high.

The Price/Earnings (P/E) ratio is the ratio of a company's current share price to the earnings per share. A high P/E ratio indicates strong shareholder confidence in the company and its future, e.g., in profit growth, and a lower P/E ratio indicates lower confidence.

**LEARN**

\[
\text{Dividend yield} = \frac{\text{Dividend on the share for the year}}{\text{Current market value of the share (ex div)}} \times 100\%
\]

(a) The dividend per share is taken as the dividend for the previous year.
(b) Ex-div means that the share price does not include the right to the most recent dividend.

Shareholders look for both dividend yield and capital growth. Obviously, dividend yield is therefore an important aspect of a share's performance.

2.2.4 Other analytical techniques

Other analytical techniques include:

(a) **Comparisons of financial information.** For example, the comparison of key expense accounts taking into account any known changes could highlight unusual increases or decreases.

(b) **Examining related accounts** in conjunction with each other. Often revenue and expense accounts are related to statement of financial position accounts and comparisons should be made to ensure relationships are reasonable.

(c) **Trend analysis.** Sophisticated statistical techniques can be used to compare this period with previous periods (see Section 2.2.5 below).

(d) **Reasonableness tests.** These involve calculating expected value of an item and comparing it with its actual value, for example, for straight-line depreciation.

\[
\text{Charge in statement of profit or loss and other comprehensive income} = (\text{Cost} + \text{Additions} – \text{Disposals}) \times \text{Depreciation %}
\]

(e) **Scanning analytics.** This technique involves searching within accounts or other data to find anomalies in individual items.
2.2.5 Trend analysis

As we have seen in Section 2.2, certain accounts and line items are related and dependent on each other. An auditor can use these to depict a historical trend or relationship. This relationship can be compared to other audit evidence obtained to assess consistency with it and also to identify unusual areas for further audit investigation.

Information technology can be used in trend analysis, to enable auditors to see trends graphically with relative ease and speed.

Methods of trend analysis include:

- Scatter graphs
- Bar graphs
- Pie charts
- Any other visual representations
- Time series analysis
- Statistical regression

Time series analysis involves techniques such as eliminating seasonal fluctuations from sets of figures, so that underlying trends can be analysed. This is illustrated below.

**Example**

Line 1 in the diagram shows the actual sales made by a business. There is a clear seasonal fluctuation in the run-up to Christmas, in December. Line 2 shows a level of sales with ‘expected seasonal fluctuations’ having been stripped out. It shows that sales were lower than expected for December and continued to be low, despite December sales being higher than the other months.

In this analysis the seasonal fluctuations have been estimated. This analysis is useful however, because the estimate is likely to be based on past performance, so the conclusion from this is that there might be a problem:

- Sales are below the levels of previous years
- Sales are below expectation
Kitchens To Go Pte Ltd (‘KTG’) is a successful retailer of budget fitted kitchens. Retail showrooms display all kitchen designs and specialist kitchen designers produce 3D kitchen plans for customers. Once a customer has placed an order, KTG aims to deliver a kitchen within seven days. KTG do not have their own kitchen fitting team.

You are a member of the audit team of KTG for the year ended 31 December 20X2 and are responsible for carrying out audit procedures over revenue. The finance manager has informed you that approximately 40% of sales comprise three KTG kitchens, Oak, Ash and Elm. You have been provided with the following information by the finance manager at KTG.

<table>
<thead>
<tr>
<th>Year</th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Floor space (sq m)</td>
<td>9,544</td>
<td>10,555</td>
<td>13,022</td>
</tr>
<tr>
<td>Total revenue ($k)</td>
<td>106,662</td>
<td>115,698</td>
<td>141,535</td>
</tr>
<tr>
<td>Gross profit from Oak ($k)</td>
<td>4,025</td>
<td>4,555</td>
<td>5,644</td>
</tr>
<tr>
<td>Gross profit from Ash ($k)</td>
<td>4,755</td>
<td>5,044</td>
<td>5,248</td>
</tr>
<tr>
<td>Gross profit from Elm ($k)</td>
<td>4,195</td>
<td>4,653</td>
<td>5,899</td>
</tr>
</tbody>
</table>

**Required**

Use trend analysis to perform analytical procedures on the data provided by KTG.

### 2.3 Use of analytical procedures as risk assessment procedures

The auditor’s risk assessment procedures must include analytical procedures. This enhances the auditor’s understanding of the business. These procedures may:

- Identify aspects of the entity of which the auditor was unaware, including newly identified risks
- Provide a basis for designing and implementing responses to the assessed risks
- Help identify the existence of unusual transactions or events
- Assist the auditor in identifying risks of fraud and error

In other words analytical procedures at the planning stage help to identify risk and assists the auditor in planning the audit approach. Ratio analysis and identification of trends between one year and the next are particularly useful at this stage. However, at the planning stage of the audit, as compared to the rest of the audit, data forming the basis of analytical procedures is likely to be aggregated at a high level. The results therefore only provide a broad initial indication about whether a material misstatement may exist. Generally, analytical procedures are amongst the most efficient of audit procedures, as they cover most of the assertions, but substantive procedures are still required to audit significant accounts.

### 2.3.1 Practical approach

Having identified a particular problem or unusual fluctuation the auditor must explore why this variation has taken place. For example, changes in revenue may be due to changes in sales volume or changes in sales price or a combination of the two. Factors that may have caused these changes include:

- More customers
- Different customers
- New outlets
- One-off transactions
- Error
- Fraud
Considering factors like these will assist the auditor in assessing the risk of material misstatement. Remember that whilst fraud is a key issue, misstatement due to unintentional error or unconscious bias is more common in practice.

Any remaining problems or unanswered questions are then investigated during the audit fieldwork.

### 2.4 Use of analytical procedures as substantive procedures

SSA 520 provides guidance in this area.

#### SSA 520.3

The objectives of the auditor are:

- To obtain relevant and reliable audit evidence when using substantive analytical procedures
- To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

There are a number of factors which the auditors should consider when deciding whether to use analytical procedures as substantive procedures.

<table>
<thead>
<tr>
<th>Factors to consider</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>The plausibility and predictability of the relationships identified for comparison and evaluation</td>
<td>The strong relationship between certain selling expenses and revenue in businesses where the sales force is paid by commission.</td>
</tr>
<tr>
<td>The objectives of the analytical procedures and the extent to which their results are reliable</td>
<td>Where there are common relationships between items such as gross profit and revenue, where there are constant or known profit margins and limited changes in the mix of goods sold. It may be less appropriate to use analytical procedures in relation to one-off large transactions as opposed to large numbers of small, similar transactions where it is likely to be very effective.</td>
</tr>
<tr>
<td>The detail to which information can be analysed</td>
<td>Analytical procedures may be more effective when applied to financial information or individual sections of an operation such as individual factories or shops.</td>
</tr>
<tr>
<td>The availability of information</td>
<td>What kind of information does the entity produce which can be used? Can it be available in time for the audit? Financial: are budgets or forecasts available? Non-financial: eg the number of units produced or sold.</td>
</tr>
<tr>
<td>The relevance of the information available</td>
<td>Whether the budgets are established as results to be expected rather than as tough targets (which may well not be achieved)</td>
</tr>
<tr>
<td>The reliability of the information available</td>
<td>Information being used for analytical procedures is more reliable if it is obtained from outside the entity.</td>
</tr>
<tr>
<td>The comparability of the information available</td>
<td>Comparisons with average performance in an industry may be of little value if a large number of companies differ significantly from the average.</td>
</tr>
<tr>
<td>The knowledge gained during previous audits</td>
<td>The effectiveness of the accounting and internal controls. The types of problems giving rise to accounting adjustments in prior periods.</td>
</tr>
</tbody>
</table>
Factors which should also be considered when determining the reliance that the auditors should place on the results of substantive analytical procedures are:

<table>
<thead>
<tr>
<th>Reliability factors</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other audit procedures directed towards the same financial statements assertions</td>
<td>Other procedures auditors undertake in reviewing the collectability of receivables, such as the review of subsequent cash receipts, may confirm or disprove questions arising from the application of analytical procedures to a profile of customers' accounts which lists for how long monies have been owed.</td>
</tr>
<tr>
<td>The accuracy with which the expected results of analytical procedures can be predicted</td>
<td>Auditors normally expect greater consistency in comparing the relationship of gross profit to sales from one period to another than in comparing expenditure which may or may not be made within a period, such as research or advertising.</td>
</tr>
<tr>
<td>The frequency with which a relationship is observed</td>
<td>A pattern repeated monthly as opposed to annually.</td>
</tr>
</tbody>
</table>

2.4.1 Practical approach

Substantive analytical procedures involve five key steps:

**STEP 1**
Determine the suitability of analytical procedures for the given assertion.

**STEP 2**
Evaluate the reliability of the data.

**STEP 3**
Formulate expectations.

**STEP 4**
Calculate an ‘acceptable difference’ and compare expected value to actual amount.

**STEP 5**
Obtain possible reasons for variance and evaluate impact on audit.

Each of these steps is explained below.
Determine the suitability of analytical procedures for the given assertion

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are deficient, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Evaluate the reliability of the data

The reliability of data is determined by a number of factors:

- The source of the information; if it comes from outside the audited entity it can be considered to be more independent
- The extent to which the information is comparable, for example to industry-wide data relevant to the audited entity
- The nature and relevance of the information available
- The controls that are in place over the preparation of the information to ensure that it is complete, accurate and valid

Formulate expectations

The auditor develops an expectation of figures in the financial statements using prior year financial statements, budgets, industry information etc. The expectation should be developed so that any material difference between this and the actual values in the financial statements indicates a potential misstatement.

To carry out this procedure, the auditor will need access to industry data and environmental factors affecting that industry. Access to the financial statements is not required at this time as this could prejudice the expectations of the auditor.

Example

Confirming the accuracy of salary expense in the statement of profit or loss and other comprehensive income. The prior year salary figure can be obtained from the prior year financial statements. This year's salary can be estimated using the average number of employees (from personnel records) and the average salary again from personnel records. Changes in numbers of staff can be checked as reasonably accurate from knowledge of the industry sector (expanding or declining?) and initial knowledge of the client's business (expanding or contracting?). Average number of employees multiplied by average salary should give an approximate salary cost for the financial statements.

Calculate an 'acceptable difference'

In making this comparison, the auditor must decide the amount of deviation which will be allowed between the expected and actual figures – in other words set a materiality limit. If the difference between the two figures exceeds this materiality threshold then further investigation will be required in an attempt to explain the difference. If the difference is below the materiality threshold then no further investigation will be necessary.

Compare expected value to actual recorded amount

The auditor compares the expected value with the actual amount in the financial statements. Using our example, the actual salary expense in the statement of profit or loss and other comprehensive income can be found. Assuming that salary cost does not involve overtime, then the estimated amount and the actual should be relatively close. Materiality may be set at say 10% difference between the two figures in the prior step.
Obtain possible reasons for variances and evaluate impact on audit

The auditor attempts to identify reasons for the difference between the expected figure and the actual figure in the financial statements. The level of investigation depends to some extent on the accuracy of the auditor's expected figure. If the expected figure is precise, then more investigation will be expected for a smaller difference. Where the expected figure is an imprecise estimation, the difference between the expected and actual figures might be seen as a result of the inaccuracy of the estimation, so long as it is not too large. A large difference will still require investigation work.

Corroboration of any difference will normally start by obtaining management representations. However, these representations should be treated with scepticism due to the inherent problem of reliability of this source of evidence. Evidence from other sources will be required to ensure management representations are accurate.

If the expected and actual salary expenses are more than 10% different, then further work is needed to determine why this is the case. Initial discussions with management may highlight areas where costs will be different, e.g. expansion in the last month of the year may skew the average number of managers to a larger number than expected. Or a salary increase late in the year may also inflate expectations of average salary. These management representations will be checked back in detail to the salary records.

Finally, the auditor will evaluate the impact of any unresolved differences on audit work and the financial statements. A large difference may mean that additional substantive testing is required on the account balance to determine its accuracy. Any small remaining difference may be ignored as immaterial.

Hopefully, differences in expected and actual salaries will be resolved and any remaining residual difference will be immaterial. However, where differences remain, additional substantive testing of the salaries figure will be required.

2.4.2 Investigating results

If analytical procedures produce results that are inconsistent with other relevant information or expected values, the auditors should investigate this by making inquiries of management and performing other audit procedures as necessary.

2.5 Using analytical procedures when forming an overall conclusion

The aim of analytical review procedures performed when forming an overall conclusion is to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion. In other words, rather than looking at individual balances the auditor now needs to look at the financial statements as a whole and determine whether they are consistent with the auditor's understanding of the business. The aim at this stage is not to obtain additional substantive evidence but to identify any variances or inconsistencies with the substantive audit evidence obtained thus far. In this case SSA 315 requires that the auditor revises the assessment of the risks of material misstatement and modifies planned audit procedures accordingly. Review procedures are discussed further in Chapter 12.

Question 7.3

Geylang Ltd is a ladies fashion retailer operating a chain of shops from a small head office. Your AE has been the auditor of Geylang Ltd for some years.

During the current year one shop was closed and the product range of the remaining eight shops was extended to include accessories and footwear.

The company has a computerised accounting system and the audit manager is keen to ensure that the audit is as efficient as possible.

As senior in charge of the audit you are currently planning the audit work for trade payables and you have obtained the following draft financial statements from the client.
Summary statement of profit or loss
Revenue $8,173 $5,650
Gross profit $1,717 $1,352

Summary statement of financial position
Non-current assets $2,799 $2,616
Current assets $1,746 $1,127
Trade payables $991 $718
Other payables $514 $460

**Required**
State what observations you can draw from the extracts from the draft financial statements and how they may affect your audit of trade payables.

### SECTION SUMMARY

Analytical procedures must form part of the risk assessment procedures and must be used when forming an overall conclusions near the end of the audit. They may also form part of the substantive procedures.

### 3 Responses to audit risk

#### SECTION INTRODUCTION

The auditor must formulate an approach to assessed risks of material misstatement.

#### 3.1 The auditor’s responses to assessed risks

**SSA 330.3 The Auditor’s Responses to Assessed Risks** states that the objective of the auditor is to obtain sufficient, appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

**3.1.1 Overall responses**

Overall responses include emphasising to the audit team the need for professional scepticism, assigning additional/alternative staff to the audit, using experts, providing more supervision on the audit and incorporating more unpredictability into the audit.

The evaluation of the control environment that will have taken place as part of the assessment of the client’s internal control systems will help the auditor determine whether they are going to take a substantive approach (focusing mainly on substantive procedures) or a combined approach (tests of control and substantive procedures). We will look at these in more detail in Chapter 8.
3.1.2 Responses to the risks of material misstatement at the assertion level

**SSA 330.6**
The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

In designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the following.

- The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk)
- Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures)

Additionally, the auditor shall obtain more persuasive audit evidence the higher the auditor's assessment of risk.

**SSA 330.18**
Irrespective of the assessed risks of material misstatement the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.

The auditor must carry out substantive procedures on material items. As you know, substantive procedures fall into two categories: substantive analytical procedures and tests of details. (We have looked at substantive analytical procedures in Section 2 of this chapter. Other audit procedures including tests of details are covered in Chapters 8, 9 and 10.) The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- Agreeing the financial statements to the underlying accounting records
- Examining material journal entries
- Examining other adjustments made in preparing the financial statements

For significant risks the auditor must perform substantive procedures that are specifically responsive to that risk. Where the approach consists only of substantive procedures these must include tests of details. High risk areas require evidence with a high level of reliability. For this reason the auditor should consider obtaining information from appropriate external parties.

3.1.3 Documentation

The auditor shall include in the audit documentation:

- The overall responses to address the assessed risks of material misstatement at the financial statement level
- Nature, extent and timing of further audit procedures performed linked to the assessed risks at the assertion level
- The results of the audit procedures, including the conclusions where these are not otherwise clear
- If the auditors plan to rely on evidence about the effectiveness of controls from previous audits, conclusions about how this is appropriate

3.1.4 Audit Practice Bulletin No 1 of 2016

In June 2016, ACRA published Audit Practice Bulletin (APB) No 1 of 2016 Identifying, Assessing and Responding to Risks of Material Misstatement in the Financial Statements. This APB was a response to the observation that public accountants were often unable to identify appropriate significant risks during inspections carried out via the Practice Monitoring Programme. The inability to identify risks led to
inappropriate and/or inadequate audit procedures being performed, which did not really address the risks of the entity being audited.

The APB provides ‘guidance on performing the required risk assessment to identify the significant risks in an audit engagement before carrying out the necessary audit procedures to address such risks.’

### 3.2 Directional testing

Directional testing is a method of undertaking detailed substantive testing. Substantive testing seeks to discover misstatements and omissions, and the discovery of these will depend on the direction of the test.

Broadly speaking, substantive procedures can be said to fall into two categories:

(a) Tests to discover misstatements (resulting in over- or understatement). These tests will start with the accounting records in which the transactions are recorded and check from the entries to supporting documents or other evidence. Such tests should detect any overstatement and also any under-statement through causes other than omission.

(b) Tests to discover omissions (resulting in understatement). These tests must start from outside the accounting records and then check back to those records. Understatements through omission will never be revealed by starting with the account itself as there is clearly no chance of selecting items that have been omitted from the account.

The concept of directional testing derives from the principle of double entry bookkeeping, in that for every debit there is a corresponding credit, (assuming that the double entry is complete and that the accounting records balance). Therefore, any misstatement of a debit entry will result in either a corresponding misstatement of a credit entry.

By designing audit tests carefully the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books. Tests are therefore designed in the following way.

The matrix set out below demonstrates how directional testing is applied to give assurance on all account areas in the financial statements.

<table>
<thead>
<tr>
<th>Type of account</th>
<th>Purpose of primary test</th>
<th>Primary test also gives comfort on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Overstatement (O)</td>
<td>Assets (O), Liabilities (U), Income (O), Expenses (U)</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Understatement (U)</td>
<td>Assets (O), Liabilities (U), Income (O), Expenses (U)</td>
</tr>
<tr>
<td>Income</td>
<td>Understatement (U)</td>
<td>Assets (O), Liabilities (U), Income (O), Expenses (U)</td>
</tr>
<tr>
<td>Expense</td>
<td>Overstatement (O)</td>
<td>Assets (O), Liabilities (U), Income (O), Expenses (U)</td>
</tr>
</tbody>
</table>

A test for the overstatement of an asset simultaneously gives comfort on understatement of other assets, overstatement of liabilities, overstatement of income and understatement of expenses.

So, by performing the primary tests shown in the matrix, the auditors obtain audit assurance in other audit areas. Successful completion of the primary tests will therefore result in them having tested all account areas both for overstatement and understatement.

The major advantage of the directional audit approach is its cost effectiveness.

(a) Assets and expenses are tested for overstatement only, and liabilities and income for under-statement only, that is, items are not tested for both overstatement and understatement.

(b) It audits directly the more likely types of transactional misstatement, ie unrecorded income and improper expense (arising intentionally or unintentionally).
Question 7.4

You are an audit manager at Eastlake and Pond. You recently attended a meeting with the CEO of an audit client, Go Shop Ltd, and the new audit partner assigned to the audit. The audit partner used the meeting to become more familiar with the client.

Go Shop Ltd is a large building company set up by the CEO, who has been in this position since incorporation. It operates across the country, purchasing land and building retail malls, which the company then manages. You are familiar with the client, as you have taken part in the audit for the last three years. The other key member of the board is the finance director, who set up the business with the CEO. The finance director is a qualified Chartered Accountant, and the accounting systems and procedures at Go Shop Ltd have always appeared to operate effectively.

You took minutes of the meeting, which are given below.

Minutes of a meeting between audit partner and CEO, 30 March 20X2

- Audit partner introduced to the CEO
- Brief history of the business given by the CEO
- Currently, the majority of income is from the property management side of the business, as the building market is becoming saturated
- With interest rates set to rise, the CEO is less keen to borrow and build
- CEO commented that customers were staying away from retail malls. This was partly due to the rise in internet shopping
- However, some of the fall in customer numbers could be attributed to a rise in interest rates and was likely to be temporary
- CEO commented that the first months of the year are always poor for retail
- CEO noted there had been a small increase in the number of empty units in the retail malls
- When asked about the current proposed legislation before the Government concerning quality standards in the building trade, the CEO commented that it seemed like a ‘load of nonsense’, and expressed some dissatisfaction with the proposals
- Audit partner explained that the legislation is more than likely to be passed and that the stringent standards would have far-reaching and expensive effects on most builders in the country
- CEO disagrees with opinion of audit partner on the new legislation
- Audit partner enquired as to whether there were any anticipated developments in the business, which the AE should know about
- CEO made reference to the finance director’s plans to retire from full-time work in the business
- When asked about plans to replace the finance director, the CEO commented that they was hoping to persuade the finance director to stay on, as the finance director deals with all the financial side, and they would be lost without him/her
- The audit partner tried to enquire how firm the finance director’s retirement plans were, but the CEO was not forthcoming
After the meeting, the audit partner asked you to ring the finance director and discuss the retirement plans. The finance director confirms the intention to retire. The finance director also informs you the family are planning to emigrate to Australia and that they are not keen to put back these plans.

The finance director asked about the possibility of Eastlake and Pond assisting in the recruitment process for a replacement finance director. The finance director does not feel that the CEO has the technical ability to recruit someone alone, and has not accepted the situation enough to recruit before their retirement. The finance director asks about the possibility of someone being seconded to the company from Eastlake and Pond to cover the finance director position after they have left and before a replacement is found.

The audit partner is keen to reappraise the audit strategy taken towards the audit of Go Shop Ltd, as the partner feels the audit could be conducted more efficiently than it has in the past. Historically the audit has been highly substantive.

**Required**

(a) Identify and explain the key business risks that exist at Go Shop Ltd.
(b) Propose and justify a strategy for the audit of Go Shop Ltd.
(c) Discuss the ethical implications for the audit of the two suggestions made by the finance director.

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**SECTION SUMMARY**

The auditor must develop an audit strategy in response to the assessed risk of material misstatement. The auditor will need to determine the overall approach and the extent to which further audit procedures include tests of controls and substantive procedures.

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**4 Fraud and error**

**SECTION INTRODUCTION**

Misunderstanding of the auditor's responsibilities in respect of fraud is a major component of the 'expectation gap'.

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**4.1 What is fraud?**

**KEY TERM**

**Fraud** is an intentional act by one or more individuals among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage.

(SSA 240.11a)
Fraud is a wide legal concept, but the auditor's main concern is with fraud that causes a material misstatement in the financial statements. It is distinguished from error, which is when a material misstatement is caused by mistake, for example, in the application of an accounting policy. Specifically, there are two types of fraud causing material misstatement in financial statements:

- Fraudulent financial reporting
- Misappropriation of assets

### 4.1.1 Fraudulent financial reporting

This may include:

- Manipulation, falsification or alteration of accounting records/supporting documents
- Misrepresentation (or omission) of events, transactions or other significant information in the financial statements
- Intentional misapplication of accounting principles

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively, for example, by recording fictitious journal entries or improperly adjusting assumptions or estimates used in financial reporting.

Aggressive earnings management is a topical issue and, at its most aggressive, may constitute fraudulent financial reporting. Auditors should consider issues such as inappropriate revenue recognition, accruals, liabilities, provisions and reserves accounting and large numbers of immaterial breaches of financial reporting requirements to see whether together, they constitute fraud.

**ALERT**

Revenue recognition is perhaps the single most common area of fraudulent financial reporting. If a scenario in your exam features complex or material revenue recognition, immediately think 'risk of fraudulent financial reporting'.

### 4.1.2 Misappropriation of assets

This is the theft of the entity's assets (for example, cash, inventory). Employees may be involved in such fraud in small and immaterial amounts, however, it can also be carried out by management for larger items who may then conceal the misappropriation, for example by:

- Embezzling receipts (for example, diverting them to private bank accounts)
- Stealing physical assets or intellectual property (inventory, sales data)
- Causing an entity to pay for goods not received (payments to fictitious vendors)
- Using assets for personal use

### 4.2 Responsibilities with regard to fraud

Management and those charged with governance in an entity are primarily responsible for preventing and detecting fraud. It is up to them to put a strong emphasis within the company on fraud prevention. This will include establishing a strong control environment, with an emphasis on the principles of good corporate governance. In relation to fraud in particular, this would mean putting policies in place to help ensure that employees are aware of their responsibilities regarding fraud, issuing guidance for employees on what they should do if they encounter or suspect a fraud.

Auditors are responsible for carrying out an audit in accordance with auditing standards, one of which is SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, which we shall look at now.
4.3 The auditor’s approach to the possibility of fraud

4.3.1 General

The key responsibility of an auditor is set out in SSA 240.

**SSA 240.5**

An auditor conducting an audit in accordance with SSAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by fraud or error.

**SSA 240.10**

The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement of the financial statements due to fraud.

(b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

(c) To respond appropriately to fraud or suspected fraud identified during the audit.

An overriding requirement of the SSA is that auditors are aware of the possibility of there being misstatements due to fraud.

**SSA 240.12**

In accordance with SSA 200, the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance.

The SSA also requires discussion by members of the engagement team of the susceptibility of the entity’s financial statements to material misstatement due to fraud, including how fraud might occur. The engagement partner must consider what matters discussed should be passed on to other members of the team not present at the discussion.

The discussion itself may include:

- An exchange of ideas between the engagement team about how fraud could be perpetrated
- A consideration of circumstances that might be indicative of aggressive earnings management
- A consideration of known factors that might give incentive to management to commit fraud
- A consideration of management’s oversight of employees with access to cash/other assets
- A consideration of any unusual/unexplained changes in lifestyle of management/employees
- An emphasis on maintaining professional scepticism throughout the audit
- A consideration of the types of circumstance that might indicate fraud
- A consideration of how unpredictability will be incorporated into the audit
- A consideration of what audit procedures might be carried out to answer any suspicions of fraud
- A consideration of any allegations of fraud that have come to the auditors’ attention
- A consideration of the risk of management override of controls

**SSA 240.17**

The auditor shall make enquiries of management regarding:

(a) Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments

(b) Management’s processes for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances or disclosures for which a risk of fraud is likely to exist
(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity, and
(d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour

SSA 240.18

The auditor shall make enquiries of management and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

SSA 240.19

For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

SSA 240.20

Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

SSA 240.21

Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

SSA 240.24

The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

The size, complexity and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example in the case of a large entity there may be factors that generally constrain improper conduct by management including effective oversight by those charged with governance, an effective internal audit function and a written code of conduct. These considerations are less likely in the case of a small entity.

Examples of fraud risk factors

SSA 240 does not attempt to provide a definitive list of risk factors but, in an appendix, identifies and gives examples of two types of fraud that are relevant to auditors:

- Fraudulent financial reporting
- Misstatements arising from misappropriation of assets

For each of these, the risk factors are classified according to three conditions that are generally present when misstatements due to fraud occur:

- Incentives/pressures
- Opportunities
- Attitudes/rationalisations
PART D PERFORMING THE STATUTORY AUDIT | 7: Risk assessment

Fraudulent financial reporting

Incentives/pressures
- Financial stability/profitability is threatened
- Pressure on management to meet the expectations of third parties
- Personal financial situation of management threatened by the entity’s financial performance
- Excessive pressure on management or operating personnel to meet financial targets

Opportunities
- Significant related-party transactions
- Assets, liabilities, revenues or expenses based on significant estimates
- Domination of management by a single person or small group
- Complex or unstable organisational structure
- Internal control components are deficient

Attitudes/rationalisations
- Ineffective communication or enforcement of the entity’s values or ethical standards by management
- Known history of violations of securities laws or other laws and regulations
- A practice by management of committing to achieve aggressive or unrealistic forecasts
- Low morale among senior management
- Relationship between management and the current or predecessor auditor is strained

Misappropriation of assets

Incentives/pressures
- Personal financial obligations
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft

Opportunities
- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Inadequate internal control over assets

Attitudes/rationalisations
- Overriding existing controls
- Failing to correct known internal control deficiencies
- Behaviour indicating displeasure or dissatisfaction with the entity
- Changes in behaviour or lifestyle

Generally, the auditor:
- Identifies fraud risks
- Relates this to what could go wrong at a financial statement level
- Considers the likelihood of a potential misstatement being material

The auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

SSA 240.26
When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.
The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is a lower risk of material misstatement due to fraud relating to revenue recognition in the case where a there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

**SSA 240.27**

The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity’s related controls, including control activities, relevant to such risks.

**Question 7.5**

You are an audit manager for Tumasik and Tanjong, Chartered Accountants. You are carrying out the planning of the audit of Kimlin Ltd, a listed company, and a high street retailer of mobile phones, for the year ending 30 September 20X7. The notes from your planning meeting with the financial director include the following:

1. One of Kimlin Ltd’s main competitors ceased trading during the year due to the increasing pressure on margins in the industry and competition from online retailers.

2. A new management structure has been implemented, with 10 new divisional managers appointed during the year. The high street shops have been allocated to these managers, with approximately 20 branch managers reporting to each divisional manager. The divisional managers have been set challenging financial targets for their areas with substantial bonuses offered to incentivise them to meet the targets. The board of directors has also decided to cut the amount that will be paid to shop staff as an annual bonus.

3. In response to recommendations in the prior year’s Report to Management, a new inventory system has been implemented. There were some problems in its first months of operation but a report has been submitted to the board by the chief accountant, confirming that the problems have all been resolved and that information produced by the system will be accurate. The finance director commented that the chief accountant has had to work very long hours to deal with this new system, often working at weekends and even refusing to take any leave until the system was running properly.

4. The company is planning to raise new capital through a share issue after the year-end in order to finance expansion of the business into Europe. As a result, the finance director has requested that the auditor’s report is signed off by 15 December 20X7 (six weeks earlier than in previous years).

5. The latest Board summary of results includes:

<table>
<thead>
<tr>
<th>Period</th>
<th>Revenue</th>
<th>Cost of sales</th>
<th>Gross profit</th>
<th>Operating expenses</th>
<th>Exceptional profit on sale of properties</th>
<th>Profit before tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>9 months to 30 June 20X7 (unaudited)</td>
<td>320</td>
<td>215</td>
<td>105</td>
<td>(89)</td>
<td>30</td>
<td>46</td>
</tr>
<tr>
<td>Year to 30 September 20X6 (audited)</td>
<td>280</td>
<td>199</td>
<td>81</td>
<td>(70)</td>
<td>–</td>
<td>11</td>
</tr>
</tbody>
</table>

**Required**

Identify and explain any fraud risk factors that the audit team should consider when planning the audit of Kimlin Ltd.
4.3.2 Responding to assessed risks

The auditor must then come up with responses to the assessed risks.

SSA 240.28

In accordance with SSA 330 the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

<table>
<thead>
<tr>
<th>SSA 240.29</th>
</tr>
</thead>
</table>

In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:

(a) Consider the assignment and supervision of personnel
(b) Consider the accounting policies used by the entity
(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures

SSA 240.30

In accordance with SSA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:

(a) Consider the assignment and supervision of personnel
(b) Consider the accounting policies used by the entity
(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures

The auditor may have to amend the nature, timing or extent of planned audit procedures to address assessed risks. For example, an auditor could have identified that the management of a newly listed entity are under pressure to report growth in revenue. Controls over sales returns are weak in the entity and a risk management is inflating sales by including returned items exists. In this situation, the nature of audit procedures might be amended to obtain additional corroborative evidence. For instance, when sending external confirmations for trade receivables, the auditors could also ask the customer to confirm any right of return. The timing of audit procedures could also be amended so that more substantive testing is performed near the period end to better address the risk. In addition, sample sizes could be increased to amend the extent of testing in this area or CAATS can be used to enable more extensive testing.

Example: Specific audit procedures to respond to the assessed risk of material misstatement due to fraud

If the risk of misappropriation of cash or inventory is high, the auditor might choose to attend previously unvisited branches to carry out inventory or cash checks.

If the risk of fraudulent revenue recognition is high, the auditor might perform detailed analytical procedures using disaggregated data, for example, comparing sales and costs of sales by location.

If management integrity is in doubt, the auditor might use an expert to assess management estimates in a subjective area.

The auditor must also perform audit procedures responsive to the risks related to management override of controls. Audit procedures must be designed and performed to:

- Test the appropriateness of journal entries and other adjustments
- Review accounting estimates for bias
- Evaluate the business rationale for significant transactions outside the normal course of business
4.3.3 Management override of controls

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) Select journal entries and other adjustments made at the end of a reporting period; and

(iii) Consider the need to test journal entries and other adjustments throughout the period.

The focus should be on reviewing manual, non-standard and unusual journal entries.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

4.4 Evaluation of audit evidence

At the end of the audit, the auditor will perform analytical procedures to assist in forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. The auditor must evaluate whether these analytical procedures indicate a previously unrecognised risk of material misstatement due to fraud.

If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognising that an instance of fraud is unlikely to be an isolated occurrence.

If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

The auditor must obtain written representation that management accepts its responsibility for the prevention and detection of fraud and has made all relevant disclosures to the auditors.
4.5 Documentation
The auditor must document:

- The significant decisions reached as a result of the team's discussion of fraud
- The identified and assessed risks of material misstatement due to fraud
- The overall responses to assessed risks
- Results of audit procedures
- Communication on fraud to management, those charged with governance, regulators and others
- Reasons for concluding that the presumption that there is a risk of fraud related to revenue recognition is not applicable

4.6 Reporting
There are various reporting requirements in SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

**SSA 240.40**
If the auditor has identified a fraud or has obtained information that indicates a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

**SSA 240.41**
Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

(a) Management;
(b) Employees who have significant roles in internal control; or
(c) Others, where the fraud results in a material misstatement in the financial statements.

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

The auditor should also make relevant parties within the entity aware of significant deficiencies in the design or implementation of controls to prevent and detect fraud which has come to the auditor's attention, and consider whether there are any other relevant matters to bring to the attention of those charged with governance with regard to fraud.

The auditor may have a statutory duty to report fraudulent behaviour to regulators outside the entity. If no such legal duty arises, the auditor must consider whether to do so would breach their professional duty of confidence. In either event, the auditor may consider it appropriate to take legal advice.

**ALERT**
Remember the confidentiality issues from Chapter 2. When you are considering whether to make a public interest disclosure, you should always bear these in mind.
Guidance is provided in Section 207 of the Companies Act. Section 9 states that if an auditor, in the course of the performance of his/her duties as auditor of a company, is satisfied that:

(a) There has been a breach or non-observance of any of the provisions of the Companies Act; and
(b) The circumstances are such that in his/her opinion the matter has not been or will not be adequately dealt with by comment in his/her report on the financial statements or consolidated financial statements or by bringing the matter to the notice of the directors of the company or, if the company is a subsidiary company, of the directors of the parent company,

the auditor shall immediately report the matter in writing to the Registrar.

Section 9A states that if an auditor of a public company or a subsidiary corporation of a public company, in the course of the performance of his/her duties as auditor, has reason to believe that a serious offence involving fraud or other dishonesty is being or has been committed against the company by officers or employees of the company, he/she shall immediately report the matter to the Minister of Finance. A serious offence is an offence that is punishable by imprisonment for a term that is not less than two years and where the value of the property obtained or likely to be obtained from the commission of such an offence is not less than $100,000.

The auditor must always have due regard to the risk of ‘tipping off’; it is an offence to disclose information that is likely to prejudice a criminal investigation.

### 4.7 Auditor unable to continue

The auditor shall consider the need to withdraw from the engagement if encountering exceptional circumstances with regards to fraud. For example, where the entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements.

SSA 240 states that the auditor shall:

- Determine the professional and legal responsibilities, including whether there is a requirement for the auditor to report to the person who made the audit appointment to regulatory authorities
- Consider whether it is appropriate to withdraw from the engagement where withdrawal is possible under applicable law or regulation.
- If the auditor withdraws:
  - Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal and the reasons for withdrawal.
  - Determine whether there is a professional or legal requirement to report to the person who made the audit appointment, or to regulatory authorities, the auditor’s withdrawal and the reasons for the withdrawal.

### 4.8 Fraud in uncertain economic conditions

Additional pressures may exist during uncertain economic conditions for a variety of reasons.

**Personal**

Employees may be under significant financial strain due to low or no salary increases or bonuses, reduced working hours or worries over job security. This may result in an employee being able to rationalise and justify fraud.

**Company performance**

Fraud may be perpetrated as management feel pressure to maintain earnings or meet company debt covenants rather than for personal gain.

**Practical**

Companies may have to reduce costs by cutting staff numbers in a global economic downturn. This may reduce the company’s ability to segregate duties and thus increase the opportunity for fraud and error.
Pressures from uncertain economic conditions combine with the opportunity to commit fraud and the rationalisation of actions to form what is known as the Fraud Triangle.

ACRA Practice Bulletin No 2 of 2011: Audit Considerations in an Uncertain Economic Environment covers the areas which become more significant when performing an audit in difficult or uncertain economic conditions. These include:

- Communicating with clients
- Fraud considerations
- Impairment of non-financial assets
- Financial statement disclosures
- Subsequent events
- The independent auditor's report
- Involvement in the audit

**Question 7.6**

**Detection of fraud**

**Required**

(a) Discuss what responsibility auditors have to detect fraud.

(b) Explain how the auditors might conduct their audit in response to an assessed risk of:

(i) Misappropriation

(ii) Fraudulent financial reporting

**SECTION SUMMARY**

The auditor must obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.
Chapter Roundup

Risk assessment

Business risk
The risk inherent to the company in its operations
May (but not necessarily) impact

Audit risk
The risk of an inappropriate opinion being given on the financial statements

Three components

Financial risk
Operational risk
Compliance risk

Responses to assessed risks

Overall response
- Staff
- Supervision
- Experts
- Professional scepticism
- Timing

Analytical procedures
- Ratio analysis
- Trend analysis
- Reasonableness tests
- Related accounts
- Comparisons

Overall conclusion
Chapter 12

Substantive procedures
Formulate expectations
Calculate acceptable difference
Expected vs actual
Obtain reason for variance and evaluate audit impact

Tests of details
Tests of controls
Substantive procedures
AP

Business risk
The risk inherent to the company in its operations

Audit risk
The risk of an inappropriate opinion being given on the financial statements

Overall conclusion
Chapter 12

Analytical procedures
- Ratio analysis
- Trend analysis
- Reasonableness tests
- Related accounts
- Comparisons

Substantive procedures
Formulate expectations
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Expected vs actual
Obtain reason for variance and evaluate audit impact

Tests of details
Tests of controls
Substantive procedures
AP

Risk assessment
Quick Quiz

1. Complete the following definition:
   ………………. risk is the risk that the auditor expresses an ……………... audit opinion when the financial statements are ……………... ……………...

2. Identify whether the following matters, which represent potential business risks to the company are financial, operational or compliance risks. Note some items may represent more than one type of business risk.

<table>
<thead>
<tr>
<th>Item</th>
<th>Potential business risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Going concern</td>
<td></td>
</tr>
<tr>
<td>Physical disasters</td>
<td></td>
</tr>
<tr>
<td>Breakdown of accounting systems</td>
<td></td>
</tr>
<tr>
<td>Loss of key personnel</td>
<td></td>
</tr>
<tr>
<td>Credit risk</td>
<td></td>
</tr>
<tr>
<td>Breach of legislation</td>
<td></td>
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<tr>
<td>GST problems</td>
<td></td>
</tr>
<tr>
<td>Currency risk</td>
<td></td>
</tr>
<tr>
<td>Poor brand management</td>
<td></td>
</tr>
<tr>
<td>Environmental issues</td>
<td></td>
</tr>
</tbody>
</table>

3. Identify the significant relationships in the list of items below:
   (a) payables  (b) interest  (c) purchases  (d) sales
   (e) amortisation (f) loans  (g) receivables (h) intangibles

4. Complete the matrix.

<table>
<thead>
<tr>
<th>Type of account</th>
<th>Purpose of primary test</th>
<th>Primary test also gives comfort on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>U</td>
<td>Assets</td>
</tr>
<tr>
<td>Liabilities</td>
<td>U</td>
<td>Liabilities</td>
</tr>
<tr>
<td>Income</td>
<td>U</td>
<td>Income</td>
</tr>
<tr>
<td>Expense</td>
<td>U</td>
<td>Expense</td>
</tr>
</tbody>
</table>

5. Define fraud.

6. Draw a table showing the reporting requirements of SSA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.
Answers to Quick Quiz

1. Audit, inappropriate, materially misstated

2. | Item                                      | Potential business risk |
---|-------------------------------------------|-------------------------|
    | Going concern                             | Financial               |
    | Physical disasters                       | Operational/financial   |
    | Breakdown of accounting systems          | Financial               |
    | Loss of key personnel                    | Operational             |
    | Credit risk                              | Financial               |
    | Breach of legislation                    | Compliance              |
    | GST problems                             | Compliance              |
    | Currency risk                            | Financial               |
    | Poor brand management                    | Operational             |
    | Environmental issues                     | Compliance              |

3. (a) (c) (b) (f) (d) (g) (e) (h)

4. | Type of account | Purpose of primary test | Assets | Liabilities | Income | Expenses |
---|-----------------|-------------------------|--------|-------------|--------|---------|
    | Assets          | Overstatement (O)       | U      | O           | O      | U       |
    | Liabilities     | Understatement (U)      | U      | O           | O      | U       |
    | Income          | Understatement (U)      | U      | O           | O      | U       |
    | Expense         | Overstatement (O)       | U      | O           | O      | U       |

5. Fraud is the use of deception to obtain unjust or illegal financial advantage and intentional misrepresentation by management, employees or third parties.

6. **Management**
   - If the auditors suspect or detect any fraud (even if immaterial) as soon as they can they should tell management.

   **Those charged with governance**
   - If the auditor has identified fraud involving management, employees with significant roles in internal control, or others, if it results in a material misstatement, they must report it to those charged with governance.

   **Third parties**
   - Auditors may have a statutory duty to report to a regulator. Auditors are advised to take legal advice if reporting externally to the company.
7.1 Audit risk

The following matters are relevant to planning Fragrant Flowers Pte Ltd’s audit:

Audit risks – inherent

Related parties and group issues

Fragrant Flowers Pte Ltd is part of a complicated group structure. This raises several issues for the audit:

- There is a risk of related party transactions existing and not being properly disclosed in the financial statements in accordance with SFRS(I) 1-24 Related Party Disclosures.
- Similarly, there is a risk that it will be difficult to ascertain the controlling party for disclosure.
- There is likely to be some group audit implications. My AE may be required to undertake procedures in line with the group auditors’ requirements if Fragrant Flowers Pte Ltd is to be consolidated.

Receivables

Fragrant Flowers Pte Ltd is a service provider, and it extends credit to customers. This is likely to mean that trade receivables will be a significant audit balance. However, there is limited audit evidence concerning trade receivables due to the effects of a computer virus. There are also indicators of a possible fraud.

Fraud

There are various factors that may indicate a sales ledger fraud has taken/is taking place:

- Lack of segregation of duties
- Extensive credit offered
- The virus only destroyed sales ledger information – too specific?
- Poorly paid sales ledger clerk – with expensive lifestyle
- Sales ledger clerk is daughter of a well-paid shareholder and they do not have a good relationship

None of these factors necessarily point to a fraud individually, but added together raise significant concerns.

Profit-driven management

Mr Rose is motivated for the financial statements to show a profit for two reasons:

- He receives a commission (presumably sales driven, which impacts on profit).
- He receives dividends as shareholder, which will depend on profits.

There is a risk that the financial statements will be potentially affected by management bias.

Credit extended

We should ensure that the line of credit extended to customers is provided on standard business terms. There are unlikely to be any complications, for example, interest, but if there were, we should be aware of any laws and regulations which might become relevant, and any accounting issues which would be raised.

Audit risk – control

There are three significant control problems at Fragrant Flowers Pte Ltd.

Segregation of duties

There appears to be a complete lack of segregation of duties on the three main ledgers. This may have led to a fraud on the sales ledger. The fact that there is no segregation on payroll is also a concern as this is an area where fraud can easily be carried out.
Lack of segregation of duties can also lead to significant errors being made and not being detected by the system. This problem means that control risk will have to be assessed as high and substantial substantive testing will need to be undertaken.

*Personal computer*

A PC is used for the accounting system. This is likely to have poor built-in controls and further exacerbate the problems caused by the lack of segregation of duties.

The security over PCs is also often poor, as has been the case here, where a virus has destroyed evidence about the sales ledger.

*Key man*

The fact that Mr Rose is dominant in management may also be a control problem, particularly if he were ever to be absent.

**Audit risk – detection**

The key detection risk is that this is the first audit, so we will have no prior understanding of the entity to draw upon. We have not audited the opening balances and comparatives. We should review the previous auditor’s opinion and any modification. We should also ask the client for permission to contact any previous auditors in order to review their working papers. If there were no previous auditors, these are unaudited. We must ensure that our auditor’s report is clear on this issue.

There is also significant detection risk in relation to related parties, as discussed above.

### 7.2 Trend analysis

A initial glance at the data provided by the finance manager indicates that total revenue and gross profit from the top three selling kitchens has increased year on year for the last three years.

However, when the revenue per square metre of kitchen showroom is calculated it can be seen that this has fallen from $11.2k in 20X0 to $11.0k in 20X1 and then $10.9k in 20X2. Trend analysis can be used to help identify the reason for this fall. The gross profit per square metre of showroom for each product can be calculated as follows and then illustrated graphically in a bar graph.

<table>
<thead>
<tr>
<th>Year</th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oak per sq m ($)</td>
<td>42.2</td>
<td>43.2</td>
<td>43.3</td>
</tr>
<tr>
<td>Ash per sq m ($)</td>
<td>49.8</td>
<td>47.8</td>
<td>40.3</td>
</tr>
<tr>
<td>Elm per sq m ($)</td>
<td>44.0</td>
<td>44.1</td>
<td>45.3</td>
</tr>
</tbody>
</table>
The bar graph clearly shows that the gross profit from Ash per square metre of showroom is in decline. This may be due to a number of legitimate reasons including Ash becoming a less fashionable kitchen design, special offers on other kitchen types or it might indicate a misstatement.

As an auditor, you will need to inquire as to the reason for this decline from KTG and evaluate whether further audit procedures are required.

7.3 Analytical procedures: planning

The audit senior can carry out analytical procedures on the financial statements of Geylang Ltd to spot trends or anomalies that may be useful in planning the audit of financial statements.

Useful calculations will include the increase or decrease in trade payables and trade payables days in the year. Since the other side of the trade payables double entry is cost of sales, procedures analysing cost of sales will also be of interest when looking at trade payables.

The auditor will need to consider any other information received about Geylang Ltd and whether the trade payables or cost of sales figures are as expected, given that information, for example the introduction of new product lines.

<table>
<thead>
<tr>
<th>Observations</th>
<th>Impact on audit of trade payables</th>
</tr>
</thead>
</table>
| **Gross profit margin has fallen from 24% last year to 21% this year.** | Business strategy and performance must be discussed with the directors.  
   The lower margin could arise from genuine business factors including some relating to payables such as new suppliers charging higher prices increases in the cost of raw materials used by suppliers.  
   These factors would have to be confirmed during the audit of payables. |
| **Cost of sales has increased by 50% whilst revenue has increased by 45%.** | Where the decline in margin cannot be adequately explained by business factors, accounting errors must be considered. These could include:  
   – An inaccurate cut-off on goods received which misstates purchases and trade payables  
   – Misclassification between purchases and other expenses  
   Potential misstatements would increase the level of work required on payables. |
| **Trade payables have increased by 38%, which is less than the increase in cost of sales.** | The scope of circularisation and/or supplier statement reconciliation work may have to be extended if there are trade payables that have not been recorded.  
   Test for omission of liabilities, in order to ascertain completeness. |
Observations | Impact on audit of trade payables
--- | ---
The trade payables payment period has been reduced slightly from 61 days last year to 56 days this year. | Information on payment terms with new suppliers (eg for footwear) must be obtained to establish expectations.
There is a risk of unrecorded liabilities (eg due to omission of goods received not invoiced or inaccurate cut-off in the purchase ledger).
Review of subsequent cash payments to payables should cover the period after the year-end. The period covered depends on the nature of the business and on the credit terms of the invoices. If the credit term is two months, then the review should cover two months.

Other payables have risen by 12% – this does not seem consistent with a reduction in the number of shops. | Payables for purchases may be misclassified as other payables.

7.4 Audit strategy

(a) Key business risks at Go Shop Ltd

Operational – industry

The building industry is generally considered to be a volatile industry and sensitive to changes in economic climate. The CEO has identified that the particular market that the company operates in, retail malls, has become saturated. Go Shop Ltd's business is therefore likely to be volatile generally and the market for the services Go Shop Ltd provides is saturated. This is an operational risk – what will Go Shop Ltd do if it does not do what it has done historically?

The company is not only strongly connected with the building industry, but also the retail industry. This is another industry that is volatile. It has recently been affected by higher interest rates and reduced consumer spending.

Operational – personnel

The business is about to lose a key member of personnel on the financial side, and there appear to be no current plans for a replacement. This could severely affect systems in the finance department, which could have a knock-on effect on crucial supplier and customer relations and hence the operations of the wider business.

Finance

It is likely that Go Shop Ltd has a high level of borrowings secured on the buildings that they have built and now manage. If this is the case, the increase in interest rates will adversely affect their business directly in the form of interest on these loans. This may be particularly severe if they have over-borrowed when interest rates were low.

Compliance

There is currently legislation before the Government that is likely to have far-reaching effects on the operations of Go Shop Ltd's building arm. The law relates to quality standards in the building industry and is likely to be costly to implement. It is possible that Go Shop Ltd will struggle to afford to implement such standards. An even more significant concern is that it appears that the director has taken no steps to mitigate this risk and has put no action plans into place to ensure that the law would be complied with, if passed. This could mean that the company could be liable to legal action and fines.
(b) **Audit strategy**

The audit strategy will depend on certain matters such as the date when the finance director leaves the business. Assuming that they leave after the audit, the audit team may continue to rely on the results of their initial risk assessment. This is because business risks have already been identified and there are significant links between the business risks and the financial statements. Identifying the business risks and responding appropriately is therefore efficient.

The control environment has historically been strong, so making use of controls testing would also appear to be appropriate. This in particular is highly dependent on the presence of the finance director at the audit date.

The audit manager has experience of the client and significant knowledge of the business therefore it seems appropriate to use analytical procedures. It also appears that strong explanations will be available for movements on accounts over the period. Again, this is dependent on the presence of the finance director.

(c) **Ethical implications**

(i) **Recruitment**

It is very important that the AE does not take management decisions on behalf of the entity. Hence it would be appropriate for it to take an advisory role in the recruitment process, perhaps reviewing CVs and advising as to qualifications and factors to look for. However, it should not get heavily involved in the interviewing process, as this could lead it to, in effect, making management decisions on behalf of the directors.

(ii) **Secondment**

If a staff member of the AE is to be seconded to the audit client to work in this significant role, the AE would have to be very clear that there were boundaries or safeguards in place between that staff member and the audit team. This may in practice be impossible.

However, provided that objectivity can be retained for the audit team and that there is not a problem of familiarity, a secondment might be appropriate.

A problem of familiarity could arise if:

(1) The person seconded had previously worked on the audit and the strategy and approach were not changed; or

(2) The audit team were familiar with the person seconded and had a personal relationship with him that presented a significant risk to objectivity.

---

7.5 **Fraud risk factors**

In this scenario there are a large number of factors that should alert the auditors to the possibility of misstatements arising from fraudulent financial reporting, and others that could indicate a risk of misstatements arising from misappropriation of assets.

1 **Operating conditions within the industry**

The failure of a competitor in a highly competitive business sector highlights the threat to the survival of a business such as Kimlin Ltd and this could place the directors under pressure to overstate the performance and position of the company in an attempt to maintain investor confidence, particularly given the intention to raise new share capital.

2 **Management structure and incentives**

It is not clear in the scenario how much involvement the new divisional managers have in the financial reporting process but the auditors would need to examine any reports prepared or reviewed by them very carefully as their personal interest may lead them to overstate results in order to earn their bonuses.
3 **New inventory system/chief accountant**

The problems with the implementation of the new inventory system suggest that there may have been control deficiencies and errors in the recording of inventory figures. Misstatements, whether deliberate or not, may not have been identified. The amount of time spent by the chief accountant on the implementation of the new inventory system could be seen as merely underlining the severity of the problems, but the fact that he has not taken any leave should also be considered as suspicious and the auditors should be alert to any indication that he may have been involved in any deliberate misstatement of figures.

4 **Results**

The year on year results look better than might be expected given the business environment. The gross profit margin has increased to 32.8% (20X6 25.3%) and the operating profit margin has increased to 5% (20X6 3.9%). This seems to conflict with what is known about the industry and should increase the auditor's professional scepticism in planning the audit.

5 **Time pressure on audit**

The auditors should be alert to the possibility that the tight deadline may have been set to reduce the amount of time the auditors have to gather evidence after the end of the reporting period, perhaps in the hope that certain deliberate misstatements will not be discovered.

6 **Risk of misappropriation of assets**

The nature of the inventory held in the shops increases the risk that staff may steal goods. This risk is perhaps increased by the fact that the attitude of the staff towards their employer is likely to have been damaged by the cut in their annual bonus. The problems with the new inventory recording system increase the risk that any such discrepancies in inventory may not have been identified.

7.6 **Detection of fraud**

(a) The primary responsibility for the prevention and detection of fraud and irregularities rests with management and those charged with governance. This responsibility may be partly discharged by the institution of an adequate system of internal control including, for example, authorisation controls and controls covering segregation of duties.

The auditors should recognise the possibility of material irregularities or frauds which could, unless adequately disclosed, distort the financial position and performance shown by the financial statements. SSA 240 states that the auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by fraud or error. Auditors are required to carry out their audit with professional scepticism.

Auditors are required to carry out risk assessment procedures in respect of fraud. This will involve making enquiries of management, considering if any risk factors (such as the existence of pressure for management to meet certain targets) are present and to consider the results of analytical procedures if any method or unexpected relationships have been identified.

If there is an assessed risk of fraud, the auditor must make suitable responses. Overall responses include considering the personnel for the assignment (for example, using more experienced personnel), considering the accounting policies used by the entity (have they changed? are they reasonable?) and incorporating an element of unpredictability into the audit.

Specific responses to the risk of misstatement at the assertion level due to fraud will vary depending on the circumstances but could include:

(i) Changing the nature of audit tests, for example, introducing CAATs (computer assisted audit techniques) if more detail is required about a computerised system

(ii) Changing the timing of audit tests (for example, testing throughout an audit period, instead of extending audit conclusions from an interim audit)

(iii) Changing the extent of audit tests (for example, increasing sample sizes)
(b) (i) Misappropriation

Misappropriation of assets can take place in many ways including directly taking physical inventory, PPE or cash, creating a fictitious payable or employee account or embezzling receipts. Sometimes employees attempt to disguise misappropriation by creating false documents and records.

Many substantive procedures normally performed by the auditors may assist in isolating employee frauds, if they are occurring. For example, tests performed on physical assets or inventory may reveal missing items or goods unaccounted for.

If the auditors have already identified a risk of misappropriation, they will respond by varying the nature, timing and extent of audit procedures in that area. Certain tests such as cash counts could be carried out on a surprise basis or the audit approach will be amended.

For example, if the auditors have identified a risk of misappropriation due to weak controls over payroll, the auditors could review personnel files for any containing no performance review as this may indicate a fictitious employee. Alternatively, the auditors could use a CAAT to look for duplicate addresses or bank account details within the payroll records.

(ii) Fraudulent financial reporting

If the auditors conclude that there is a high risk of fraudulent financial reporting by management they will concentrate on techniques such as analytical procedures, scrutiny of unusual transactions and all journal entries, review of events after the reporting period (including going concern evaluation), and review of the financial statements and accounting policies for any changes or material distortions.
Auditors must obtain evidence through the course of their work to support the audit opinion. The basic requirements of audit evidence are that:

- It must be sufficient
- It must be appropriate
- It must be adequately documented

Assessing sufficiency and appropriateness of audit evidence is subjective and requires the audit partner's professional judgment. The basic audit evidence requirements are governed by SSA 500 Audit Evidence and SSA 230 Audit Documentation.

In addition, the requirements of several other SSAs may be relevant, for example, when dealing with the work of an expert; related party transactions; and when obtaining written representations from management. The auditor should also consider any relevant SFRS(I)s with specific disclosure requirements that must be supported by audit evidence.
### Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evidence</td>
<td></td>
</tr>
<tr>
<td>Explain the matters that are likely to be relevant in determining what constitutes sufficient, appropriate evidence.</td>
<td>3</td>
</tr>
<tr>
<td>Evaluate whether a given scenario represents sufficient evidence.</td>
<td>3</td>
</tr>
<tr>
<td>Explain the rules for documentation of audit evidence, using appropriate media and the reasons for those rules.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and describe audit procedures to obtain sufficient audit evidence from identified sources, eg inquiries, inspection, observation and re-performance.</td>
<td>3</td>
</tr>
<tr>
<td>Assess whether more cost-efficient methods for obtaining evidence to support an assertion would have been possible in a given scenario.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and evaluate the audit evidence expected to be available to support the assertions about classes of transactions, account balances, and presentation and disclosure.</td>
<td>3</td>
</tr>
<tr>
<td>Apply analytical procedures as substantive audit procedures using financial and non-financial data.</td>
<td>3</td>
</tr>
<tr>
<td>Explain the specific audit risks and procedures concerning related parties and related party transactions including significant transactions outside normal business.</td>
<td>3</td>
</tr>
<tr>
<td>Recognise circumstances that may indicate the existence of unidentified related parties and select appropriate audit procedures.</td>
<td>3</td>
</tr>
<tr>
<td>Explain the use of written management representations to support other audit evidence and the limitations of representations as evidence.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and explain the circumstances in which an auditor is likely to need an expert opinion to obtain sufficient, appropriate evidence on a matter.</td>
<td>3</td>
</tr>
<tr>
<td>Explain the differences for evidence evaluation between an expert appointed by an auditor and an expert appointed by a client.</td>
<td>3</td>
</tr>
<tr>
<td>Evaluate the work required to be done when there is the use of an expert including:</td>
<td></td>
</tr>
<tr>
<td>• Evaluating the relevance, completeness and accuracy of that source data significant to that expert's work provided by management;</td>
<td></td>
</tr>
<tr>
<td>• Evaluation of the expert's competence, capabilities and objectivity for the statutory auditor's purposes;</td>
<td></td>
</tr>
<tr>
<td>• Adequacy of the expert's work; and</td>
<td></td>
</tr>
<tr>
<td>• The auditor's duty to form a concurring opinion with the expert.</td>
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</tbody>
</table>
1 Audit evidence

SECTION INTRODUCTION

The auditor gathers evidence in relation to financial statement assertions through audit testing, so as to support the audit opinion.

1.1 Obtaining evidence

Audit procedures are designed to obtain evidence about the financial statement assertions.

ALERT

It is essential that you tailor audit procedures to the specific scenario given in the question.

KEY TERM

FINANCIAL STATEMENT ASSERTIONS are the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

For example, by approving the financial statements, the directors are making representations about the information therein. These representations or assertions may be described in general terms in a number of ways.

Guidance on assertions is found in SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment.
SSA 315.25

The auditor shall identify and assess the risks of material misstatement at:

(a) The financial statement level; and
(b) The assertion level for classes of transactions, account balances, and disclosures.

To provide a basis for designing and performing further audit procedures.

It gives examples of assertions in these areas.

### Assertions used by the auditor

<table>
<thead>
<tr>
<th>Assertions used by the auditor</th>
<th>Occurrence: transactions and events that have been recorded have occurred and pertain to the entity.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compleness: all transactions and events that should have been recorded have been recorded.</td>
<td></td>
</tr>
<tr>
<td>Accuracy: amounts and other data relating to recorded transactions and events have been recorded appropriately.</td>
<td></td>
</tr>
<tr>
<td>Cut-off: transactions and events have been recorded in the correct accounting period.</td>
<td></td>
</tr>
<tr>
<td>Classification: transactions and events have been recorded in the proper accounts.</td>
<td></td>
</tr>
<tr>
<td>Presentation: transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assertions used by the auditor</th>
<th>Existence: assets, liabilities and equity interests exist.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rights and obligations: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.</td>
<td></td>
</tr>
<tr>
<td>Completeness: all assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.</td>
<td></td>
</tr>
<tr>
<td>Accuracy valuation and allocation: assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.</td>
<td></td>
</tr>
<tr>
<td>Classification: assets, liabilities and equity interests have been recorded in the proper accounts.</td>
<td></td>
</tr>
<tr>
<td>Presentation: transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.</td>
<td></td>
</tr>
</tbody>
</table>

Some examples of where disclosure is especially important would include: SFRS(I) 5 on discontinued operations; SFRS(I) 1-37 on provisions and contingent liabilities; SFRS(I) 1-24 on related parties; SFRS(I) 7 on financial instruments.

SSA 500 *Audit Evidence* outlines the objective of the auditor and procedures used by auditors to obtain evidence.
The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

The table below details the most common procedures used by auditors in obtaining audit evidence.

<table>
<thead>
<tr>
<th>Procedures</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection of assets</td>
<td>Inspection of assets that are recorded in the accounting records confirms existence, but does not necessarily confirm valuation or rights and obligations.</td>
</tr>
<tr>
<td>Inspection of documentation</td>
<td>Inspection of supporting documentation of items recorded in accounting records to confirm that an asset exists or a transaction occurred. Items recorded in supporting documentation are also traced to accounting records to ensure completeness of transactions recording. Cut-off can be verified by inspecting a reverse population, that is, checking transactions recorded after the end of the reporting period to supporting documentation to confirm that they occurred after the end of the reporting period. Inspection also provides evidence of valuation/measurement, rights and obligations and the nature of items (presentation and disclosure). It can also be used to compare documents (and hence test consistency of audit evidence) and confirm authorisation.</td>
</tr>
<tr>
<td>Observation</td>
<td>Observation involves watching a procedure being performed (for example, mail opening). It is of limited use, as it only confirms the procedure took place when the auditor is watching.</td>
</tr>
<tr>
<td>Inquiry</td>
<td>Seeking information from client staff or external sources. Strength of evidence depends on knowledge and integrity of source of information.</td>
</tr>
<tr>
<td>Confirmation</td>
<td>Seeking confirmation from another source of details in client's accounting records for example, confirm bank balances via confirmation from the bank.</td>
</tr>
<tr>
<td>Recalculations</td>
<td>Checking the arithmetic of client's records, for example, adding up a ledger account.</td>
</tr>
<tr>
<td>Reperformance</td>
<td>Reperformance is the auditor's independent execution of procedures or controls originally performed as part of the entity's internal control, either manually or using CAATs. CAATs are covered in Chapter 18.</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures are covered in Section 1.3.</td>
</tr>
</tbody>
</table>
1.2 Sufficient and appropriate audit evidence

**KEY TERMS**

The **SUFFICIENCY** (of audit evidence) is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

The **APPROPRIATENESS** (of audit evidence) is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

(SSA 500.4)

In essence, auditors need to obtain sufficient reliable audit evidence to support the audit opinion. The audit partner will make the ultimate assessment of audit efficiency and quality based on their professional judgment.

When assessing the sufficiency and appropriateness of audit evidence, auditors must consider the following.

(a) The risk of misstatement related to the assertion.

(b) Generally speaking, the higher the risk of misstatement, the greater the efficiency of audit evidence that is required for that assertion. In order to conduct the audit efficiently, the auditor has to balance the need to reach a balance between obtaining sufficient audit evidence and performing more work.

(c) Source and nature of evidence. Third party independent evidence is more reliable than internally generated evidence. Similarly, original evidence sources (e.g., documents) are more reliable than duplicates. Physical evidence is more reliable than verbal responses to audit enquiries, and evidence is more reliable when obtained directly by the auditor rather than from an indirect source.

(d) Contradictory or corroborative evidence. Contradictory evidence reduces the reliability of all related sources; while corroborative evidence has a strengthening effect.

(SSA 500.11)

If audit evidence obtained from one source is inconsistent with that obtained from another, or the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect, if any, on other aspects of the audit.

1.2.1 Sampling

An effective audit test provides appropriate audit evidence that will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required to determine the sufficiency of information to be used as audit evidence (in addition to relevance and reliability). The means available to the auditor for selecting items for testing are:

- Selecting all items (100% examination)
- Selecting specific items
- Audit sampling

The application of any one or a combination of these means may be appropriate depending on the particular circumstances. SSA 530 Audit Sampling is based on the premise that auditors do not normally examine all the information available to them, as it would be impractical to do so and using audit sampling will produce valid conclusions.
KEY TERMS

**AUDIT SAMPLING** involves the application of audit procedures to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

**STATISTICAL SAMPLING** is any approach to sampling that involves random selection of a sample, and use of probability theory to evaluate sample results, including measurement of sampling risk.

**POPULATION** is the entire set of data from which a sample is selected and about which an auditor wishes to draw conclusions.

Some testing procedures do not involve sampling, such as:

- Testing 100% of items in a population
- Testing all items with a certain characteristic (for example, over a certain value) as the selection is not representative

The SSA distinguishes between statistically based sampling, which involves the use of random selection techniques from which mathematically constructed conclusions about the population can be drawn, and non-statistical methods, from which auditors draw a judgmental opinion about the population. However, the principles of the SSA apply to both methods.

The auditor’s judgment as to what is sufficient appropriate audit evidence is influenced by a number of factors.

- Risk assessment
- The nature of the accounting and internal control systems
- The materiality of the item being examined
- The experience gained during previous audits
- The auditor’s knowledge of the business and industry
- The results of audit procedures
- The source and reliability of information available

If they are unable to obtain sufficient appropriate audit evidence, the auditors should consider the implications for their report.

**1.2.2 External confirmations**

The reliability of audit evidence is affected by its source. Audit evidence is more reliable when it is obtained from independent sources outside the entity.

Both SSA 330 *The Auditor’s Responses to Assessed Risks* and SSA 505 *External Confirmations* address the need for external confirmations in gathering sufficient and appropriate audit evidence.

**SSA 330.19**

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions.
Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information from bankers
- Accounts receivable balances
- Inventories held by third parties
- Property deeds held by lawyers or financiers
- Investments held as at the end of the reporting period
- Investments held for safekeeping by third parties or purchased from stockbrokers but not delivered at the end of the reporting period
- Loans from lenders
- Accounts payable balances
- Related party transactions

The auditor shall maintain control over external confirmation requests. So to take the example of a receivables circularisation, it is the auditor who should be in control of sending and receiving the requests and the responses from customers.

If management refuses to allow the auditor to send an external confirmation request, the auditor must consider whether this is reasonable and whether audit evidence can be obtained in another way. If evidence cannot be obtained from another source, the auditor should communicate this to those charged with governance, and consider the impact on the auditor's report (there is a possibility that the auditor's opinion will have to be modified (qualified) on the basis of an inability to obtain sufficient appropriate audit evidence, or that a disclaimer of opinion will be issued).

ACRA's Audit Practice Bulletin No 1 of 2010: *External confirmations* highlighted four key deficiencies over external confirmations that had been observed during audit inspections. They were:

- Allowing the client to send out confirmations
- Failure to authenticate the validity of confirmations received via fax or email
- Use of excessively small sample sizes with tests not satisfactorily completed
- Failure to carry out alternative procedures for all balances not confirmed

These four areas need to be addressed to ensure a rigorous approach is adopted when using external confirmations.

**Question 8.1**

‘The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.’

*(SSA 500.4)*

**Required**

Discuss the extent to which each of the following sources of audit evidence is sufficient and appropriate.

(a) Oral representation by management in respect of the completeness of sales where the majority of transactions are conducted on a cash basis

(b) Flowcharts of the accounting and control system prepared by a company’s internal audit department

(c) Year-end suppliers’ statements

(d) Physical inspection of a non-current asset by an auditor

(e) Comparison of statement of profit or loss items for the current period with corresponding information for earlier periods
1.3 Substantive analytical procedures

1.3.1 Role of analytical procedures

Chapter 7 covered the use of analytical procedures in detail. Analytical procedures are widely used as a substantive procedure and can be much more cost effective than carrying out high volumes of tests of details.

<table>
<thead>
<tr>
<th>SSA 520.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SSA 330, the auditor shall:</td>
</tr>
<tr>
<td>(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;</td>
</tr>
<tr>
<td>(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;</td>
</tr>
<tr>
<td>(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and</td>
</tr>
<tr>
<td>(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.</td>
</tr>
</tbody>
</table>

1.3.2 Examples

Comparisons with estimates prepared by the auditors

A common example of this is where a business may have a large number of items of plant and machinery that are depreciated at different rates. The auditor could perform a quick calculation:

\[
\text{Closing balance of plant and machinery (cost)} \times \text{Average depreciation rate}
\]

If this estimate was similar to the actual depreciation charge, it would go some way to allowing the auditor to conclude that the charge was materially correct.

Relationship between financial and non-financial information

In making an estimate of employee costs, probably for one specific department, such as manufacturing, the auditor might use information about the number of employees in the department, as well as rates of pay increases. The estimate might be

\[
\frac{\text{Prior year wages expense}}{\text{Average no. of employees prior year}} \times \frac{\text{Average no. of employees current year}}{\text{Average no. of employees prior year}} \times \text{% pay increase}
\]

If the actual expense does not make sense when compared to the estimate, explanations would need to be sought and corroborated. For example, management might explain that for several months of the year the factory ran double shifts, so a higher proportion of hours worked were paid at higher overtime rates. Further examination of production records for those months would be required, eg inspecting timesheets from the factory and overtime rates from payroll.

If no explanation is available, then more detailed substantive testing will be required, directed towards possible misstatements such as mispostings or frauds such as payments to dummy employees.
1.3.3 Suitability of using analytical procedures

The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

SECTION SUMMARY

Auditors must obtain sufficient, appropriate audit evidence. The reliability of evidence is influenced by its source and nature.

2  Related parties

SECTION INTRODUCTION

Auditors are required to obtain sufficient appropriate audit evidence regarding the identities of related parties as well as related party transactions.

2.1 Importance of related parties

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.

- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

In addition, fraud may be more easily committed through related parties. Companies not trading at arm's length have been central to a number of government investigations in various countries. Such transactions were made possible by a degree of control or influence exercised by directors over both parties to the transactions. SSA 550 Related Parties covers this area.
KEY TERM

**RELATED PARTY** – a party that is either:

(a) A related party as defined in the applicable financial reporting framework; or

(b) Where the applicable financial reporting framework establishes minimal or no related party requirements:

(i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

(ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

(iii) Another entity that is under common control with the reporting entity through having:

- Common controlling ownership;
- Owners who are close family members; or
- Common key management

(SSA 550.10)

The definition of a ‘related party’ in SFRS(I) 1-24 Related Party Disclosures was extended following Improvements to FRSs issued in January 2014. The updated definition includes the entity, or any member of a group of which it is a part, that provides key management personnel services to the reporting entity or to the parent of the reporting entity as a related party.

KEY TERM

**KEY MANAGEMENT PERSONNEL** are persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

(SFRS(I) 1-24 Related Party Disclosures Para 9)

Improvements to FRSs (January 2014) also increased the disclosure requirements in relation to key management personnel.

WEBSITE

To facilitate compliance with the increased disclosure requirements of SFRS(I) 1-24, the Companies Act and the Singapore Exchange Listing Manual, ISCA issued A Practical Guide to Obtaining Confirmation from Key Management Personnel on Related Party Disclosures in March 2014. The guide can be accessed at:


The guidance aims to enhance consistency among auditors and within the financial reporting community. It contains confirmation templates which auditors are strongly encouraged to use when obtaining related party confirmations from directors and key management personnel. It does not provide guidance on how to identify key management personnel.

Management is responsible for the identification of related party transactions. Such transactions should be properly approved as they are frequently not at arm’s length. Management is also responsible for the disclosure of related party transactions.
An audit cannot be expected to detect all material related party transactions. The risk that undisclosed related party transactions will not be detected by the auditors is especially high when:

- Related party transactions have taken place without management being aware of their existence.
- Related party transactions are not self-evident to the auditors.
- Transactions are with a party that the auditors could not reasonably be expected to know is a related party.
- Active steps have been taken by management to conceal either the full terms of a transaction, or that a transaction is, in substance, with a related party.
- The corporate structure is complex.

The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud, and

(ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

- Achieve fair presentation (for fair presentation frameworks), or
- Are not misleading (for compliance frameworks).

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

2.2 Assessment and identification of risks

As part of the risk assessment procedures required by SSA 315, the auditor must carry out the following procedures to obtain information relevant to identifying risks associated with related parties.

- Audit team discussion of risk shall include specific consideration of susceptibility of financial statements to material misstatement through related parties and their transactions

- Auditor shall inquire of management:

  - The identity of related parties including changes from prior period
  - The nature of the relationships between the entity and its related parties
  - Whether any transactions occurred between the parties, and if so, what
  - What controls the entity has to identify, account for and disclose related party relationships and transactions
  - What controls the entity has to authorise and approve significant transactions and arrangements with related parties
  - What controls the entity has to authorise and approve significant transactions and arrangements outside the normal course of business

(The auditor may have to perform risk assessment procedures in addition in respect of the latter three points.)
Remain alert for evidence of related party transactions when obtaining other audit evidence, in particular, when scrutinising bank and legal confirmations and minutes of meetings.

- If significant transactions outside the normal course of business are discovered, inquire of management the nature of the transactions and whether related parties could be involved.
- Share information obtained about related parties with the audit team.

The following procedures may be helpful:

- Enquire of management and the directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements that are applicable to the entity.
- Review prior year working papers for names of known related parties.
- Review minutes of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests.
- Review accounting records for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period.
- Review confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity.
- Review investment transactions, for example purchase or sale of an interest in a joint venture or other entity.
- Enquire as to the names of all pension and other trusts established for the benefit of employees and the names of their management and trustees.
- Enquire as to the affiliation of directors and officers with other entities.
- Review the register of interests in shares to determine the names of principal shareholders.
- Enquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties.
- Review the entity's tax returns, returns made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties.
- Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions.

If risks relating to related parties and their transactions are identified, they should be treated as significant risks in accordance with SSA 315. Also, due to the close connection between related parties and possible fraud, the auditor must consider the overlap with SSA 240 here as well.

### 2.3 Responses to the risks

As part of the SSA 330 requirement that the auditor respond to assessed risks, the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.
The audit procedures discussed above must include the following:

**Further audit procedures: risk of misstatement due to related parties**

<table>
<thead>
<tr>
<th>Situation</th>
<th>Actions by auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditor suspects existence of related parties not disclosed by management</td>
<td>Determine whether the information does confirm the existence of related parties</td>
</tr>
</tbody>
</table>
| Auditor identifies related parties not disclosed by management | • Tell the rest of the audit team  
• Request management to identify all transactions with identified related party  
• Inquire as to why company controls failed to identify related party  
• Perform substantive procedures relating to related party and its transactions with entity  
  – Making enquiries of third parties presumed to have knowledge, such as legal counsel  
  – Conducting an analysis of accounting records for transactions with the related party  
  – Verifying terms and conditions of transactions by looking at the contract  
• Reconsider the risk of further related parties existing and not being disclosed to the auditor  
• If non-disclosure appears intentional, and therefore indicative of fraud, evaluate implications for audit |
| Auditor identifies related party transactions outside normal course of business | • Inspect contracts/agreements and evaluate whether:  
  – The business rationale (or lack thereof) suggests a fraudulent purpose (is it overly complex, does it have unusual terms of trade, does it lack a logical business purpose?)  
  – The terms of the transactions are consistent with management's explanations  
  – The transactions have been accounted for and disclosed properly |
| Management has asserted in the financial statements that related party transactions were conducted at arm's length | • Obtain sufficient appropriate evidence that this is true by looking at the terms of the contract and assessing:  
  – Price  
  – Credit terms  
  – Contingencies  
  – Specific charges |

**2.4 Written representations**

**SSA 550.26**

Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management, and where relevant, those charged with governance, that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware, and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.
The templates provided in ISCA’s *A Practical Guide to Obtaining Confirmation from Key Management Personnel on Related Party Disclosures* should be used.

### 2.5 Audit conclusions and reporting

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the auditor's report appropriately.

Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

### 2.6 Transactions with directors and management

Auditors may find it difficult to obtain sufficient assurance that they have identified all disclosable transactions because of:

- The low value of certain transactions, making them difficult to detect when using normal audit procedures
- Any requirements for disclosure of transactions between the company and the connected persons of a director, given that it may not always be easy for the auditors to identify such connected persons
- The fact that there may be little or no documentary evidence of transactions requiring disclosure

The complexity of the relevant legislation may give rise to difficulties of interpretation.

#### 2.6.1 Loans to directors and to persons connected with the directors

A key related party transaction you should be familiar with is a loan to directors. A company (other than an exempt private company) shall not make a loan, or quasi-loan, or enter into any guarantee or credit transaction, or provide any security in connection with a loan, quasi-loan or credit transaction made to a director of a company, directors of related companies, to persons connected with directors of the company, and spouses and children (including adopted children and stepchildren) of directors.

Companies (other than exempt private companies) are prohibited from making loans to another company or to enter into any guarantee or provide any security in connection with a loan, if a director or directors of the first-mentioned company is or together are interested in 20% or more of the total number of equity shares in the other company.

Any director who authorises entering into transactions breaching these prohibitions shall be guilty of an offence and shall be liable to a fine not exceeding $20,000 or to imprisonment not exceeding two years.

#### 2.6.2 Enquiry of company procedures

Auditors should enquire as to the company's procedures for ensuring that all disclosable transactions are properly identified and recorded. Such procedures are likely to include the following.

- Advise all directors and officers that they have a responsibility to disclose transactions in which they have an interest, either directly or through connected persons. (Such disclosure should take place at a meeting of the directors)
- Record all transactions notified in the minutes of directors' meetings
- Maintain a register in which details of all transactions requiring disclosure are recorded
Establish some method of:
- Identifying proposed transactions which will require the approval of the members in general meeting
- Ensuring that the company does not enter into any illegal transaction

Monitor the system by checking on a regular basis (as a minimum, once a year) that each director is in agreement with the company's record of his disclosable transactions and is satisfied that such records are both complete and accurate.

Obtain from each director at the end of each financial year a formal statement indicating the disclosures necessary for the purposes of the financial statements.

With smaller organisations, auditors may well find that there may be no formalised procedures or that they are inadequate. Auditors should advise each director of their statutory responsibilities, and make a request for written confirmation of any disclosable transaction in which they have an interest.

2.6.3 Audit procedures

Further audit procedures to be adopted should include the following.

- Inspect the board minutes and other records of transactions with directors and connected persons to consider their adequacy and whether or not they appear to have been kept up to date.
- Examine any agreements and contracts involving directors and connected persons, including tracing the details of such transactions to any source documentation available.
- Consider whether transactions disclosed are on commercial terms.
- Assess the recoverability of amounts due from directors or connected persons.
- Review the legality of the disclosable transactions recorded by the company. Where auditors are of the opinion that a transaction is illegal, they should:
  - Immediately advise the directors of their view.
  - Give careful consideration as to whether any reference to the matter will be required in the auditor's report.
- Advise the client to seek legal advice in those cases where there are doubts as to the legality and/or disclosable nature of a transaction.
- Consider the possibility that the company's details of disclosable transactions may be incomplete as regards those directors (and connected persons) who have not been in office throughout the year.
- Review subsequent events in order to consider whether they might have any impact on the matters requiring disclosure.

Finally, auditors should consider obtaining written representations from each director giving confirmation of any disclosable transaction which relates to himself and any persons connected with them.

Question 8.2

You are the senior in charge of the audit of Orchard Properties Pte Ltd for the year ended 31 May 20X1. Details of Orchard Properties Pte Ltd and certain other companies are given below.

**Orchard Properties Pte Ltd**

A building company formed by Arthur Loo and his brother, Bertrand.
Orchard Properties Pte Ltd has issued share capital of $500 comprising 500 ordinary shares, owned as shown below.

<table>
<thead>
<tr>
<th>Name</th>
<th>Shares</th>
<th>Percentage</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arthur Loo</td>
<td>210</td>
<td>42%</td>
<td>Founder and director</td>
</tr>
<tr>
<td>Bertrand Loo</td>
<td>110</td>
<td>22%</td>
<td>Founder and director</td>
</tr>
<tr>
<td>Catherine Loo (Bertrand's wife)</td>
<td>100</td>
<td>20%</td>
<td>Company secretary</td>
</tr>
<tr>
<td>Prema Pathare</td>
<td>20</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Omar bin Ahmed</td>
<td>60</td>
<td>12%</td>
<td>Director</td>
</tr>
</tbody>
</table>

Omar bin Ahmed is a local business owner and a close friend of both Arthur and Bertrand Loo. He gave the brothers advice when they set up the company and remains involved through his position on the board of directors. His own company, Fancy Designs, supplies Orchard Properties Pte Ltd with stationery and publicity materials.

Prema Pathare is Arthur Loo's ex-wife. She was given her shares as part of the divorce settlement and has no active involvement in the management of the company. Arthur's girlfriend, Felicia Xu, is the company's solicitor. She is responsible for drawing up and reviewing all key building and other contracts, and frequently attends board meetings so that she can explain the terms of a particular contract to the directors. Her personal involvement with Arthur started in May 20X1 and, since that time, she has spent increasing amounts of time at the company's premises.

**Cuts and Curls Pte Ltd**

A poodle parlour, of which 50% of the issued shares are owned by Prema Pathare and 50% by Gillian Loo, who is Arthur and Prema's daughter.

Cuts and Curls Pte Ltd operates from premises owned by Orchard Properties Pte Ltd for which it pays rent at the normal market rate.

**IP Roofing Pte Ltd**

A roofing company owned 60% by Orchard Properties Pte Ltd and 40% by Ian Pope, the managing director.

IP Roofing Pte Ltd carries out regular work for Orchard Properties Pte Ltd and also does roofing work for local customers. Arthur Loo is a director of IP Roofing Pte Ltd and Catherine Loo is the company secretary. All legal work is performed by Felicia Xu.

**Required**

(a) Based on the information given above, identify the potential related party transactions you expect to encounter during the audit of Orchard Properties Pte Ltd and summarise, giving your reasons, what disclosure, if any, will be required in the full financial statements.

(b) Prepare notes for a training session for junior staff on how to identify related party transactions. Your notes should include:

   (i) A list of possible features which could lead you to investigate a particular transaction to determine whether it is in fact a related party transaction

   (ii) A summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified
3 Written representations

SECTION INTRODUCTION
Written representations from management form part of the audit evidence obtained by the auditor.

3.1 Representations
The auditors receive many representations during the audit, both unsolicited and in response to specific questions. Some of these representations may be critical to obtaining sufficient appropriate audit evidence. Representations are also required for general matters, eg full availability of accounting records. SSA 580 Written Representations covers this area.

SSA 580.6
The objectives of the auditor are:
(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other SSAs; and
(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Written representations should be requested from management or directors with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

3.2 Management from whom written representations are requested

SSA 580.9
The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

SSA 580 requires the auditor to determine the appropriate individuals from whom to seek written representations. In most cases this is likely to be management, as they would be expected to have sufficient knowledge of the way in which the entity's financial statements have been prepared. However, the SSA goes on to point out that in circumstances where others are responsible for the financial statements, for example, those charged with governance, then they should be requested to provide the representations.
The SSA emphasises the need for management to make informed representations. In some cases the auditor may request that management confirms that it has made appropriate enquiries to enable it to do so.

### 3.3 Written representations concerning management responsibilities

#### SSA 580.10
The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

#### SSA 580.11
The auditor shall request management to provide a written representation that:

(a) It has provided the auditor with all the relevant information and access as agreed in the terms of the audit engagement; and

(b) All transactions have been recorded and are reflected in the financial statements.

This can be done when the auditors receive a signed copy of the financial statements which incorporate a relevant statement of management responsibilities. Alternatively, and almost invariably in practice, the auditors may obtain such evidence in the form of a written representation from management (a representation letter).

The responsibilities of management should also be set out as they are in the terms of engagement.

### 3.4 Other written representations

In addition to written representations relating to responsibility for the financial statements, the auditors may wish to rely on written representations from management as audit evidence, and several other SSAs require them.

#### SSA 580.13
Other SSAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

As written representations do not form sufficient audit appropriate evidence on their own, when the auditors receive such representations they should:

- Seek corroborative audit evidence from sources inside or outside the entity
- Evaluate whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations
- Consider whether the individuals making the representations can be expected to be well-informed on the particular matters

#### KEY POINT

Written representations cannot be used as a substitute for evidence which the auditors should have been able to obtain independently.
The table below suggests areas where written representations may be required.

<table>
<thead>
<tr>
<th>Other written representations</th>
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<tbody>
<tr>
<td><strong>Required by SSAs</strong></td>
</tr>
<tr>
<td>The following SSAs require specific written representations:</td>
</tr>
<tr>
<td>- SSA 240 <em>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</em></td>
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<tr>
<td>- SSA 250 <em>Consideration of Laws and Regulations in an Audit of Financial Statements</em></td>
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<td>- SSA 450 <em>Evaluation of Misstatements Identified during the Audit</em></td>
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<td>- SSA 501 <em>Audit Evidence – Specific Considerations for Specific Items</em></td>
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<td>- SSA 540 <em>Auditing Accounting Estimates Including Fair Value Accounting Estimates and Related Disclosures</em></td>
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<td>- SSA 550 <em>Related Parties</em></td>
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<td>- SSA 560 <em>Subsequent Events</em></td>
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<td>- SSA 570 <em>Going Concern</em></td>
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<tr>
<td>- SSA 710 <em>Comparative Information – Corresponding Figures and Comparative Financial Statements</em></td>
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<tr>
<td>- SSA 720 <em>The Auditor's Responsibilities Relating to Other Information</em></td>
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<table>
<thead>
<tr>
<th>Other management responsibility issues</th>
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<tbody>
<tr>
<td>- Whether the selection of accounting policies is appropriate</td>
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<tr>
<td>- Whether the following matters have been recognised, measured, presented or disclosed correctly:</td>
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<tr>
<td>- Plans or intentions affecting values of assets</td>
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<tr>
<td>- Liabilities (actual and contingent)</td>
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<tr>
<td>- Title to or control over assets</td>
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<tr>
<td>- Aspects of laws and regulations that may affect the FS</td>
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<tr>
<td>- Whether all deficiencies of internal controls have been communicated to the auditor</td>
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<tr>
<th>Concerning specific assertions</th>
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<tr>
<td>- Matters of director's judgment and intention (corroborated to meeting minutes for example)</td>
</tr>
</tbody>
</table>

Where representations are sought regarding specific assertions the auditor may need to consider the following:

- The entity's past history in carrying out its stated intentions
- The entity's reasons for choosing a particular course of action
- The entity's ability to pursue a specific course of action
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent
3.4.1 Doubt as to the reliability of written representations

**KEY POINT**

Management representations cannot simply be accepted at face value. Like all other audit evidence the auditor must exercise professional judgment and scepticism and evaluate the extent to which the evidence can be relied on.

The auditor will have to determine the effect of the following on the reliability of written representations (if one of the following arises):

- Concerns over the competence, integrity, ethical values or diligence of management
- Inconsistency of written representations with other evidence obtained

The auditor will seek to resolve the latter by performing audit procedures. However, if it remains unresolved, particularly in addition to the first point, the auditor will have to take appropriate actions, which may include modifying the auditor's opinion in accordance with SSA 705.

3.4.2 Requested written representations not provided

If requested representations are not provided, the auditor must:

- Discuss the matter with management.
- Re-evaluate the integrity of management and the effect that this may have on other representations and audit evidence in general.
- Take appropriate actions, including determining the possible effect on the auditor's report per SSA 705, i.e. a limitation on the scope of the audit work.

3.5 Form, timing and documentation of representations by management

The auditors should include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.

A written representation shall take the form of a representation letter from management.

The date of the letter should be as near as practicable to the date the auditor's report is signed, but not after it. In practice, the date of the letter will invariably coincide with the date on which the financial statements are authorised for issue as well as the date of the auditor's report. If the letter is received significantly before the date of the audit report, the auditor should request an updated letter.

**Question 8.3**

You are an audit manager reviewing the completed audit file of Leaf Oil Pte Ltd.

(a) There have been no events subsequent to the period end requiring adjustment in the financial statements.

(b) The company has revalued two properties in the year. The directors believe that the property market is going to boom next year, so have decided to revalue the other two properties then.

(c) The directors confirm that the company owns 75% of the newly formed company, Subsidiary Pte Ltd, at the year-end.

(d) The directors confirmed that the 500 gallons of oil in Warehouse B belong to Flower Oil Pte Ltd.

**Required**

Comment on whether you would expect to see these matters referred to in the written representation letter.
SECTION SUMMARY

Management is required to give written representations regarding the preparation and presentation of the financial statements, information provided to the auditor and management responsibilities. Other representations may also be sought, but it is important to remember they do not provide sufficient appropriate audit evidence on their own.

4 Reliance on the work of an expert

SECTION INTRODUCTION

Sometimes auditors may need to use the work of an expert to obtain sufficient, appropriate audit evidence.

4.1 Experts

Professional audit staff are highly trained and educated, but their experience and training is limited to accountancy and audit matters. In certain situations it will therefore be necessary to employ someone else with different expert knowledge to gain sufficient, appropriate audit evidence.

KEY TERM

An expert is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

Auditors have sole responsibility for their opinion, but may use the work of an expert in order to obtain sufficient audit evidence regarding certain financial statement assertions.

SSA 620 Using the Work of an Auditor’s Expert distinguishes between the ‘auditor’s expert’ and ‘management’s expert’. The latter is used by the entity in the form of assistance in the preparation of financial statements and is dealt with in SSA 500.

KEY TERMS

AUDITOR’S EXPERT – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor’s expert may be either an auditor’s internal expert (who is a partner or staff, including temporary staff, of the auditor’s firm or a network firm), or an auditor’s external expert.

MANAGEMENT’S EXPERT – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

(SSA 620.6)
4.2 Determining the need to use the work of an auditor's expert

SSA 620.3

... if the auditor using the work of an auditor's expert... concludes that the work of that expert is adequate for the auditor's purposes the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- Valuations of certain types of assets, for example complex financial instruments, land and buildings, plant and machinery
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans
- The estimation of oil and gas reserves
- The valuation of environmental liabilities, and site clean-up costs
- The interpretation of contracts, laws and regulations
- The analysis of complex or unusual tax compliance

When deciding whether to use an auditor's expert, the auditors should consider:

- Whether management has used a management's expert in preparing the financial statements
- The nature and significance of the matter, including its complexity
- The risks of material misstatement in the matter
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters
- The availability of alternative sources of audit evidence

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work
- Whether the management expert is employed by the entity, or is a party engaged by it to provide relevant services
- The extent to which management can exercise control or influence over the work of the management's expert
- The management's expert's competence and capabilities
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements
- Any controls within the entity over the management expert's work

SSA 620 requires that a written agreement exists covering instructions to the auditor's expert.

ALERT

Engaging an auditor's expert is a costly business and the client and auditors will only want to if there is a real need to do so, in other words, in circumstances where other relevant and reliable audit evidence is not available.

Once it is decided that an auditor's expert is required, the approach should be discussed with the management of the entity. Where the management is unwilling or unable to engage an expert, the auditors should consider engaging an expert themselves unless sufficient alternative audit evidence can be obtained.
SSA 620 distinguishes between 'internal' and 'external' auditor's experts.

- Auditor's internal experts may be a partner or staff of the auditor's AE or a network firm.
- Auditor's external experts are not members of the engagement team and they are not part of the auditor's AE.

### 4.3 Competence, capabilities and objectivity of the auditor's expert

**SSA 620.9**

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

This will involve considering:

- The expert's professional certification, or licensing by, or membership of, an appropriate professional body
- The expert's experience and reputation in the field in which the auditors are seeking audit evidence

The risk that an expert's objectivity is impaired increases when the expert is:

- Employed by the entity
- Related in some other manner to the entity, for example, by being financially dependent upon, or having an investment in, the entity

If the auditors have reservations about the competence or objectivity of the expert they may need to carry out other procedures, or obtain evidence from another expert.

### 4.4 The scope of work of the auditor's expert

**SSA 620.11**

The auditor shall agree, in writing when appropriate, on... the nature, scope and objectives of that expert's work.

Written agreements usually cover the auditor's expert's terms of reference and such agreements may cover such matters as follows.

- The objectives and scope of the expert's work
- A general outline as to the specific matters the expert's report is to cover
- The intended use of the expert's work
- The extent of the expert's access to appropriate records and files
- Clarification of the expert's relationship with the entity, if any
- Confidentiality of the entity's information
- Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods

### 4.5 Assessing the work of the auditor's expert

**SSA 620.12**

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes including... the relevance and reasonableness of that expert's findings or conclusions.
KEY POINT

The auditor must apply professional scepticism throughout the audit. This applies to dealings with auditors' experts. The auditor must evaluate the work of the expert and determine the extent to which it can be relied on as sufficient appropriate audit evidence. The auditor cannot simply assume that as the work has been performed by another professional that it is reliable for audit purposes.

Auditors should assess whether the substance of the auditor's expert's findings is properly reflected in the financial statements or supports the financial statement assertions. It will also require consideration of:

- The source data used
- The assumptions and methods used
- When the expert carried out the work
- The reasons for any changes in assumptions and methods
- The results of the expert's work in the light of the auditors' overall knowledge of the business and the results of other audit procedures

The auditors do not have the expertise to judge the assumptions and methods used; these are the responsibility of the expert. However, the auditors should seek to obtain an understanding of these assumptions, to consider their reasonableness based on other audit evidence, knowledge of the business and so on.

Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with industry standards
- Clearly expressed, including reference to the objectives agreed and standards used
- Based on an appropriate period and take into account any subsequent events
- Subject to any reservation, limitation or restriction on use
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert

SSA 620.13

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(a) Agree with that expert on the nature and extent of further work to be performed by that expert, or
(b) Perform additional audit procedures appropriate to the circumstances.

4.6 Reference to an auditor's expert in the auditor's report

SSA 620.14

The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so.

Such a reference may be misunderstood and interpreted as a modification of the audit opinion, or as a division of responsibility, neither of which is appropriate.

If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.
4.7 Use of the work of a management’s expert

The issues which the auditor needs to consider are very similar to those in respect of the auditors’ expert.

SSA 500.8

If information to be used as audit evidence has been prepared using the work of a management’s expert, the auditor shall, to the extent necessary, having regard to the significance of that expert’s work for the auditor’s purposes:

(a) Evaluate the competence, capabilities and objectivity of that expert;
(b) Obtain an understanding of the work of that expert;
(c) Evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertions.

Information regarding the competence, capabilities and objectivity of a management’s expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert
- Discussions with the expert/others who are familiar with that expert’s work
- Knowledge of the expert’s qualifications, membership of a professional body or industry association, licence to practice or other forms of external recognition
- Published papers or books by that expert
- Evidence from an auditor’s expert who is assisting to evaluate the management’s expert

Considerations when evaluating the appropriateness of the management’s expert’s work may include:

- The relevance and reasonableness of that expert’s findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements
- If that expert’s work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert’s work involves significant use of source data, the relevance, completeness and accuracy of that source data.

Question 8.4

Using an auditor’s expert

(a) ‘The useful life of each oil platform is assessed annually on factors such as weather conditions and the period over which it is estimated that oil will be extracted.’ You are auditing the useful lives of the oil platforms.

(b) ‘Piles of copper and brass, that can be distinguished with a simple acid test, have been mixed up.’ You are attending the inventory count.

Required

Explain whether it is necessary to use the work of an auditor’s expert in these situations. Where relevant, you should describe alternative procedures.

SECTION SUMMARY

The auditor must evaluate whether the expert has the necessary competence, capabilities and objectivity. The auditor must obtain an understanding of the expert’s work and evaluate its adequacy for audit purposes.
5 Documentation

SECTION INTRODUCTION

All evidence obtained should be documented. Working papers should be reviewed by a more senior audit staff member before an audit conclusion is drawn.

5.1 Document what?

All audit work must be documented: the working papers are the tangible evidence of all work done in support of the audit opinion. SSA 230 Audit Documentation provides guidance on documentation.

In the case of areas where the evidence is difficult to obtain, such as related parties, with evidence being obtained through discussions with management, it is vital that notes are made of conversations and that, as discussed earlier in this chapter, representations on material matters are confirmed in writing.

A key requirement of SSA 230 concerns what to include on a working paper as follows.

SSA 230.8

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) The nature, timing and extent of the audit procedures performed to comply with the SSAs and applicable legal and regulatory requirements.

(b) The results of the audit procedures performed, and the audit evidence obtained.

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

The key reason for having audit papers therefore is that they provide evidence of work done. They may be required in the event of litigation arising over the audit work and opinion given.

Audit documentation may be recorded on paper or on electronic or other media.

The SSA sets out certain requirements about what should be recorded, such as the identifying characteristics of the specific items being tested.

It also sets out points an auditor should record in relation to significant matters, such as the extent of professional judgment exercised in performing the work and evaluating the results.

If an auditor felt it necessary to depart from customary audit work required by audit standards, he/she should document why, and how the different test achieved audit objectives.

The SSA also contains details about how the audit file should be put together and actions in the event of additional work being carried out.

Specific consideration is given to smaller entities. The SSA recognises that the documentation of a smaller entity will be less extensive, but emphasises the overriding requirement that it should be capable of being understood by an experienced auditor.

Review of working papers is important, as it allows a more senior auditor to evaluate the evidence obtained during the course of the audit for sufficiency and reliability, so that more evidence can be obtained to support the audit opinion, if required.
5.2 Review of audit working papers

Work performed by each auditor should be reviewed by a more experienced team member to consider whether:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements
- Significant matters have been raised for further consideration
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- There is a need to revise the nature, timing and extent of work performed
- The work performed supports the conclusions reached and is appropriately documented
- The evidence obtained is sufficient and appropriate to support the auditor's report
- The objectives of the engagement procedures have been achieved.

The following should be reviewed on a timely basis by the engagement partner:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement
- Significant risks
- Other areas the engagement partner considers important

The engagement partner need not review all audit documentation, but may do so. However, the partner documents the extent and timing of the reviews.

In some cases, particularly in large complex audits, personnel not involved in the audit may be asked to review some or all of the audit work, to identify whether the audit evidence is sufficient and appropriate or whether further additional procedures are required prior to the auditor's report being signed. However, ultimately the audit engagement partner will continue to take full responsibility of the auditor's report.

SECTION SUMMARY

Audit work is documented to provide evidence of the work done which has formed the basis of the audit opinion.
Chapter Roundup

Audit risk

Financial statement assertions

Audit evidence

Procedures
- Inspection
- Observation
- Inquiry
- Confirmation
- Recalculation
- Reperformance
- AP

Sufficient

Appropriate

Relevant

Reliable

Should it be there?
Value?
Any more?
Disclosure?

Related party transactions?

Sources of evidence

Client
Third party

Audit procedures

Documentation

SAP

Sampling

Statistical

Non-statistical

Value?

Any more?

Disclosure?
Quick Quiz

1. Give five examples of financial statement assertions.
   (1) ....................................
   (2) ....................................
   (3) ....................................
   (4) ....................................
   (5) ....................................

2. Which of the following is not a procedure designed to obtain evidence?

3. Give five reasons why the nature of related party relationships and transactions may give rise to increased risk.
   (1) ....................................
   (2) ....................................
   (3) ....................................
   (4) ....................................
   (5) ....................................

4. Written representations from management might take the form of a letter from the auditors acknowledged and signed by the director.
   True [ ]
   False [ ]

5. Complete the definition.
   An .................................. is a person or organisation possessing .......................................................
   in a field other than ............................................. or ............................................................... .

6. Give three examples of audit evidence which can be obtained from an auditor’s expert.
   (1) ....................................
   (2) ....................................
   (3) ....................................
Answers to Quick Quiz

1. Any five from the following:
   - Existence
   - Rights and obligations
   - Occurrence
   - Completeness
   - Valuation
   - Cut-off
   - Classification
   - Accuracy
   - Allocation
   - Presentation

2. Deduction

3. (1) Related parties may operate through a wide and complex range of relationships and structures.
   (2) Management unaware of the existence of all related party relationships and transactions.
   (3) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
   (4) Related party transactions may not be conducted under normal market terms and conditions.
   (5) Related party relationships provide a greater opportunity for collusion, concealment or manipulation by management.

4. True

5. Expert, expertise, accounting, auditing

6. (1) Valuations of assets
   (2) Determination of quantities of assets
   (3) Legal opinions
8.1 Audit evidence

Appropriate – relevance

The relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statements. The evidence should allow the auditor to conclude on the following:

- Statement of financial position items (existence, rights and obligations, completeness, accuracy, valuation and allocation, classification and presentation)
- Statement of profit or loss items (occurrence, completeness, accuracy, cut-off, classification and presentation)

(a) The representation by management in respect of the completeness of sales is relevant when gathering evidence on statement of profit or loss items. However, additional audit procedures should be performed, to which the extent depends on the system operated by the client and the controls over cash sales.

(b) The flowcharts prepared by the internal audit function will not be directly relevant to the auditor's opinion on individual figures in the financial statements, but rather when the auditor is following the requirement in SSA 315 to understand the entity's system of recording and processing transactions. The auditor will wish to assess the adequacy of the system as a basis for the preparation of financial statements so the flowcharts will be relevant only if they are sufficiently detailed to allow the auditor to carry out this assessment. The auditor would also wish to make an initial assessment of internal controls at this stage so the flowcharts will be more relevant for control procedures that are specifically identified.

(c) Year-end suppliers' statements provide evidence relevant to the auditor's conclusions on:

(i) The completeness of payables, as omissions from the purchase ledger listing would be identified by comparing statements received to that listing
(ii) The existence of payables recorded in the purchase ledger
(iii) The fact that the liabilities are properly those of the entity (for example, the statements are addressed to, say, the managing director in his own name)
(iv) The valuation of payables at the year-end with respect to cut-off of invoices and credit notes, and discounts or allowances

(d) The physical inspection of a non-current asset is clearly relevant to the auditor's opinion as to the existence of the asset, and to some extent the completeness of recording of assets, that is, the auditor can check that all the assets inspected have been recorded.

(e) The comparison of statement of profit or loss items with prior periods will provide evidence as to:

(i) Completeness of recording, as omissions can be identified and investigated
(ii) Accuracy, in cases where the auditor has appropriate information on which to base expectations, for example, if the number of workers has doubled during the year and a set percentage wage increase had been effected in the year
(iii) Classification, as the comparison should highlight any inconsistencies of classification and treatment from year to year
Appropriate – reliable

Reliability of audit evidence depends on the particular circumstances but the guideline offers three general presumptions.

- Documentary evidence is more reliable than oral evidence.
- Evidence obtained from independent sources outside the entity is more reliable than that secured solely from within the entity.
- Evidence originating with the auditor, e.g., by analysis or physical inspection, is more reliable than evidence originating with others.

(a) The oral representations by management would be regarded as relatively unreliable using the criteria in the guidelines, as they are oral and internal. The auditor should obtain corroborative evidence and ensure that oral representations are included in the letter of representation to support any conclusions.

(b) The assessment of how reliable the flowcharts are would depend on the auditor's overall assessment of whether the work of the internal auditors is likely to be adequate for the purposes of the external audit. The factors to be considered would include its objectivity; the internal auditors' technical competence; whether the work is carried out with due professional care; and whether there is likely to be effective communication between the internal auditors and the external auditor. This assessment should be documented by the external auditor if he is to make use of the flowcharts in his audit planning and design of tests.

(c) Suppliers' statements would generally be seen as reliable evidence, being documentary and from sources external to the entity. If the auditor had doubts as to the reliability of this evidence, it could be improved by the auditor originating similar evidence by means of a payables' circularisation rather than relying on suppliers' statements received by the client.

(d) Physical inspection of a non-current asset is a clear example of auditor-originated evidence, so would usually be considered more reliable than that generated by others.

(e) Analysis such as this comparison of statement of profit or loss items with the prior periods would again be termed auditor-generated evidence, and would be considered more reliable than evidence generated by others. Ultimately the reliability of such audit evidence depends on the reliability of the underlying data, which should be checked by substantive testing.

Sufficiency

The auditor needs to obtain sufficient relevant and reliable evidence to form a reasonable basis for his opinion on the financial statements. His judgments will be influenced by factors such as:

- His knowledge of the business and its environment
- The risk of misstatement
- The persuasiveness of the evidence

(a) To decide if the representations were sufficient with regard to concluding on the completeness of sales the auditor would consider:

(i) The nature of the business and the inherent risk of unrecorded cash sales

(ii) The materiality of the item; in this case it would appear that cash sales are material

(iii) Any possible management bias

(iv) The persuasiveness of the evidence in the light of other related audit work, for example, testing of cash receipts

If the auditor believes there is still a risk of material understatement of sales in the light of the above, he should seek further evidence.
(b) Client-prepared flowcharts are not sufficient as a basis for the auditor's evaluation of the system. To confirm that the system does operate in the manner described, the auditor should perform 'walk through' tests, tracing a small number of transactions through the system. There is, however, no need for the auditor to prepare his own flowcharts if he is satisfied that those produced by internal audit are accurate.

(c) The auditor's decision as to whether the suppliers' statements were sufficient evidence would depend on his assessment of materiality and the risk of misstatement. Its persuasiveness would be assessed in conjunction with the results of other audit work, for example, substantive testing of purchases, returns, and cash payments, and compliance testing of the purchases system.

(d) Inspection of a non-current asset would be sufficient evidence as to the existence of the asset (provided it was carried out at or close to the period end). Before concluding on the non-current asset figure in the financial statements, the auditor would have to consider the results of his work on other aspects, such as the ownership and valuation of the asset.

(e) In addition to the general considerations such as risk and materiality, the results of a comparison alone would not give very persuasive evidence. It would have to be followed by a detailed investigation of variances (or lack of variances where they were expected). The results should be compared to the auditor's expectations based on his knowledge of the business, and explanations given by management should be verified. The persuasiveness of the evidence should be considered in the light on other relevant testing, for example, compliance testing of payments systems, or substantive testing of expense invoices.

8.2 Related party transactions

<table>
<thead>
<tr>
<th>Person/entity</th>
<th>Related party</th>
<th>Why</th>
<th>Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arthur Loo</td>
<td>✓</td>
<td>Director</td>
<td></td>
</tr>
<tr>
<td>Bertrand Loo</td>
<td>✓</td>
<td>Director</td>
<td>No transactions mentioned</td>
</tr>
<tr>
<td>Catherine Loo</td>
<td>✓</td>
<td>Wife of director</td>
<td></td>
</tr>
<tr>
<td>Omar bin Ahmed</td>
<td>✓</td>
<td>Director</td>
<td>Purchases of stationery</td>
</tr>
<tr>
<td>Fancy Designs</td>
<td>✓</td>
<td>Investee of director</td>
<td></td>
</tr>
<tr>
<td>Prema Pathare</td>
<td>×</td>
<td>No longer close family and ≥ 20%</td>
<td></td>
</tr>
<tr>
<td>Felicia Xu</td>
<td>✓</td>
<td>Presumed close family and shadow director</td>
<td>Contracts drawn</td>
</tr>
<tr>
<td>Cuts and Curls</td>
<td>✓</td>
<td>Close family</td>
<td>Rental agreement</td>
</tr>
<tr>
<td>IP Roofing</td>
<td>✓</td>
<td>Sub of Orchard Properties Pte Ltd</td>
<td>Work done for Orchard (see below)</td>
</tr>
<tr>
<td>Ian Pope</td>
<td>✓/×</td>
<td>Could be considered key management of group</td>
<td></td>
</tr>
</tbody>
</table>

Disclosure

Once a related party has been identified then SFRS(I) 1-24 Related Party Disclosures requires disclosure of the nature of the relationship, as well as information about the transactions and outstanding balances.

Transactions with subsidiary companies, that is, IP Roofing and transactions with a director, Omar bin Ahmed:

Disclosure is not required of transactions which are cancelled on consolidation. However, if consolidated financial statements are not prepared due to a small/medium group exemption material transactions between the two companies would need to be disclosed.
Disclosure should include:

(i) The amount of the transactions
(ii) The amount of outstanding balances, including commitments, and:
- Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement
- Details of any guarantees given or received
(iii) Provisions for doubtful debts related to the amount of outstanding balances
(iv) The expense recognised during the period in respect of bad or doubtful debts due from related parties
(v) Payments made on behalf of related parties

(b) Notes for staff training sessions:

(i) A logical place to start the audit of related party transactions would be to identify all possible related parties. This would always include:
- Directors and shadow directors
- Group companies
- Pension funds of the company
- Associates

It is likely that the other related parties would include:
- Key management (perhaps identified by which staff have key man cover)
- Shareholder owning > 20% of the shares
- Close relatives, associates of any of the above

A related party transaction needs to be reported if it is material either to the reporting entity or to the other party to the transaction.

Related party transactions do not necessarily have to be detrimental to the reporting entity, but those which are will be easier to find. Features which may indicate this may include:
- Unusually generous trade or settlement discounts
- Unusually generous payment terms
- Recorded in the general ledger code of any person previously identified as a related party (for example, director)
- Unusual size of transaction for customers (for example, if ABM were paying a suspiciously high legal bill for a building company)

(ii) Audit steps to find related party transactions may include:
- Identification of excessively generous credit terms by reference to aged trade accounts receivable analysis
- Identification of excessive discounts by reference to similar reports
- Scrutiny of cash book/cheque records for payments made to directors or officers of the company (probably more realistic for smaller entities)
- Review of board minutes for evidence of approval of related party transactions (directors are under a fiduciary duty not to make secret profits)
- Written representations from directors to give exhaustive list of all actual/potential related parties (that is, allow us to make the materiality assessment, not them)
• Review of accounting rewards for large transactions, especially near the year-end and with non-established customers/suppliers
• Identification of any persons holding > 20% of the shares in the entity by reference to the shareholders' register

8.3 Written representations
(a) I would expect to see this referred to in a representation letter. SSA 580 gives this as an example of a matter to be included in the letter, as management should inform auditors of relevant subsequent events. If there is none, a statement to such an effect should be included in the representation letter.
(b) This should not appear on a representation letter, even though management opinion is involved. This indicates an incorrect accounting treatment which the auditors should be in disagreement with the directors over.
(c) This should not appear on a representation letter as there should be sufficient alternative evidence for this matter. The auditor should be able to obtain registered information about Subsidiary Pte Ltd from the companies' registrar, as well as other supporting documents, eg board or shareholders' minutes or resolutions.
(d) This should not appear on a representation letter. The auditors should be able to obtain evidence from Flower Oil Pte Ltd that the inventory belongs to them.

8.4 Using an auditor's expert
(a) Platforms
It is not necessary to use an auditor's expert to audit the useful lives of the platforms as there are many other available sources of evidence. Relevant procedures include:
(i) Obtaining weather reports to see whether management's determination of useful lives is consistent with them
(ii) Comparing budgeted oil against actual oil extracted (if the budget was optimistic, so might the useful life be)
(iii) Reviewing published industry comparators (such as Shell and BP). If the useful lives of their platforms as published in financial statements is significantly different, discuss with management why that might be
(iv) Considering whether management's determination of useful lives in the past has been proved accurate

(b) It is not necessary to use an auditor's expert, as the question states that a 'simple' test is available. The auditors should confirm that the company will be making use of this test during the inventory count to separate the inventory. The auditor should reperform the test on a sample of 'brass' and 'copper' as counted to ensure it has been separated correctly.
Chapters 9 and 10 cover specific accounting issues that require special consideration by the auditor. The requirements of the relevant SFRS(I) need to be carefully considered by the auditor during the audit. Four key matters should be considered for each specific accounting issue: (1) Risk; (2) Materiality; (3) Relevant accounting standards; and (4) Audit evidence. This chapter focuses primarily on the last two points above, as the first two are heavily dependent on the scenario presented in any given question. You have previously studied the audit of a basic set of financial statements. At this level the issues you will be presented with will be more complex, but remember that the key basic points apply.
1 Fair value

SECTION INTRODUCTION

Fair value measurements may arise from both the initial recording of a transaction and subsequent changes in value. Auditing fair value requires both the assessment of risk and an evaluation of the appropriateness of the fair value.

1.1 Accounting recap

KEY TERM

FAIR VALUE – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

(SFRS(I) 13)

Fair value accounting affects the audit of valuation for both assets and liabilities. Examples of accounting treatments where fair values are relevant and will require the auditor to carry out procedures include the following.

- Financial instruments (see Section 6 of this chapter)
- Employee benefits (covered in Chapter 10)
- Share-based payments (covered in Chapter 10)
- Measurement of the value of an investment property (see Section 4 of this chapter)
- Revaluation of an item of property, plant or equipment (see Section 2 of this chapter)
- Impairment of an intangible/non-current asset (see Sections 2 and 3 of this chapter)
- Goodwill calculations following business combinations (see Chapter 11)
SFRS(I) 13 uses a ‘fair value hierarchy’, which categorises the inputs used in valuation techniques into three levels:

- **Level 1 inputs**: quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date, eg quoted shares in a company trading on the Singapore Exchange.
- **Level 2 inputs**: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, eg bonds traded on a market with quoted prices but infrequent recent transactions.
- **Level 3 inputs**: unobservable inputs for the asset or liability, eg unquoted shares in a private company where valuation is calculated by using various techniques such as applying a multiple to net profit or comparing the price/earnings ratio to other similar companies.

The ‘fair value hierarchy’ aims to increase consistency and comparability when measuring fair value. As level 1 inputs are considered to be the most reliable inputs, these must be used without adjustment where available. Least priority is given to the use of level 3 inputs.

The level of disclosure in the financial statements required by SFRS(I) 13 is impacted by the level of inputs used in calculating the fair value. Additional disclosures are required for lower levels in the ‘fair value hierarchy’. The auditor will need to ensure that the correct level of disclosure has been made in the financial statements in addition to gaining sufficient, appropriate audit evidence on the fair value measurement itself.

### 1.2 Auditing fair values

For auditors, the determination of fair value will generally be more difficult than determining historical cost. It will be more difficult to establish whether fair value is reasonable for complex assets and liabilities than for more straightforward assets or liabilities which have a market and therefore a market value. For example, for an apartment held as an investment property, a fair value might be relatively easy to estimate, as there may be a large and active market for similar properties that can be used as a guide to the value of the property in question. If, on the other hand, an entity owns over-the-counter (OTC) derivatives which are contracts directly negotiated and traded between two entities, it can be difficult to measure fair value since most trades are not public and therefore the fair value computation may be subject to significant unobservable inputs. There is little to compare the fair value to and the auditor will have to be very careful about the assumptions made in arriving at a valuation.
Generally speaking, balances held at fair value carry the following risks:

<table>
<thead>
<tr>
<th>Component of audit risk</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent risk</td>
<td>Estimates are inherently imprecise, and involve judgments, eg about market conditions, timing of cash flows, or the intentions of the entity. Estimation models are often complex, eg discounted cash flows, or actuarial calculations. There is a risk of the model being misapplied. Assumptions often have to be made when estimating fair values, eg growth and discount rates. However, obtaining a fair value for some assets will be straightforward, eg assets that are regularly traded on a stock exchange.</td>
</tr>
<tr>
<td>Control risk</td>
<td>Fair value assessment is likely to take place once a year, outside of normal internal control systems. Therefore it may not be monitored as stringently as more routine transactions and balances. Alternatively, management may take extra care over a fair value assessment because it is a material amount, in which case control risk is low.</td>
</tr>
<tr>
<td>Detection risk</td>
<td>The auditor minimises detection risk through understanding the entity and its environment at the planning stage, determining whether and where fair values are present, and what the level of risk associated with them is.</td>
</tr>
</tbody>
</table>

1.3 Requirements of SSA 540

The relevant standard here is SSA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.

**KEY TERM**

**ACCOUNTING ESTIMATE** – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

(SSA 540.7)

SSA 540's requirements are as follows:

- The auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:
  - The requirements of the applicable financial reporting framework.
  - The means by which the management identifies transactions, events and conditions that may give rise to the accounting estimate to be recognised or disclosed in the financial statements.
  - How management makes the accounting estimate and an understanding of the data on which they are based.

This means that the auditor must have a sound knowledge of the accounting requirements relevant to the entity and when fair value is allowed, for example, SFRS(I) 1-16 allows fair value provided ‘it can be measured reliably’.

- The auditor shall evaluate the degree of estimation uncertainty associated with the accounting estimate and assess whether this gives rise to significant risks.
Based on the assessed risks the auditor will determine whether the financial reporting framework has been properly applied and whether methods for making estimates are appropriate and have been applied consistently.

The auditor will also:
- Determine whether events occurring up to the date of the auditor’s report provide evidence regarding the accounting estimate
- Test how management made the accounting estimate
- Test the operating effectiveness of controls together with appropriate substantive procedures
- Develop a point estimate or a range to evaluate the management’s point estimate

**KEY TERM**

**MANAGEMENT’S POINT ESTIMATE** is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

For accounting estimates which give rise to significant risks, the auditor should also evaluate the following:
- How management has considered alternative assumptions or outcomes
- Whether the significant assumptions used are reasonable
- Management intent to carry out specific courses of action and its ability to do so, where these affect the accounting estimate
- Management’s decision to recognise, or to not recognise the accounting estimate
- The selected measurement basis

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

The possibility of management bias must be considered by the auditor.

### 1.4 Risk procedures: fair value

The auditor is required to assess the entity’s process for determining accounting estimates including fair value measurements and disclosures and the related control activities and to assess the arising risks of material misstatement.

Management’s processes for determining fair values will vary considerably from organisation to organisation. Some companies will habitually value items at historical cost where possible, and may have very poor processes for determining fair value if required. Others may have complex systems for determining fair value if they have a large number of assets and liabilities which they account for at fair value, particularly where a high degree of estimation is involved in determining the fair value.

Once the auditors have assessed the risks associated with determining fair value, they should determine further procedures to address those risks.

### 1.5 Audit procedures: fair value

Audit procedures will depend heavily on the complexity of the fair value measurement. Where the fair value equates to market value, the auditor should be able to verify this with reference to the market, for
example, published price quotations for marketable securities, or by using the work of an expert, for example, an estate agent in the case of land and buildings.

However, in some cases, there may be a great deal of estimation and management assumption related to a fair value. Where this is the case, the auditor needs to consider matters such as the intent and ability of management to carry out certain actions stated in the assumptions. This includes:

- Reviewing management's past history of carrying out its stated intentions with respect to assets or liabilities
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes etc
- Considering management's stated reasons for choosing a particular course of action
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report
- Evaluating management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments

If there are alternative allowable methods for measuring fair value, or a particular method is not prescribed by the relevant accounting standard, the auditor should consider whether the entity's method is consistent with other fair value measurements in the financial statements and whether it is applied consistently.

The auditor should consider the following when considering fair value measurements:

- The length of time any assumptions cover (the longer, the more subjective the value is)
- The number of assumptions made in relation to the item
- The degree of subjectivity in the process
- The degree of uncertainty associated with the outcome of events
- Any lack of objective data
- The timings of any valuations used
- The reliability of third party evidence
- The impact of subsequent events on the fair value measurement

The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

1.6 Exposure Draft (ED) of proposed ISA 540 (revised)

During 2017, IAASB consulted on proposed changes to ISA 540 to take account of the following developments in audit practice regarding accounting estimates:

'...the auditor's identification and assessment of the risks of material misstatement for accounting estimates, and the auditor's responses to those assessed risks, are affected by complexity, the need for the use of judgment by management, and estimation uncertainty. Accordingly, these three factors are incorporated throughout ED-540. ED-540 also emphasizes the important considerations regarding complex models, forward-looking information, and internal controls in auditing accounting estimates.'

'Professional scepticism plays a central role in the audit of accounting estimates. ED-540 contains several key provisions that are designed to enhance the auditor's application of professional scepticism and consideration of the potential for management bias, including enhanced risk assessment requirements, more granular requirements with respect to obtaining audit evidence, and requirements to “stand back” and evaluate the audit evidence obtained.'

(ED 540, Executive Summary)

At the time of going to press, ISCA has responded to ED 540 but not yet issued a revised SSA 540. Full details of the ED can be found here: https://isca.org.sg/media/2238117/proposed-isa-540-revised-auditing-accounting-estimates-and-related-disclosures.pdf
SECTION SUMMARY

The auditor must assess the entity’s process for determining accounting estimates including fair value measurements. Audit procedures to address those risks will depend on the complexity of the fair value measurement.

2 Tangible non-current assets

SECTION INTRODUCTION

Auditors should ensure that tangible non-current assets have been subjected to an impairment review if there are indicators of impairment.

You covered all the key aspects relating to tangible non-current assets in your earlier studies. If you are in any doubt in this area, go back to your previous material and revise. The issue of fair value discussed in Section 1 is likely to affect the audit of non-current assets.

2.1 Recognition of non-current assets

One audit risk in relation to initial recognition is of costs being incorrectly recognised as assets, when they should in fact have been expensed to the statement of profit or loss.

SFRS(I) 1-16 Property, Plant and Equipment lists the following as components of cost:

- Purchase price, less any trade discount or rebate
- Import duties and non-refundable purchase taxes
- Directly attributable costs of bringing the asset to working condition for its intended use, for example:
  - The cost of site preparation
  - Initial delivery and handling costs
  - Installation costs
  - Testing
  - Professional fees (architects, engineers)
- Initial estimate of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located

However, the following should not be included in the cost of the asset, and should be recognised as an expense:

- Administration and other general overhead costs
- Start-up and similar pre-production costs
- Initial operating losses before the asset reaches planned performance
- Any incidental costs

2.2 Valuation of non-current assets

Non-current assets are valued using either cost or valuation (if an item has been revalued). Cost can be straightforward to audit, as it can often be verified to original purchase documentation. Valuation is not always straightforward to audit. It can be verified to the valuation certificates or reports but these rely on many assumptions and the auditors will need to assess the basis of these assumptions. Some other
assets are also not so straightforward, for example assets in the course of construction. On initial recognition, non-current assets will be held at cost (whatever the purchase price). After initial recognition, non-current assets can be held at cost or at a revalued amount (if the fair value can be measured reliably). The carrying value of most non-current assets is therefore depreciated cost, or depreciated valuation.

Once a company has revalued assets, it is required to continue revaluing them regularly so that the valuation is not materially different from the fair value at period end. The auditors should therefore check that valuation is comparable to market value. They would do this by comparing the existing valuation to current market values (for example, recent sale prices of property on the URA's website).

Depreciation can be verified by reperforming the depreciation calculations. Often a 'proof-in-total' check will be sufficient, where auditors calculate the relevant depreciation percentage on the whole class of assets to see if it is comparable to the depreciation charged for that class of assets in the year.

The depreciation rate is determined by reference to the useful life of the asset. This is determined by management based on expectations of how long the asset is expected to be in use in the business. Management must review the useful life of the asset on at least an annual basis. Note that any changes in the useful lives of non-current assets must be accounted for as a change in accounting estimate as per SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors, covered in Chapter 10 of this Textbook.

The auditors will audit useful life of assets by scrutinising those expectations and verifying them where possible – for example, to the minutes of the meeting where management decided to buy the asset, to capital replacement budgets, to past practice in the business.

Depreciation methods based on revenue are specifically disallowed under SFRS(I) 1-16. A method based on revenue is inappropriate as depreciation will reflect factors other than the consumption of the economic benefits of an asset. For example, revenue can be affected by inflation which has no bearing on the way in which an asset is consumed. Auditors must ensure that depreciation rates for non-current assets are not based on revenue.

Question 9.1

You are reviewing the file on the audit, which is nearing completion, of a listed company, Bukit Ltd. Bukit Ltd produces two products, the X and the W.

Bukit Ltd purchased two new pieces of plant in the year. Plant is valued at cost. The X103 was bought to replace the X102, which was scrapped at the start of the year. The W103 was bought to replace the W102. The W102 will no longer be used in producing the W, but will be used to test new products, particularly the V, which Bukit Ltd is hoping to be able to market and sell in the next two years.

Required

Describe matters you would consider and the audit evidence you would expect to see on file in respect of the valuation of these pieces of plant.
2.3 Impairment of non-current assets

An asset is impaired when its carrying amount (depreciated cost or depreciated valuation) exceeds its recoverable amount. You should be familiar with the following key terms from your accounting studies.

**KEY TERMS**

- **RECOVERABLE AMOUNT** of an asset or cash-generating unit is the higher of its fair value less costs to sell and its value in use.
- **CASH-GENERATING UNIT** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- **VALUE IN USE** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Management are required to determine if there is any indication that the assets are impaired. SFRS(I) 1-36 Impairment of Assets specifies the following indicators of possible impairment:

**External sources of information regarding possible impairment:**

- Market value declines significantly
- Negative changes in technology, markets, economy, or legal environment
- Increases in market interest rates that are likely to affect the discount rate using to calculate value in use
- Company stock price is below book value

**Internal sources of information regarding possible impairment:**

- Obsolescence or physical damage
- Significant changes with an adverse effect on use, eg asset will become idle, is part of a restructuring, or is held for disposal
- Internal evidence shows worse economic performance of the asset than was expected

The auditors will consider whether there are any indicators of impairment when carrying out risk assessment procedures. They will use the same impairment criteria laid out in SFRS(I) 1-36 as management do. If the auditors believe that impairment is indicated, they should request that management show them the impairment review that has been carried out. If no impairment review has been carried out, then the auditors should discuss the need for one with management, and if management refuse to carry out an impairment review, qualify their opinion on grounds of a material misstatement in respect of SFRS(I) 1-36 as a result of management not carrying out an impairment review.

If an impairment review has been carried out, then the auditors should audit that impairment review. Management will have estimated whether the recoverable amount of the asset/cash-generating unit is lower than the carrying amount.

For auditors, the audit risk is that recoverable amount requires estimation, which involves management using its judgment. Auditors will need to consider whether the judgment made by management is reasonable in accordance with SFRS(I) 1-36.

The ACRA Audit Practice Bulletin 2 of 2011 Audit Considerations in an Uncertain Economic Environment notes that the economic slowdown may have a negative impact on a company's profitability and its cash flows from non-financial assets and increase the likelihood of assets impairment.

Management have to determine if recoverable amount is higher than carrying amount. It may not have been necessary for them to estimate both fair value less cost to sell and value in use, because if one is
higher than carrying amount, then the asset is not impaired. If it is not possible to make a reliable estimate of fair value less cost to sell, then it is necessary to calculate value in use.

Fair value less cost to sell is only calculable if there is an active market for the asset, and would therefore be audited in the same way as fair value which was set out in Section 1. Costs to sell such as taxes can be recalculated by applying the appropriate tax rate to the fair value itself. Delivery costs can be verified by comparing costs with published rates by delivery companies, for example, on the internet.

If management have calculated the value in use of an asset or cash-generating unit, then the auditors will have to audit that calculation. The following procedures will be relevant.

<table>
<thead>
<tr>
<th>Value in use</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Obtain management's calculation of value in use</td>
</tr>
<tr>
<td>• Reperform calculation to ensure that it is mathematically correct</td>
</tr>
<tr>
<td>• Compare the cash flow projections to recent budgets and projections approved by the Board to ensure that they are realistic</td>
</tr>
<tr>
<td>• Calculate/obtain from analysts the long term average growth rate for the products and ensure that the growth rates assumed in the calculation of value in use do not exceed it</td>
</tr>
<tr>
<td>• Refer to competitors' published information to compare how similar assets are valued by companies trading in similar conditions</td>
</tr>
<tr>
<td>• Compare to previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been included</td>
</tr>
<tr>
<td>• Ensure that the cost/income from disposal of the asset at the end of its life has been included</td>
</tr>
<tr>
<td>• Review calculation to ensure cash flows from financing activities and income tax have been excluded</td>
</tr>
<tr>
<td>• Compare discount rate used to published market rates to ensure that it correctly reflects the return expected by the market</td>
</tr>
<tr>
<td>• Obtain expert opinion on the value in use computation, and on the assumptions used</td>
</tr>
</tbody>
</table>

If the asset is impaired and has been written down to recoverable amount, the auditors should review the financial statements to ensure that the write-down has been carried out correctly and that the SFRS(I) 1-36 disclosures have been made correctly.

Audit Practice Bulletin No 2 of 2010: Impairment of Non-Financial Assets covered the main findings of ACRA when reviewing this area performed by Chartered Accountants. The main findings were as follows:

• Failure to identify the appropriate cash-generating unit to which an asset belongs
• Inadequate impairment assessment carried out on pre-operating or start-up subsidiary companies
• Failure to consider impairment of underlying assets prior to using the net tangible assets value of subsidiary companies to assess for indications of impairment of investments in subsidiary companies
• Failure to justify the basis of using profit (instead of cash flow) projections for value in use calculation
• Incorrect comparison of amounts when assessing impairment
• Insufficient testing or challenging of the cash flow projections prepared by management
• Reasonableness of discount rates used not adequately assessed
• No assessment of reversal of impairment loss previously recognised

ALERT

Audit Practice Bulletins are issued by ACRA to highlight current or emerging issues that may have a bearing on the conduct of audits. Only 15 have been published since 2009. You should familiarise yourself with these as they detail common errors made in real-life scenarios.
2.4 Held for sale non-current assets

SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations applies to non-current assets and disposal groups. A disposal group is a group of assets and associated liabilities that are to be disposed of in a single transaction.

SFRS(I) 5 requires that non-current assets and disposals groups that are ‘held for sale’ should be presented separately in the statement of financial position. ‘Held for sale’ here means that the non-current asset/disposal group’s carrying amount will be recovered principally through a sale rather than through continuing use. A number of detailed criteria must be met:

(a) The asset must be available for immediate sale in its present condition
(b) The sale must be highly probable

For sale to be highly probable the following must apply:

(a) Management must be committed to a plan to sell the asset
(b) There must be an active plan to locate a buyer
(c) The asset must be marketed at a price that is reasonable in relation to its current fair value
(d) The sale should be expected to take place within one year from the date of classification
(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn

A non-current asset held for sale should be measured at the lower of its carrying amount and fair value less costs to sell. An impairment loss should be recognised where fair value less costs to sell is lower than the carrying amount.

Non-current assets held for sale should not be depreciated even if they are still being used by the entity.

The following audit procedures will therefore be relevant.

- Confirm that the asset meets the definition of an asset held for sale:
  - Discuss with management the availability of asset for sale
  - Assess management commitment, eg recorded in board minutes
  - Evaluate and assess practical steps being taken to sell the asset eg appropriate real estate agents appointed
  - Determine when the sale is expected to take place by assessing progress to date
  - Determine and assess the basis on which the sale price has been set
  - Discuss with management any significant changes to the plans
- Confirm that the asset has been valued as held for sale in accordance with SFRS(I) 5 and assess how fair value has been determined
- Check that the asset has not been depreciated from the date of reclassification
- Confirm separate disclosure in accordance with SFRS(I) 5
SECTION SUMMARY

Key assertions relating to assets are existence, completeness, valuation and rights and obligations. This section has explained the valuation assertion. You should have covered the other assertions in your earlier studies.

3 Intangible non-current assets

SECTION INTRODUCTION

Accounting guidance for intangibles is given in SFRS(I) 1-38 *Intangible Assets* and SFRS(I) 3 *Business Combinations*.

The types of asset we are likely to encounter under this heading include patents, licences, trademarks, development costs and goodwill. All intangibles with indefinite useful lives or not available for use should be subject to an annual impairment review.

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

An intangible asset is 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.

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture film rights, customer lists, franchises and fishing rights. An item should not be recognised as an intangible asset, however, unless it fully meets the definition in the standard. The guidelines go into great detail on this matter.

Internally generated goodwill may not be recognised as an asset.

The auditor should carry out the following procedures.

**Completeness**

Prepare analysis of movements on cost and amortisation accounts

**Rights and obligations**

- Obtain confirmation of all patents and trademarks held by a patent agent
- Verify payment of annual renewal fees

**Valuation**

- Review specialist valuations of intangible assets, considering:
  - Qualifications of valuer
  - Scope of work
  - Assumptions and methods used
- Confirm carried down balances represent continuing value, which are proper charges to future operations

**Additions (rights and obligations, valuation and completeness)**
- Inspect purchase agreements and supporting documentation for intangible assets acquired in period
- Confirm purchases have been authorised
- Verify amounts capitalised of patents developed by the company with supporting costing records

### Amortisation
- Review amortisation
  - Check computation
  - Confirm that rates used are reasonable

### Income from intangibles
- Review sales return dockets and statistics to verify the reasonableness of income derived from patents, trademarks, licences etc

There is a rebuttable presumption that revenue-based depreciation methods for intangible assets are inappropriate. Intangible assets can only be amortised using a revenue-based method if:

- It can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated; or
- The intangible asset is expressed as a means of revenue such as the right to operate a toll road until a fixed amount of revenue has been collected.

Auditors will need to incorporate a consideration of whether intangible assets are being amortised on an appropriate basis into their audit procedures on amortisation.

### 3.1 Goodwill

Key audit procedures are as follows.

- Agree consideration to a sales agreement
- Review the purchase price allocation exercise and the valuation of assets acquired (tangible and intangible) and liabilities assumed (actual and contingent) is reasonable
- Check purchased goodwill is calculated correctly
- Check goodwill does not include non-purchased goodwill
- Ensure carrying amount of goodwill is reasonable by reviewing prior year’s financial statements and discussion with the directors
- Ensure impairment review has been carried out at least annually
- Review impairment review for reasonableness
- Obtain expert opinion on the valuation of goodwill/impairment review

Goodwill is covered in more detail in the context of the audit of groups in Chapter 11.

### 3.2 Development costs

**SFRS(I) 1-38 Intangible Assets**
- Development costs may be included in the statement of financial position (that is to say, capitalised) only in 'special circumstances' laid out in SFRS(I) 1-38 *Intangible Assets*.
- SFRS(I) 1-38 defines research and development as follows.
  - Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
PART D PERFORMING THE STATUTORY AUDIT

– Development is 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.

• Expenditure on research is required to be recognised in profit or loss in the year of expenditure.
• SFRS(I) 1-38 states that the development costs of a project should be recognised as an asset only 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.

The development costs of a project recognised as an asset should not exceed the amount that is likely to be recovered from related future economic benefits, after deducting further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product.

• In all other circumstances development costs should be recognised in profit or loss in the year of expenditure.

The key audit tests largely reflect the criteria laid down in SFRS(I) 1-38.

• Check accounting records to confirm:
  – Project is clearly defined (separate cost centre or general ledger codes)
  – Related expenditure can be separately identified, and certified to invoices, timesheets

• Confirm feasibility and viability:
  – Examine market research reports, feasibility studies, budgets and forecasts
  – Consult client’s technical experts

• Review budgeted revenues and costs by examining results to date, production forecasts, advance orders and discussion with directors.

• Review calculations of future cash flows to ensure resources exist to complete the project.

• Review previously deferred expenditure to ensure SFRS(I) 1-38 criteria are still justified.

• Check amortisation:
  – Commences with production
  – Charged on a systematic basis

The good news for the auditors in this audit area is that many companies adopt a prudent approach and write-off research and development expenditure in the year it is incurred. The auditors’ concern in these circumstances is whether the R&D charge in the statement of profit or loss is complete, accurate and valid.

3.3 Brands

The key accounting issue with regard to brands is whether the asset is internally generated or not. Remember, SFRS(I) 1-38 forbids the capitalisation of internally generated brands.

If a brand has been purchased separately then auditors should test the value of the brand according to the sales documentation.
SECTION SUMMARY
The key audit issues relating to intangibles are whether an asset should be recognised and, if so, at what value both at initial and subsequent recognition.

4 Investment properties

SECTION INTRODUCTION
Accounting guidance for investment properties is given in SFRS(I) 1-40 Investment Property.

A key assertion to consider when auditing investment properties is existence according to the criteria of SFRS(I) 1-40 Investment Property.

KEY TERM
INVESTMENT PROPERTY is property (land or a building – or part of a building – or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:
- Use in the production or supply of goods or services or for administrative purposes, or
- Sale in the ordinary course of business

(SFRS(I) 1-40)

<table>
<thead>
<tr>
<th>Type of non-investment property</th>
<th>Applicable SFRS(I)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property held for sale in the ordinary course of business</td>
<td>SFRS(I) 1-2 Inventories</td>
</tr>
<tr>
<td>Owner-occupied property</td>
<td>SFRS(I) 1-16 Property, Plant and Equipment</td>
</tr>
</tbody>
</table>

Substantive tests
- Confirm that property meets the SFRS(I) 1-40 definition of investment property
- Verify rental agreements, ensuring that occupier is not a related company and that the rent has been negotiated at arm's length

The second important assertion in relation to investment properties is valuation. SFRS(I) 1-40 requires that investment properties either be held at cost or at fair value. This approximates to open market value. Fair value should be determined in accordance with SFRS(I) 13 Fair Value Measurement.

The last key issue with regard to investment properties is disclosure. The auditor should review the disclosures made in the financial statements in relation to investment properties to ensure that they have been made appropriately, in accordance with SFRS(I) 1-40.
SECTION SUMMARY

The auditor must determine whether an investment property meets the definition in SFRS(I) 1-40. If held at fair value the valuation must be in accordance with SFRS(I) 13.

5 Inventory

SECTION INTRODUCTION

When standard costing is used, the auditor must assess whether the valuation is reasonable.

5.1 Inventory

SFRS(I) 1-2 Inventories

Inventory should be measured at the lower of cost and net realisable value. Costs include costs of purchase, conversion and others incurred in bringing inventory to its present location and condition.

SSA 501 Audit Evidence – Specific Considerations for Selected Items contains specific guidance on inventory. It says that attending the inventory count is compulsory where inventory is material (unless it is not practical to do so). The auditor must then perform procedures to determine whether inventory in the financial statements accurately reflects the inventory actually counted. Further guidance is provided in AGS 4 Existence and Valuation of Inventories In the Context of the Historical Cost System.

5.2 Inventory count

Where inventory is material, auditors shall obtain sufficient appropriate audit evidence regarding its existence and condition by attending the physical inventory count (unless this is impracticable) to do the following:

- Evaluate management's instructions and procedures for recording and controlling the result of the physical inventory count
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts

The auditor shall also perform audit procedures over the entity's final inventory records to determine whether they accurately reflect the count results.

Attendance at the inventory count can serve as either substantive procedures or tests of controls, depending on the auditor's risk assessment, planned approach and specific procedures carried out.

Factors to consider when planning attendance at the inventory count include the following:

- The risks of material misstatement related to inventory
- The nature of internal control related to inventory
• Whether adequate procedures are expected to be established and proper instructions issued for counting
• The timing of the count
• Whether the entity maintains a perpetual inventory system
• Locations at which inventory is held (including materiality at different locations)
• Whether the assistance of an auditor's expert is required

A business may count inventory by one or a combination of the following methods.

(a) Physical inventory counts at the year-end
(b) Physical inventory counts before or after the year-end
   This will provide audit evidence of varying reliability depending on:
   (i) The length of time between the physical inventory count and the year-end (the greater the time period, the less the value of audit evidence)
   (ii) The business's system of internal controls
   (iii) The quality of records of inventory movements in the period between the physical inventory count and the year-end
(c) A perpetual inventory system where management has a programme of inventory counting throughout the year

If a perpetual inventory system is used, auditors will verify that management:

(a) Ensures that all inventory lines are counted at least once a year.
(b) Maintains adequate inventory records that are kept up to date. Auditors may compare sales and purchase transactions with inventory movements and carry out other tests on the inventory records, for example, checking casts and classification of inventory.
(c) Has satisfactory procedures for inventory counts and test-counting. Auditors should confirm the inventory count arrangements and instructions are as rigorous as those for a year-end inventory count by reviewing instructions and observing counts. Auditors will be particularly concerned with cut-off, that there are no inventory movements while the count is taking place and inventory records are updated up until the time of the inventory count.
(d) Investigates and corrects all material differences. Reasons for differences should be recorded and any necessary corrective action taken. All corrections to inventory movements should be authorised by a manager who has not been involved in the detailed work. These procedures are necessary to guard against the possibility that inventory records may be adjusted to conceal shortages. Auditors should check that the procedures are being operated effectively.

Key audit procedures for auditing a perpetual inventory system are as follows.

• Attend at least one of the inventory counts (to observe and confirm that instructions are being adhered to).
• Follow up the inventory counts attended to compare quantities counted by the auditors with the inventory records, obtaining and verifying explanations for any differences, and checking that the client has reconciled count records with book inventory records.
• Review the year's inventory counts to confirm the extent of counting, the treatment of discrepancies and the overall accuracy of records (if matters are not satisfactory, auditors will only be able to gain sufficient assurance by a full count at the year-end).
• Assuming a full count is not necessary at the year-end, compare the listing of inventory with the detailed inventory records, and carry out other procedures (cut-off, analytical review) to gain further comfort.
Where a perpetual inventory system is used, the test count will act as a test of controls. The auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

The auditor must also perform substantive audit procedures to obtain audit evidence over the completeness and existence assertions of inventory balances at the year-end.

Attendance at an inventory count gives evidence of the existence and apparent ownership of inventory. It also gives evidence of the completeness of inventory, as do the follow-up tests to ensure all inventory sheets were included in the final count.

### 5.3 Planning attendance at inventory count

As part of the planning for attendance at the inventory count, the auditors should ensure that adequate audit procedures (eg audit coverage) are planned based on the considerations listed below and that the client's count instructions are reviewed.

<table>
<thead>
<tr>
<th>Audit Plan: Planning Inventory Count</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gain knowledge</strong></td>
</tr>
<tr>
<td>• Review previous year's arrangements</td>
</tr>
<tr>
<td>• Understand the inventory count arrangements and significant changes through discussion with management</td>
</tr>
<tr>
<td><strong>Consider key factors</strong></td>
</tr>
<tr>
<td>• The nature and volume of the inventory</td>
</tr>
<tr>
<td>• Risks relating to inventory</td>
</tr>
<tr>
<td>• Identification of high value items</td>
</tr>
<tr>
<td>• Method of accounting for inventory</td>
</tr>
<tr>
<td>• Location of inventory and how it affects inventory control and recording</td>
</tr>
<tr>
<td>• Internal control and accounting systems (for identification of potential areas of difficulty)</td>
</tr>
<tr>
<td><strong>Plan procedures</strong></td>
</tr>
<tr>
<td>• Ensure a representative selection of locations, inventory and procedures are covered</td>
</tr>
<tr>
<td>• Ensure sufficient attention is given to high value items</td>
</tr>
<tr>
<td>• Arrange to obtain third party confirmation (if inventory is being held by third parties)</td>
</tr>
<tr>
<td>• Consider the need for expert help</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Review of Inventory Count Instructions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Organisation of count</strong></td>
</tr>
<tr>
<td>• Supervision by senior staff including senior staff not normally involved with inventory</td>
</tr>
<tr>
<td>• Tidying and marking inventory to prevent double counting</td>
</tr>
<tr>
<td>• Restriction and control of the production process and inventory movements during the count</td>
</tr>
<tr>
<td>• Identification of damaged, obsolete, slow-moving, third-party and returnable inventory</td>
</tr>
<tr>
<td><strong>Counting</strong></td>
</tr>
<tr>
<td>• Systematic counting to ensure all inventory is counted</td>
</tr>
<tr>
<td>• Teams of two counters, with one counting and the other checking or two independent counts</td>
</tr>
<tr>
<td><strong>Recording</strong></td>
</tr>
<tr>
<td>• Serial numbering, control and return of all inventory sheets</td>
</tr>
<tr>
<td>• Inventory sheets being completed in ink and signed</td>
</tr>
<tr>
<td>• Information to be recorded on the count records (location and identity, count units, quantity counted, conditions of items, stage reached in production process of work-in-progress)</td>
</tr>
<tr>
<td>• Recording of last numbers of goods inwards and outwards records</td>
</tr>
<tr>
<td>• Reconciliation with inventory records and investigation and correction of any differences</td>
</tr>
</tbody>
</table>

### 5.4 Attendance at inventory count

During the count the auditors should observe whether the count is being carried out according to instructions, perform test counts, and watch out for third-party inventory and slow-moving inventory and cut-off problems.
Key audit procedures during the inventory count are as follows.

- Observe whether the client’s staff are following instructions, as this will help to ensure the count is complete and accurate.
- Perform test counts to ensure procedures and internal controls are working properly, and to gain evidence over existence and completeness of inventory.
- Ensure that the procedures for identifying damaged, obsolete and slow-moving inventory operate properly; the auditors should obtain information about the inventory’s condition, age, usage and, in the case of work-in-progress, its stage of completion to ensure that it is valued appropriately.
- Confirm that inventory held on behalf of third parties is separately identified and accounted for so that inventory is not overstated.
- Conclude whether the count has been properly carried out and is sufficiently reliable as a basis for determining the existence of inventory.

Overall, the auditor must gain sufficient appropriate audit evidence of the existence and valuation of inventory held so that the auditors may conclude whether the figure for inventory appearing in the financial statements is reasonable.

When carrying out test counts the auditors should select items from the count records and from the physical inventory and check one to the other. These two-way tests provide evidence for existence and completeness of the count records. The auditors should concentrate on high value inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory be recounted.

5.5 Audit procedures for cut-off

Cut-off is most critical to the accurate recording of transactions in a manufacturing or trading enterprise at particular points in the accounting cycle as follows.

- The point of purchase and receipt of goods and services
- The requisitioning of raw materials for production
- The transfer of completed work-in-progress to finished goods
- The sale and despatch of finished goods

While cut-off is a transaction assertion, it is important to note that it has a direct impact on the related statement of financial position balances. For example, a cut-off error in the recording of revenue will result in misstatements in the inventory and receivables balances. A cut-off error in the recording of purchases of raw materials will have an equal knock-on effect on inventory and payables. Therefore, cut-off testing is often used to confirm the completeness of inventory, as well as the existence of receivables and payables.

The auditors should consider whether management has implemented adequate cut-off procedures: procedures intended to ensure that movements into, within and out of inventory are properly identified and reflected in the accounting records.

Purchase invoices should be recorded as liabilities only if the goods were received prior to the count. A schedule of 'goods received not invoiced' should be prepared, and items on the list should be accrued for in the accounts.

Conversely, sales invoices for goods despatched after the count should not be recorded as revenue for the period.

Prior to the physical inventory count, management should make arrangements for cut-off to be properly applied.

(a) Appropriate systems of recording of receipts and despatches of goods are in place, and also a system for documenting materials requisitions. GRNs and GDNs should be sequentially pre-numbered.

(b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and sales have been recorded in the current period.
Note that it may be necessary to also examine the terms of sales agreements to determine exactly when the transfer of inventory ownership occurs.

(c) Arrangements should be made to ensure that the cut-off arrangement for inventory held by third parties is satisfactory.

There should ideally be no movement of inventory during the count. Preferably, receipts and despatches should be suspended for the full period of the count. It may not be practicable to suspend all deliveries, in which case any deliveries which are received during the count should be segregated from other inventory and are carefully documented.

The above procedures are suitable where a business makes a physical inventory count at the year-end. However, a business may make a physical inventory count before or after the year-end. If the physical inventory count is performed at a date which is different to the year-end, the auditors must perform procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. An example of such a procedures is vouching delivery notes to inventory that has been delivered between the inventory count and year-end.

5.6 After the inventory count

After the count the auditors should check that final inventory sheets have been properly compiled from count records and the inventory balance in the general ledger has been appropriately adjusted.

After the count, the matters recorded in the auditors' working papers at the time of the count or measurement should be followed up. Key audit procedures include the following.

- Trace items that were test counted to final inventory sheets.
- Observe whether all count records have been included in final inventory sheets.
- Inspect final inventory sheets to ensure they are supported by count records.
- Ensure that perpetual inventory records have been adjusted to the amounts physically counted or measured, and that differences have been investigated.
- Confirm accuracy of cut-off by using details of the last serial number of goods inward and outward notes and details of movements during the count.
- Review confirmation replies from third parties on inventory held by them.
- Check computation of inventory balances (ie price x quantity).

5.7 Inventory held by third parties

Where the entity has inventory that is held by third parties and which is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence by performing one or both of the following:

- Direct confirmation from the third party regarding quantities and condition (in accordance with SSA 505 External confirmations)
- Inspection or other appropriate audit procedures (if third party's integrity and objectivity are doubtful, for example)

The other appropriate audit procedures referred to above could include the following:

- Attending, or arranging for another auditor to attend, the third party's inventory count
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation in respect of third-party inventory (eg warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral
5.8 Standard costing

An additional thing to consider in the audit of inventory is what evidence to obtain about cost, when there is a standard costing system in operation. Remember that SFRS(I) 1-2 allows standard costs to be used when prices are fluctuating. For accuracy and proper valuation, standard costs should approximate actual costs.

Where standard costing is being used the auditor will have two objectives:

- Ensure that standard costing is an appropriate basis for valuing inventory
- Ensure that the calculation of the standard cost is reasonable

In evaluating whether standard costs are an appropriate basis, the auditor must:

- Establish whether prices have fluctuated. This can be done by reviewing purchase invoices, consulting a price index and enquiry of management.
- Consider if the use of standard costing is the best accounting policy to use. This should be discussed with the directors.
- If the accounting policy has changed from the previous year, he must consider the comparability of the financial statements.
- There should also be disclosure about any changes of accounting policy in the financial statements, which he should ensure is sufficient.

In ensuring that the calculation of the standard cost is reasonable, the auditor must:

- Obtain a copy of the calculation of standard cost
- Check the additions and calculations
- Consider whether the calculation is reasonable (for example, based on averages of costs over the year)
- Verify elements of the calculation to appropriate documentation, for example:
  - Purchase prices to invoices
  - Wages and salaries to personnel records
  - Overheads to expenses in the financial statements where possible
- Or, the standard cost may be verifiable by analytical procedures with comparison to total expense figures in the statement of profit or loss, for example, wages should be based on the total wage cost divided by the production total for the year.
- Analyse the variances for the year. When a variance account has a large balance, the auditor must consider allocate on a pro-rata basis the variance to inventory and to cost of sales, instead of charging the entire variance to cost of sales. A large adverse material price variance, for example, may indicate that the true cost of inventory is greater than the standard cost. If the variance is written off, the cost of inventory is understated.

SECTION SUMMARY

Attending an inventory count is compulsory where inventory is a material figure on the statement of financial position.
6 Financial instruments

SECTION INTRODUCTION
When auditing financial instruments, the auditors will have to ensure that recognition and valuation is in accordance with SFRS(I) 9 Financial Instruments.

6.1 Background
If you read the financial press you will probably be aware of rapid international expansion in the use of financial instruments over the last 15 years or so. These vary from straightforward, traditional instruments, such as loans and deposits, through to various and exotic forms of derivative instruments, structured products, and commodity contracts. Some of the more complex instruments played a role in the financial crisis of 2007/8.

This is a particularly risky area for auditors, as accounting for these instruments involves an unavoidable element of complexity, often requiring the use of management’s own judgments. The amounts involved can be highly material, which adds not only audit risk but business risk too.

ALERT
The main risk with financial instruments is that they are not accounted for in accordance with SFRS(I). Also, management may not understand the business risks to which they may be exposing the entity (which may affect the assessment of going concern).

The auditing guidance in this section is based on SSA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures. The Singapore Auditing Practice Note (SAPN) 1000 Special Considerations in Auditing Financial Instruments which was released in May 2013 also provides some useful guidance on this area.

6.2 Accounting treatment recap
Under SFRS(I), the relevant standard is now SFRS(I) 9 Financial Instruments. The standard applies for annual periods beginning on or after January 2018, but earlier application is permitted. SFRS(I) 9 sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. SFRS(I) 9 replaces the existing standard SFRS(I) 1-39 Financial Instruments: Recognition and Measurement. It was issued following calls from the users of financial statements for a new Standard for reporting financial instruments that was principle-based and less complex.

Other requirements for financial instruments are found in SFRS(I) 1-32 Financial Instruments: Presentation and SFRS(I) 7 Financial Instruments: Disclosure. You should be familiar with these from your financial reporting studies.
KEY TERMS

A **FINANCIAL INSTRUMENT** is a contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

A **FINANCIAL ASSET** is any asset that is:

- Cash
- An equity instrument of another entity
- A contractual right to receive cash or another financial asset from another entity or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity
- A contract that will or may be settled in the entity's own equity instruments and is:
  - A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

A **FINANCIAL LIABILITY** is a liability that is:

- A contractual obligation:
  - To deliver cash or another financial asset to another entity
  - To exchange financial instruments with another entity under conditions that are potentially unfavourable
- A contract that will or may be settled in the entity's own equity instruments and is:
  - A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments or
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

An **EQUITY INSTRUMENT** is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

(SFRS(I) 1-32.11)

Financial instruments include:

(a) Primary instruments, eg receivables, payables and equity securities
(b) Derivative instruments, eg options, futures and forwards, interest rate swaps and currency swaps

Examples of financial assets include:

- Trade receivables
- Options
- Shares (when used as an investment)

Financial assets are classified on the basis of the business model within which they are held and their contractual cash flow characteristics. There are three possible classifications which are:

- Fair value through profit or loss
- Fair value through other comprehensive income
- Amortised cost
Examples of financial liabilities include:

- Trade payables
- Debenture loans payable
- Redeemable preference (non-equity) shares
- Forward contracts standing at a loss

Except for trade receivables, a financial instrument is recognised initially at its fair value plus (in most cases) transaction costs that are directly attributable to the acquisition or issue of the financial instrument.

### 6.2.1 SFRS(I) 7 Financial Instruments: Disclosure

SFRS(I) 7 requires entities to make extensive disclosures in relation to financial instruments, which we will recap briefly here. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

Two types of disclosure need to be made: about the significance of the financial instruments, and about the nature and extent of risks arising from the financial instruments.

### 6.2.2 SFRS(I) 1-32 Financial Instruments: Presentation

One key requirement of SFRS(I) 1-32 relates to compound financial instruments, for example convertible debt, where SFRS(I) 1-32 requires the debt and equity elements of the instrument to be presented separately in the financial statements. The following method is recommended to calculate the split:

(a) Calculate the value for the liability component
(b) Deduct this from the instrument as a whole to leave a residual value for the equity component

Accounting in this area requires a level of judgment, which can be risky from an auditor's point of view. For example, judgment is required when calculating the present value of debt repayments (e.g. in selecting an appropriate discount rate).

### 6.3 Business risk

Financial instruments may help to reduce business risk if used well, but their inherent complexity may increase business risk. This is particularly likely where management:

- Do not fully understand the risks of using financial instruments and have insufficient skills and experience to manage those risks;
- Do not have the expertise to value them appropriately in accordance with SFRS(I);
- Do not have sufficient controls in place over financial instrument activities; or
- Inappropriately hedge risks or speculate.

### 6.4 Auditing financial instruments

#### 6.4.1 Audit risk

Audit risk will probably be increased by the presence of complex financial instruments because:

(a) It may be difficult to understand the nature of financial instruments and what they are used for, and the risks to which the entity is exposed.

(b) Market sentiment and liquidity can change quickly, placing pressure on management to manage their exposures effectively.

(c) Evidence supporting valuation may be difficult to obtain.
(d) There may be large individual payments, which may increase the risk of misappropriation of assets.

(e) The amounts in the financial statements may not be proportionate to the level of risk involved.

(f) There may be undue reliance on a few key employees, who may exert significant influence on the entity's financial instruments transactions, and whose compensation may be linked to the performance of these instruments. This may be a risk of fraudulent financial reporting.

SAPN 1000 notes that the need for professional scepticism increases with the complexity of financial instruments.

It is important to realise, however, that financial instruments do not always result in high audit risk. If the entity is making use of simple financial instruments, eg loans or bonds, then these can be audited without any particular difficulties. Other factors affecting the risk of material misstatement include:

- The volume of financial instruments to which the entity is exposed
- The terms of the financial instrument, including whether the financial instrument itself includes other financial instruments
- The nature of the financial instruments

### 6.4.2 Audit planning

Where financial instruments are present, the auditor should focus on the following matters.

<table>
<thead>
<tr>
<th>Financial instruments – matters to focus on in audit planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understanding the accounting and disclosure requirements (ie Section 6.2 above)</td>
</tr>
<tr>
<td>Understanding the financial instruments to which the entity is exposed, and their purpose and risks</td>
</tr>
<tr>
<td>Determining whether specialised skills and knowledge are needed in the audit</td>
</tr>
<tr>
<td>Understanding and evaluating the system of internal control in light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit</td>
</tr>
<tr>
<td>Understanding the nature, role and activities of the internal audit function</td>
</tr>
<tr>
<td>Understanding management's process for valuing financial instruments, including whether management has used an expert or a service organisation</td>
</tr>
<tr>
<td>Assessing and responding to the risk of material misstatement</td>
</tr>
</tbody>
</table>

The auditor must decide to what extent internal controls can be relied upon. The SAPN points out that entities with a high volume of trading are more likely to have sophisticated controls (which might be relied upon), whereas entities with a low volume of trading will probably have to be audited substantively in this area.

### 6.5 Audit procedures

#### 6.5.1 General procedures

Analytical procedures are unlikely to be used as substantive procedures here (they are high-level, and may fail to pick up on risks arising from the complexity of the financial instruments).

SAPN 1000 suggests the following procedures for testing completeness, accuracy and existence.

<table>
<thead>
<tr>
<th>Procedures on completeness, accuracy and existence</th>
</tr>
</thead>
<tbody>
<tr>
<td>External confirmation of bank accounts, trades, and custodian statements – eg direct confirmation with the counterparty</td>
</tr>
<tr>
<td>Reviewing reconciliations of statements or data feeds from custodians (eg investment funds) with the entity's own records</td>
</tr>
<tr>
<td>Reviewing journal entries and the controls over the recording of such entries</td>
</tr>
</tbody>
</table>
Procedures on completeness, accuracy and existence

- Reading individual contracts and reviewing supporting documentation of the entity's financial instrument transactions, including accounting records
- Testing controls, eg by reperforming controls
- Reviewing the entity's complaints management systems – unrecorded transactions may result in the entity's failure to make a cash payment to a counterparty, and may be detected by reviewing complaints received
- Reviewing master netting arrangements to identify unrecorded instruments

6.5.2 Procedures relating to valuation

Where financial instruments are held at fair value (in accordance with Section 6.2 above), their valuation must be tested. This is one of the riskiest aspects of auditing them. In developing a valuation, management may do any of three things:

(a) Utilise information from third-party pricing sources, eg a broker
(b) Gather data to develop their own estimate using various techniques including models
(c) Engage an expert to develop an estimate

The following procedures apply generally:

Procedures on valuations of financial instruments

- Test how management made the accounting estimate and the data used. Check that fair value is arrived at in accordance with SFRS(I) 13, using the ‘fair value hierarchy’.
- Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Develop a point estimate or a range to evaluate management's point estimate, eg the auditor can make his own estimate of the fair value.
- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate, eg are there any indicators of impairment?

Where management has taken option (a) above (use information from a third party), the following considerations apply.

- The type of third-party pricing source – how much information is available about the valuation?
- The nature of inputs used and the complexity of the valuation technique – eg are inputs Level 1 or Level 3 inputs, per SFRS(I) 13?
- The reputation and experience of the third-party pricing source – does their experience include this specific type of financial instrument?
- The entity's controls over the use of third-party pricing sources – has the entity assessed whether the third party is reliable?
- The third-party pricing source's controls.
- The objectivity of the third-party pricing source.

When management uses its own model (b, above), there are two options available to the auditor: test management's model or develop the auditor's own model.

Finally, management may use a management's expert (valuation procedure (c) above). In this case SSA 500 applies, and procedures may include:

- Evaluating the competence, capabilities and objectivity of management's expert
- Obtaining an understanding of the work of the management's expert
- Evaluating the appropriateness of that expert's work as audit evidence
6.5.3 Disclosures

SFRS(I)s require extensive disclosures about financial instruments, and there is a risk that these have not been made. Check that disclosures comply with SFRS(I) 7. This includes qualitative disclosures about exposure to risk and risk management, and quantitative disclosures of summary data about exposures.

Question 9.2

On 1 January 20X8 Silver Ltd issued a $20 million debenture at par, with a nominal rate of interest of 4%. The debenture is redeemable in five years’ time at which point the holder will have the option to convert the debenture to 12 million $1 ordinary shares in Silver Ltd. The debenture has been recorded in the financial statements as a long-term liability at the net proceeds of issue. The first payment of interest on 31 December 20X8 has also been recorded.

Required
(a) Identify the audit issues.
(b) List the audit procedures you would perform.

SECTION SUMMARY

Audit risk associated with financial instruments depends on the volume, terms and nature of financial instruments. Audit procedures will focus on completeness, accuracy, existence and valuation.

7 Foreign exchange rates

SECTION INTRODUCTION

The presence of foreign exchange transactions or translations is likely to increase audit risk, so the auditor must perform procedures to reduce this risk.

You will have studied the accounting rules in relation to foreign exchange in depth in your Financial Reporting studies. You must be familiar with the accounting issues, then think about the area from the perspective of the external auditor. The key issue here is that the introduction of foreign exchange into a scenario increases the level of audit risk. This is most likely to be examined in the context of a group that includes an overseas subsidiary company.

7.1 Individual company

Perhaps the most immediate audit risk here is that the entity fails to comply with the accounting requirements of SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates. For an individual company conducting trade in foreign currencies, there are two separate accounting issues: conversion and translation.

Conversion is uncontroversial, and relates to an entity conducting transactions in a foreign currency, and which incurs exchange gains/losses in relation to these transactions. The rule is simple: the gain or loss on conversion is recognised directly in profit or loss in the period in which it occurs. The principal risk here is of the wrong exchange rate being used, resulting in misstatement of the gain/loss in the financial statements.
Translation is more complex. Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency. SFRS(I) 1-21 distinguishes between monetary items and non-monetary items. The basic rule is that monetary items (eg cash, receivables) should be retranslated using the rate ruling at the end of each accounting period. Non-monetary items are left at the amount recognised at the date of the transaction.

The auditor also needs to determine the functional currency of the entity, that is the main currency used for business transactions.

Audit procedures here would therefore include:

- Check that foreign currency transactions are recorded at the historic rate on initial recognition (and in the statement of profit or loss).
- Check that monetary items included in the statement of financial position at the year-end are translated at the closing rate of exchange.
- Check that non-monetary items are translated at the historical rate of exchange.

### 7.2 Groups

It is also possible that a parent company may have overseas subsidiary companies. It must translate the financial statements of those operations into its own reporting currency before they can be consolidated into consolidated financial statements. There are two methods of achieving this. The method used depends on whether the foreign operation has the same functional currency as the parent.

**ALERT**

In a question on the audit of groups one of the issues you may need to consider is whether the correct treatment has been adopted for the translation of a foreign entity.

#### 7.2.1 Same functional currency as the reporting entity

In this situation the foreign operation normally carries on its business as though it were an extension of the reporting entity’s operations.

We can summarise the treatment as follows:

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th>Translate using actual rates. An average for a period may be used but not where there is a significant fluctuation and the average is therefore unreliable.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-monetary items</td>
<td>Translate using an historic rate at the date of purchase (or revaluation to fair value, or reduction to realisable/recoverable amount). This includes inventory and long-term assets (and their depreciation).</td>
</tr>
<tr>
<td>Monetary items</td>
<td>Translate at the closing rate.</td>
</tr>
<tr>
<td>Exchange differences</td>
<td>Report as part of profit for the year.</td>
</tr>
</tbody>
</table>

#### 7.2.2 Different functional currency from the reporting entity

In this situation although the reporting entity may be able to exercise control, the foreign operation normally operates in a semi-autonomous way. It accumulates cash and other monetary items, generates income and incurs expenses, and may also arrange borrowings, all in its own local currency.
We can summarise the treatment as follows:

<table>
<thead>
<tr>
<th>Assets and liabilities</th>
<th>Translate at the closing rate at the period end. (The balancing figure on the translated statement of financial position represents the reporting entity’s net investment in the foreign operation).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of profit or loss</td>
<td>Translate items at the rate ruling at the date of the transaction (an average rate will usually be used for practical purposes).</td>
</tr>
<tr>
<td>Exchange differences</td>
<td>Taken to equity</td>
</tr>
</tbody>
</table>

7.3 Other issues

The table below outlines some of the other audit risks that may be present with an overseas subsidiary company, along with some possible audit procedures to mitigate those risks.

<table>
<thead>
<tr>
<th>Audit risk</th>
<th>Procedures</th>
</tr>
</thead>
</table>
| Potential misstatement due to the effects of high inflation. SFRS(I) 1-29 Financial Reporting in Hyperinflationary Economies requires financial statements to be restated in terms of measuring units current at the end of the reporting period, and a gain or loss on the net monetary position included within net income. | • Confirm that financial statements have been correctly restated  
• Check that disclosures have been made in line with SFRS(I) 1-29 |
| Subsidiary company may have been audited by component auditors.           | Need to consider the extent to which their work can be relied upon, as per SSA 600             |
| Different accounting framework may have been used by subsidiary company.  | Confirm the accounting framework used, identify any major GAAP differences and that accounting policies are consistent with the rest of the group |
| Possible difficulty in the parent being able to exercise control, eg due to political instability, or laws and regulations. | Need to consider whether there is still control, and whether it is correct to produce consolidated financial statements per SFRS(I) 10 |
| Currency restrictions limiting payment of profits to the parent.           | • Need to consider if there is still control  
• Need to consider impact on parent’s status as a going concern |

The audit of group companies is covered more extensively in Chapter 11 of this Textbook.

**SECTION SUMMARY**

In the audit of a group of companies including a foreign subsidiary company the auditor must ensure that the correct treatment has been adopted for the translation of the foreign entity.
Chapter Roundup

Chapter 10

- Employee Benefits
- Share-based payments

Financial instruments
- Completeness
- Disclosure
- Existence
- Valuation

Investment property
- Existence
- Valuation
- Disclosure

Revaluation
- Evaluation of whether:
  - Assumptions are reasonable
  - Appropriate model used
  - Relevant information used

Impairment
- Non-current assets
- Intangible assets
- Existence
- Completeness
- Valuation
- Rights and obligations

Goodwill

Chapter 11

Other issues

Inventory
- Existence
- Completeness
- Valuation
- Rights and obligations

Foreign Exchange
- Individual company
- Groups

Audit procedures
Risk assessment
SSA 540

Fair value
Application

Evaluation of whether:
- Assumptions are reasonable
- Appropriate model used
- Relevant information used
Quick Quiz

1. Match the accounting item with the relevant accounting standard(s).
   
   (a) Investment property   (i) SFRS(I) 3
   (b) Intangible non-current assets   (ii) SFRS(I) 1-16
   (c) Tangible non-current assets   (iii) SFRS(I) 1-40
   (iv) SFRS(I) 1-38

2. Complete the definition.

   ........................................  ........................................ is the price that would be received to sell an
   ........................................  ........................................ or paid to transfer a liability in an orderly transaction between
   ........................................  ........................................ at the ........................................

3. Brands may never be capitalised.

   True  
   False  

4. Financial assets are recognised initially at their fair value.

   True  
   False  

5. Complete the definition.

   ........................................  ........................................ is property held to earn ........................................
   or for ........................................  ........................................ or both, rather than for use in the
   ........................................  ........................................ of goods or services or for administrative
   purposes, or ........................................ in the ordinary course of business.
Answers to Quick Quiz

1. (a) (iii)
   (b) (iv)
   (c) (ii)

2. Fair value, asset, market participants, measurement date

3. False. Internally generated brands may not be capitalised. Purchased brands with a separately identifiable value may be capitalised.

4. True. Subsequent measurement rules depend on the type of financial instrument being measured.

5. Investment property, rentals, capital appreciation, production, supply, sale
9.1 Non-current assets

Matters to consider

The main matter to consider here is the valuation of the W102. Now it will no longer be used in production, it may be impaired. The asset should be valued in the financial statements at the lower of carrying amount or recoverable amount. Recoverable amount will be fair value, as the W102 no longer has a value in use because it will not generate cash inflows until the V is marketed. Whether the W102 has a market (fair) value will depend on how specialised a machine it is. The fact that it can be transferred to use on a different product from the W suggests that it is not highly specialised and that there may be a second hand market from which a valuation can be taken.

Evidence that should be contained on the audit file

- Indication that the value of the X103 and W103 has been agreed to purchase invoices
- Recalculation of profit/loss on scrapping of X102
- Note of physical inspection to ensure that X102 is no longer on premises
- Minutes of directors’ meeting approving the scrapping of the X102 and change in use of the W102 reviewed
- Copy of management’s impairment review with regard to the W102
- Fair value of W102 verified by reference to price lists of suppliers of such second-hand machines
- Note of observation of operation of machines to ensure W102 no longer used in production

9.2 Financial instruments

(a) Audit issues

(i) The treatment of the debenture does not comply with SFRS(I) 9.

(ii) It should be treated as a hybrid instrument, split into its equity and liability components.

(iii) The liability component should be calculated as the discounted present value of the cash flows of the debenture.

(iv) The remainder of the proceeds should be reclassified as equity.

(b) Audit procedures

(i) Check the nominal interest rate and conversion terms to the debenture deed.

(ii) Agree amount of initial proceeds and interest payment to cash book and bank statement.

(iii) Obtain schedule calculating the fair value of the liability at the date of issue and confirm that an appropriate discount rate has been used (assuming revised treatment adopted).

(iv) Confirm whether disclosures are adequate and in accordance with SFRS(I) 7.
Chapters 9 and 10 cover specific accounting issues that require special consideration by the auditor. The requirements of the relevant SFRS(I) need to be carefully considered by the auditor during the audit. Four key matters should be considered for each specific accounting issue: (1) Risk; (2) Materiality; (3) Relevant accounting standards; and (4) Audit evidence. This chapter focuses primarily on the last two points above, as the first two are heavily dependent on the scenario presented in any given question. You have previously studied the audit of a basic set of financial statements. At this level, the issues you will be presented with will be more complex, but remember that the key basic points apply.
10: Audit procedures: specific accounting and auditing issues (ii)

PART D PERFORMING THE STATUTORY AUDIT

Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluation and review</td>
<td></td>
</tr>
<tr>
<td>Apply and evaluate audit procedures for all transactions in the extant</td>
<td>3</td>
</tr>
<tr>
<td>syllabus for the Financial Reporting module.</td>
<td></td>
</tr>
<tr>
<td>Discuss the limitations of the standards on auditing and the possible</td>
<td>2</td>
</tr>
<tr>
<td>modifications that they may require in the audits of smaller entities.</td>
<td></td>
</tr>
<tr>
<td>Identify accounting estimates and recommend audit procedures and</td>
<td>2</td>
</tr>
<tr>
<td>evaluate evidence supporting the assumptions and reasonableness of the</td>
<td></td>
</tr>
<tr>
<td>estimates, including the related disclosures.</td>
<td></td>
</tr>
</tbody>
</table>

ESSENTIAL READING

- SSA 501 Audit Evidence – Specific Considerations for Selected Items
- SSA 510 Initial Audit Engagements – Opening Balances
- SFRS(I) 1-7 Statement of Cash Flows
- SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors
- SFRS(I) 1-12 Income Taxes
- SFRS(I) 1-19 Employee Benefits
- SFRS(I) 1-23 Borrowing Costs
- SFRS(I) 1-33 Earnings per Share
- SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets
- SFRS(I) 2 Share-based Payment
- SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations
- SFRS(I) 8 Operating Segments
- SFRS(I) 15 Revenue from Contracts with Customers
- SFRS(I) 16 Leases

1 Revenue

SECTION INTRODUCTION

Revenue recognition is a critical area of audit focus due to the risk of both error and fraud. The key assertions relating to revenue are occurrence, accuracy and completeness.

1.1 Revenue recognition

The relevant standard here is now SFRS(I) 15 Revenue from Contracts with Customers. This new standard applies for annual periods beginning on or after January 2018, although early adoption is permitted. Adoption of this new standard for the first time creates a risk of material misstatement where those responsible for creating the financial statements make errors or poor judgements due to a lack of familiarity, experience and expertise in applying the new standard.

The core principle of SFRS(I) 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
It establishes a five-step model to apply to revenue earned from a contract to determine when and at what amount revenue should be recognised. It is likely to involve an increased use of estimates, as it incorporates factors such as variable consideration and the time value of money, so auditors will have to bear in mind the requirements of SSA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures when auditing revenue.

The five steps are:

**STEP 1** Identify the contract(s) with a customer. These may be written, verbal or implied, but must be enforceable and have commercial substance.

**STEP 2** Identify the separate performance obligations in the contract.

**STEP 3** Determine the transaction price.

**STEP 4** Allocate the transaction price to the separate performance obligations.

**STEP 5** Recognise revenue as the entity satisfies a performance obligation.

**KEY TERM**

A PERFORMANCE OBLIGATION is a promise in a contract with a customer to transfer to the customer either:

- A good or service (or a bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

(SFRS(I) 15 Appendix A)

An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and
obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

- Using the asset to produce goods or provide services;
- Using the asset to enhance the value of other assets;
- Using the asset to settle liabilities or to reduce expenses;
- Selling or exchanging the asset;
- Pledging the asset to secure a loan; and
- Holding the asset.

The amount of revenue recognised is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

In terms of auditing revenue, the auditor will have to review the assumptions and judgments made by the directors in identifying separate performance obligations and how they determine that the performance obligations are satisfied.

The auditor will also need to ensure that the increased disclosure requirements of SFRS(I) 15 are met. These enhanced disclosures aim to help the users of financial statements to better understand the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers.

Revenue can be audited using analytical procedures. The merits of using analytical procedures are as follows:

- Plenty of information, for example, last year's financial statements, budgets, monthly analyses (companies tend to keep a lot of information about sales)
- Analysis can be performed by segregating between division, country or product type
- Logical relationships with items such as inventory and receivables

Revenue recognition is one of the common areas of fraudulent financial reporting. Indeed, SSA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements states that the auditor should presume that there is a significant risk of fraud in relation to revenue recognition, and should obtain an understanding of the controls related to these significant risks. This presumption is rebuttable if the auditor concludes that there is a lower risk of material misstatement due to fraud, but unless this is the case, the auditor must presume that there is a possibility of revenue recognition fraud, and that the entity should have put in place controls to mitigate this risk.

**Example: Revenue recognition**

You are an audit senior on the audit of Yew Ltd, a wholesale seller of stationery and office products.

Recognised within revenue are a series of credit sales of inventory totalling $200,000 that took place close to the year-end. Yew Ltd continues to hold the legal title to this inventory. The cost price of this inventory was $100,000.

Yew Ltd holds a bank loan whose covenants impose upon it a number of conditions, one of which is that its financial statements show an acid test ratio of more than one.

The following amounts are shown in Yew Ltd's draft financial statements.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>100,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>800,000</td>
</tr>
</tbody>
</table>

*Required*

Identify and explain the principal matters to consider when auditing the revenue of Yew Ltd.
Solution

The two principal matters to consider here are interrelated: whether SFRS(I) 15 has been properly applied to Yew Ltd's inventory, and whether Yew Ltd is in breach of the conditions of its bank loan.

Inventory

SFRS(I) 15 states that revenue in respect of the sale of goods is recognised when the entity has satisfied a performance obligation. The customer must have control of the goods.

In this case, the transfer of title would appear to indicate that this has not happened, and that these items should not be recognised within revenue.

However, as auditors it will be necessary to obtain further information regarding the sale. In accordance with SFRS(I) 15.38 it is possible for legal title to be retained in order to protect Yew Ltd against the possibility of non-payment of the receivable, even though control has passed to the customer.

Further audit evidence must be obtained in order to form a judgment over whether SFRS(I) 15 has in fact been breached.

Bank loan

Yew Ltd appears to be within the criteria laid down by the bank: it has an acid test ratio of 1.125 ($ = ($1,000,000 − $100,000)/$800,000).

However, if the revenue recognised in respect of the inventory above has not been recognised in accordance with SFRS(I) 15, the financial statements may need to be amended. The amendments would change the acid test ratio to 0.875 ($ = ($900,000 − $200,000)/$800,000).

If the conditions set by the bank are breached then it is likely that some negative consequence would result from this. This could range from a fine or penalty that would need to be recognised in the financial statements, to the possibility of Yew Ltd having to repay the loan on demand (or immediately). The non-current portion of the loan will have to be reclassified as a current liability which may in turn have an adverse impact on the net working capital of the company. If this were the case, it would be necessary to consider very carefully whether significant doubts exist over Yew Ltd’s ability to continue as a going concern.

Possibility of fraud

The auditor needs to consider the possibility that management has engaged in fraudulent financial reporting in respect of revenue recognition in order not to breach the conditions set by the bank loan. If this were the case, the auditor will need to re-examine any representations it has already received from management and consider extending audit procedures to other areas that are susceptible to fraud risk in response to the alleged fraud.

1.2 Revenue recognition in an e-commerce environment

Companies that engage in e-commerce may have particular revenue recognition issues. E-commerce is covered in more detail in Chapter 18 of this Textbook.

The entity may act as a principal (when selling its own package deal) or as an agent (when selling a third party package or service).

The company may engage in reciprocal arrangements with other companies whereby they both advertise on each other’s website. Whether such an arrangement results in ‘revenue’ must be considered. It must then be accounted for appropriately.

The company may deal in unusual discounts or voucher systems to encourage customers to buy. These must also be reflected and follow the rules of SFRS(I) 15.
Lastly, the company must determine a policy for cut-off. This may be complex if the company acts as an agent. When is the sale made? When the customer clicks ‘accept’, when the company emails acknowledgement, when the sale is made known to the principal, when the goods are despatched, when the customer receives the goods, when the customer has taken advantage of the services? The company must determine a reasonable policy for when the performance obligation has been satisfied.

**CASE STUDY**

**Satyam**

Satyam Computer Services Ltd, a major Indian provider of IT services, was the subject of a major accounting scandal that has sometimes been referred to as ‘India’s Enron’.

Satyam manipulated its financial statements over a period of several years, from around 2002 to 2009, when the public announcement was made that the financial statements had been falsified. A number of methods were used to do this, including producing false invoices, which inflated reported revenue and led to the creation of significant fictitious assets in the statement of financial position.

Satyam’s auditors failed to detect this fraud, which had an ongoing and highly material impact on the financial statements. As a result of their failure to conduct the audit properly, and of the broader failure of quality control of which this was symptomatic, five Indian affiliates of PricewaterhouseCoopers were given a record fine of $7.5 million by the SEC in the US. The AEs were also required to set up employee training programmes, to reform audit policies, and to appoint an independent monitor to ensure the measures were implemented.

It is important to note that this is not a question of auditors being held **liable** for audit failings, but rather of auditors being fined by a regulatory body for failing to conduct audits in accordance with the required standards.

**SECTION SUMMARY**

When identifying and assessing the risks of material misstatement due to fraud there is a presumption that there are significant risks of fraud in revenue recognition.

**2 Liabilities**

**SECTION INTRODUCTION**

The relevant financial statement assertions for liabilities are completeness, rights and obligations and existence. Liabilities must be tested for understatement.

Fair value is a key issue when considering certain liabilities. This should be borne in mind when auditing liabilities.
2.1 Leases

The relevant accounting standard for leases is SFRS(I) 16 Leases. This standard replaces SFRS(I) 1-17 Leases, and will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted if SFRS(I) 15 Revenue from Contracts with Customers is applied. Adoption of this new standard for the first time can create a risk of material misstatement where management responsible for creating the financial statements make errors or poor judgements due to a lack of familiarity, experience and expertise in applying the new standard.

SFRS(I) 16 allows exemptions for short-term leases of less than twelve months and leases of assets with underlying low value such as tablets and personal computers.

KEY TERMS

A LEASE is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

A LESSEE is an entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.

A LESSOR is an entity that provides the right to use an underlying asset for a period of time in exchange for consideration.

2.1.1 Lessee Accounting

First it is necessary to determine whether a contract actually contains a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. For a lessee to have control of an identified asset it must have:

- The right to obtain substantially all of the economic benefits from use of the identified asset; and
- The right to direct the use of the identified asset.

A lessee recognises both a right-of-use asset and a lease liability on the start date of the lease.

The right-of-use asset is initially measured at cost and subsequently it is depreciated and subject to impairment testing. The initial cost of a right-of-use asset comprises the initial measurement of the lease liability, any lease payments made at or before the commencement date less any incentives, any direct cost incurred and an estimate of the costs of dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease.

The lease liability is initially measured at the present value of lease payments not paid at that date. The lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses the lessee’s incremental borrowing rate.

2.1.2 Lessor Accounting

This is the essentially unchanged from SFRS(I) 1-17. A lessor shall classify each of its leases as either an operating lease or a finance lease.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

At commencement date, the lessor recognises assets held under a finance lease as a receivable in the statement of financial position. Finance income is recognised over the lease term. A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis.
The following audit procedures to be performed on leases are relevant.

### Existence and rights and obligations
- Obtain a copy of the lease contract and inspect it to ensure it contains a lease according to SFRS(I) 16.

### Completeness
- Obtain a listing of service agreements and inspect these to ensure they do not contain a lease according to SFRS(I) 16.

### Accuracy, valuation and allocation
- For any new leases agree the value of the right-of-use asset/receivable to the contract.
- Agree any material direct costs capitalised to invoices or contract.
- Obtain a copy of the client's depreciation workings for right-to-use assets and recalculate.
- Assess the reasonableness of the depreciation rates used for right-to-use assets.
- Agree the opening position of right-of-use assets and lease liabilities to prior year.
- For right-of-use assets, obtain a copy of the client's impairment testing, recalculate and assess the reasonableness of assumptions used.
- Obtain a copy of the client's lease liability workings and recalculate.
- Obtain the interest rate used to calculate the present value of lease payments from the client's lease liability workings and check the rate used is in line with the requirements of SFRS(I) 16.
- Verify lease payments/income in the year to the bank statements.

### Presentation
- Inspect the notes to the financial statements to check the leases have been disclosed in line with SFRS(I) 16 in the financial statements.

#### 2.1.3 Sale and leaseback transactions
If an asset is sold and then immediately leased back, this is called a sale and leaseback transaction. Under SFRS(I) 16, the sale and lease are both accounted for separately if a performance obligation has been satisfied as per SFRS(I) 15. So, the seller/lessee will derecognise the asset and recognise the sale at fair value. The seller/lessee will then record a right-of-use asset and lease liability. This is a significant change from the SFRS(I) 1-17 treatment.

### Question 10.1
You are the manager responsible for the audit of Hougang Ltd for the year ended 31 December 20X2. Hougang Ltd has leased an asset from 1 January 20X2. The terms of the lease are as follows:
- A non-refundable deposit of $5,800 on the commencement date
- Six annual instalments of $16,000 payable in arrears

The present value of the lease payments on 1 January 20X2 is $80,000 and the asset has a useful life to the company of five years.

As part of the lease agreement the company guaranteed to Hougang that the asset could be sold for $8,000 at the end of the non-cancellable period of the lease. Hougang also incurred $2,000 of costs in setting up the lease agreement.

A right-of-use asset has been capitalised in the statement of financial position of Hougang and is being depreciated straight-line over the life of the lease. A lease liability has also been recognised.

The interest rate implicit in the lease has been calculated at 10%.

The company has total assets of $1,600,000.

**Required**
List the audit issues you would consider in this situation.
2.2 Deferred taxation

Deferred tax is accounted for under SFRS(I) 1-12 Income Taxes. Deferred tax is the tax attributable to temporary differences, which are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

**KEY TERMS**

**Deferred tax liabilities** are the amounts of income taxes payable in future periods in respect of taxable temporary differences. All taxable temporary differences give rise to a deferred tax liability.

**Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences (e.g., provisions, unrealised profits on intra-group trading)
- The carry forward of unused tax losses
- The carry forward of unused tax credits

All deductible temporary differences give rise to a deferred tax asset.

**Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either taxable or deductible temporary differences.

**Taxable temporary differences** are temporary differences that will result in taxable amounts in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**Deductible temporary differences** are temporary differences that will result in amounts that are deductible in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**The tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Deferred tax is the tax attributable to temporary differences. For example, where a company ‘saves tax’ in the current period by having accelerated capital allowances, a provision for the (deferred) tax charge is made in the statement of financial position.

The provision is made because over the course of the asset's life, the tax allowances will reduce until the depreciation charged in the financial statements is higher than the allowances. This will result in taxable profit being higher than reported profit and the company will be ‘suffering higher tax’ in this period.

**2.2.1 Types of taxable temporary difference**

**Accelerated capital allowances**

The temporary difference is the difference between the carrying value of the asset in the statement of financial position at the end of the reporting period and its tax depreciated value.

**Interest revenue** (where interest is included in profit or loss on an accruals basis but taxed when received).

The temporary difference is equivalent to the income accrual in the statement of financial position at the end of the reporting period as the tax base of the interest receivable is nil.

**Development costs** (where development costs are capitalised for accounting purposes but deducted from taxable profit in the period incurred).
The temporary difference is equivalent to the amount capitalised in the statement of financial position at the end of the reporting period. The tax base is nil since they have already been deducted from taxable profits.

**Revaluation to fair value** (in jurisdictions where the tax base of the asset is not adjusted).

The temporary difference is the difference between the asset's carrying value and tax base. A deferred liability is created even if the entity does not intend to dispose of the asset.

**Fair value adjustments on consolidation**

A temporary difference arises as for the revaluation above but the deferred tax effect is a consolidation adjustment in the same way as the revaluation itself. The deferred tax accrued on those fair value adjustments would have an impact on the goodwill figure.

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**Question 10.2**

Toa Ltd purchased an asset costing $3,000. At the end of 20X1 the carrying amount is $2,000. The cumulative depreciation for tax purposes is $1,800 and the current tax rate is 17%.

*Required*

Calculate the deferred tax liability for the asset.

---

**2.2.2 Types of deductible temporary differences**

**Provisions**

The provision is recognised for accounting purposes when there is a present obligation, but may not be deductible for tax purposes until the expenditure is incurred.

**Losses**

Current losses that can be carried forward to be offset against future taxable profits result in a deferred tax asset.

**Fair value adjustments**

For example, liabilities recognised on business combinations where the expenditure is not deductible for tax purposes until a later period.

**Unrealised profits on intra-group trading**

The profit is not realised from the group point of view until the items transferred are sold outside the group, but where the tax base is based on the cost to the individual receiving company and no equivalent adjustment for unrealised profit is made for tax purposes, a temporary difference arises.

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**Question 10.3**

Clementi Ltd recognises a liability of $20,000 for accrued product warranty costs on 31 December 20X1. These product warranty costs will not be deductible for tax purposes until the entity pays the claims. The tax rate is 17%.

*Required*

Calculate the deferred tax asset.
2.2.3 Measurement of deferred tax

The key points to remember are as follows:

(a) SFRS(I) 1-12 adopts the full provision method of providing for deferred tax. This recognises that each temporary difference at the period end has an effect on future tax payments.

(b) Deferred tax assets and liabilities are measured at the tax rates expected to apply to the period when the asset is realised or liability settled, based on the tax rates (and tax laws) that have been enacted (or substantively enacted) by the end of the reporting period.

(c) Deferred assets and liabilities cannot be discounted.

(d) Deferred tax assets are only recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

KEY POINT

In some countries it is rare for a deferred tax asset to be recognised, as the asset only exists insofar as the entity's tax liability can be reduced in the future, which in turn depends on the entity being profitable enough to have a tax liability and thus to be able to 'use' any tax losses. However, a deferred tax asset may be seen in many Singapore listed companies' financial statements.

From the auditor's perspective deferred tax assets are risky because a significant degree of judgment must be exercised in determining whether tax losses will in fact result in reduced tax liabilities in the future. This is an illustration of the importance of the auditor approaching the audit with professional scepticism. Apply scepticism if you come across a deferred tax asset in an exam question (although it is of course always possible that the deferred tax asset could be stated correctly).

2.2.4 Audit issues and procedures

Remember that manipulating the deferred tax figure will not affect the actual tax position. However, a deferred tax charge (the other part of the double entry for the statement of financial position provision) is recognised in profit or loss before dividends, even if it is not actually paid to the taxation authorities.

The following audit procedures to be performed on deferred taxation are relevant:

- Obtain a copy of the deferred tax workings and the corporation tax computation.
- Check the arithmetical accuracy of the deferred tax working.
- Agree the figures used to calculate temporary differences to those on the tax computation and the financial statements.
- Consider the assumptions made in the light of your knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness.
- Agree the opening position on the deferred tax account to the prior year financial statements and also review the deferred tax movement schedule.
- Review the basis of the provision to ensure:
  - It is line with accounting practice under SFRS(I) 1-12
  - It is suitably comparable to practice in previous years
  - Any changes in accounting policy have been disclosed
- Review financial statement disclosures.
2.2.5 IFRIC 23 – Uncertainty over Income Tax treatments

During 2017, the IFRS Interpretations Committee issued IFRIC 23 which clarifies the accounting treatment for uncertainties in income taxes – this includes the determination of taxable profit, tax bases, unused tax losses, unused tax credits and tax rates when there is uncertainty over income tax treatments under IAS 12 (SFRS(I) 1-12 Income taxes). This, plus any additional updates to SFRS(I) 1-12, is covered in more detail in your FR materials.

Question 10.4

Punggol Ltd, a company producing domestic appliances for the retail market, began trading on 1 January 20X1. Its draft financial statements for the year ended 31 December 20X2 show profit before tax of $1,000,000, net assets of $5,200,000 and a deferred tax balance of $958,000.

You are the manager responsible for the audit of Punggol Ltd and the following information relating to deferred tax has been provided by the client:

1. The deferred tax balance in the financial statements is the brought forward balance from previous years. No deferred tax adjustment has been made for the current period.
2. At the period end Punggol Ltd have plant and equipment with a carrying amount of $5,200,000 and a tax base at that date of $2,400,000.
3. The tax rate to be applied is 17%.

Required

(a) Identify the audit issues.
(b) List the procedures you would perform in respect of the amounts relating to deferred tax in the financial statements of Punggol Ltd.

2.3 Provisions and contingencies

Provisions are accounted for under SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets.

KEY TERMS

A provision is a liability of uncertain timing or amount.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(SFRS(I) 1-37)

SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets

Under SFRS(I) 1-37, an entity should not recognise a contingent asset or a contingent liability (ie a possible asset or liability). Contingent liabilities and contingent assets should only be disclosed, not recognised.

However if the following conditions are met then a provision should be recognised in relation to a contingent liability:

- There is a present obligation as a result of a past event.
- There will be a probable outflow of resources (>50% likely).
- A reliable estimate can be made.

Common examples include warranties, legal claims against an entity, onerous contracts, restructuring costs.
SFRS(I) 1-37 also gives guidance regarding a number of specific provisions. These include the following:

**Provisions for restructuring**

A restructuring is a programme that is planned and is controlled by management and materially changes either:

- The scope of the business undertaken by an entity; or
- The manner in which that business is conducted.

The SFRS(I) gives the following examples of events that would fall under this definition:

- The sale or termination of a line of business
- The closure of business locations in a country or region or the relocation of business activities from one country or region to another
- Changes in management structure
- Fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations

In order to make a provision an obligation (legal or constructive) must exist at the period end. In this context, a constructive obligation exists only in the following circumstances:

- An entity must have a detailed formal plan for the restructuring.
- It must have raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

A management or board decision alone would not normally be sufficient.

The SFRS(I) states that a restructuring provision should include only the direct expenditures arising from the restructuring.

**Onerous contracts**

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. An example might be a vacant leasehold property.

If an entity has a contract that is onerous a provision must be made for the net loss.

**Decommissioning provisions**

A provision is only recognised from the date on which the obligating event occurs.

For example when an oil company initially purchases an oil field it is put under a legal obligation to decommission the site at the end of its life. The legal obligation exists therefore on the initial expenditure on the field and therefore the liability exists immediately. The SFRS(I) also takes the view that the decommissioning costs may be capitalised as an asset representing future access to oil reserves (i.e., an asset and a provision are recognised).

**Contingent assets**

Contingent assets should not be recognised, as SFRS(I) 1-37 requires an entity to be virtually certain that it will receive an inflow of economic benefits. The asset is only recognised when it is virtually certain that there is an asset (unlike contingent liabilities, which may be provided for). The recognition of contingent assets in financial statements therefore represents a risk for auditors, and should be investigated thoroughly.
2.3.1 Audit procedures

The audit tests that should be carried out on provisions and contingent assets and liabilities are as follows.

- Obtain details of all provisions which have been included in the financial statements and all contingencies that have been disclosed as well as any contingencies discovered during the audit that have not been disclosed.
- Obtain a detailed analysis of all provisions showing opening balances, movements and closing balances.
- Determine for each material provision whether the company has a present obligation as a result of past events by:
  - Reviewing of correspondence relating to the item
  - Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation?
- Determine for each material provision whether it is probable that a transfer of economic benefits will be required to settle the obligation by:
  - Checking whether any payments have been made after the year-end in respect of the item
  - Reviewing of correspondence with solicitors, banks, customers, the insurance company and suppliers both pre and post year end
  - Sending a letter to the solicitors to obtain their views (where relevant)
  - Discussing the position of similar past provisions with the directors. Were these provisions eventually settled?
  - Considering the likelihood of reimbursement
- Recalculate all provisions made.
- In the event that it is not possible to estimate the amount of the provision, check that a contingent liability is disclosed in the financial statements.
- Consider the nature of the client's business. Would you expect to see any other provisions, for example, warranties?
- Consider whether disclosures of provisions, contingent liabilities and contingent assets are correct and sufficient.

2.3.2 Obtaining audit evidence of contingencies

Part of SSA 501 Audit Evidence – Specific Considerations for Selected Items covers contingencies relating to litigation and legal claims, which will represent the major part of audit work on contingencies. Litigation and claims involving the entity may have a material effect on the financial statements, and so will require adjustment to/disclosure in those financial statements.

SSA 501.9

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement.

Such procedures would include the following.

- Make appropriate inquiries of management including obtaining representations.
- Review board minutes and correspondence with the entity's lawyers.
- Examine legal expense account.
- Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.
SSA 501.10
If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall... seek direct communication with the entity's external legal counsel.

This will help to obtain sufficient appropriate audit evidence as to whether potential material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable. The SSA discusses the form the letter to the entity's external legal counsel should take.

SSA 501.10 (cont'd)
The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

If it is thought unlikely that the external legal counsel will respond to a general enquiry, the letter should specify the following:

(a) A list of litigation and claims
(b) Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved
(c) A request that the external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the lawyer to be incomplete or incorrect

The auditors must consider these matters up to the date of their report and so a further, updating letter may be necessary. Written representations must be provided that all actual or possible litigations and claims have been disclosed to the auditor.

A meeting between the auditors and the external legal counsel may be required, for example where a complex matter arises, or where there is a disagreement between management and the external legal counsel. Such meetings should take place only with the permission of management, and preferably with a management representative present.

SSA 501.11
If:
(a) Management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and

(b) The auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures;

The auditor shall modify the opinion in the auditor's report in accordance with SSA 705.

Question 10.5

In February 20X0 the directors of Kallang Engineering Ltd, a listed company, suspended the managing director. At a disciplinary hearing held by the company on 17 March 20X0 the managing director was dismissed for gross misconduct, and it was decided the managing director's salary should stop from that date and no redundancy or compensation payments should be made.
The managing director has claimed unfair dismissal and is taking legal action against the company to obtain compensation for loss of employment. The managing director says that they have a service contract with the company entitling them to two years' salary at the date of dismissal. The financial statements for the year ended 30 April 20X0 record the resignation of the director. However, they do not mention the dismissal and no provision for any damages has been included in the financial statements.

Required

(a) State how contingent liabilities should be disclosed in financial statements according to SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets.

(b) Describe the audit work you will carry out to determine whether the company will have to pay damages to the director for unfair dismissal, and the amount of damages and costs which should be included in the financial statements.

Note: Assume the amounts you are auditing are material.

2.4 Trade payables

The largest figure in current liabilities will normally be trade payables. These are generally checked by comparison of suppliers' statements with purchase ledger accounts. Direct confirmation of trade accounts payable is quite common and might be appropriate where the suppliers' statements or reconciliations are not available. The focus is on completeness and cut-off for trade payables, so procedures should be designed to address these risk assertions. You will have covered the audit of trade payables in detail in your earlier studies.

SECTION SUMMARY

When auditing liabilities the auditor must consider the following:

- Lessees must recognise a right-of-use asset and lease liability on commencement of a lease.
- The auditor needs to audit the movement on deferred tax.
- A provision is accounted for as a liability, contingencies are disclosed, so auditors must ensure they have been classified correctly.

3 Expenses

SECTION INTRODUCTION

The recognition and calculation of certain expenses is dependent upon accounting standards. The auditor must be familiar with the appropriate accounting treatment.

3.1 Borrowing costs

SFRS(I) 1-23 Borrowing Costs gives guidance on how to account for borrowing costs. SFRS(I) 1-23 deals with the treatment of borrowing costs, often associated with the construction of self-constructed assets, but which may also be applied to an asset purchased that takes time to get ready for use/sale.
KEY TERMS

BORROWING COSTS are interest and other costs incurred by an entity in connection with the borrowing of funds.

A QUALIFYING ASSET is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

(SFRS(I) 1-23)

SFRS(I) 1-23 Borrowing Costs

Accounting treatment

- Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.
- All eligible borrowing costs must be capitalised. Borrowing costs incurred in relation to non-qualifying assets shall be expensed in the profit or loss.

Examples of borrowing costs include:
- Interest on bank overdrafts, short- and long-term borrowings
- Amortisation of discounts or premiums related to borrowings
- Amortisation of ancillary costs incurred with arrangement of borrowings
- Interest in respect of lease liabilities
- Exchange differences as far as they are an adjustment to interest costs

The cost of borrowing is interest, which is disclosed in the statement of profit or loss and other comprehensive income. Interest can be audited by using a re-computation test, as it has a predictable relationship with loans (for example, bank loans or debentures).

Alternatively it can be verified to payment records (bank statements) and loan agreement documents.

However, if borrowing costs are capitalised in accordance with SFRS(I) 1-23 the auditor should carry out the following procedures:

- Agree figures in respect of interest payments made to statements from lender and/or bank statements.
- Ensure interest is directly attributable to construction.

3.2 Employee benefits

The Central Provident Fund (CPF) provides for the retirement, house financing and healthcare needs of the majority of employees in Singapore. Employees who are not Singapore citizens or permanent residents, which make up approximately a third of the employed population, are not entitled to participate in the CPF plan. This group comprises mainly expatriates. Company pension plans as such are gaining popularity to cater to this group as well as local employees of Singapore multinational companies who are posted overseas. Detailed guidance on pension funds or plans is provided by SFRS(I) 1-19 Employee Benefits.

Pension schemes are the most obvious example of an employee benefit, but an employer might provide post-employment death benefits to the dependants of former employees, or post-employment medical care.

Post-employment benefit schemes are often referred to as ‘plans’. The ‘plan’ receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments. The post-employment benefits are paid out of the income from the plan assets (dividends, interest) or from money from the sale of some plan assets.

There are two types or categories of post-employment benefit plan: defined contribution plans and defined benefit plans. CPF, on the other hand, is a hybrid as it provides for post-employment and immediate benefits, such as house financing and medical care financing and protection. It is a portable defined contribution plan that has immediate vesting benefits.
3.2.1 SFRS(I) 1-19 recap

Accounting for payments into defined contribution plans is straightforward.

(a) The obligation is determined by the amount paid into the plan in each period.
(b) There are no actuarial assumptions to make.
(c) If the obligation is settled in the current period (or at least no later than 12 months after the end of the current period) there is no requirement for discounting.

SFRS(I) 1-19 requires the following.

(a) Contributions to a defined contribution plan should be recognised as an expense in the period they are payable (except to the extent that labour costs may be included within the cost of assets).
(b) Any liability for unpaid contributions that are due as at the end of the period should be recognised as a liability (accrued expense).
(c) Any excess contributions paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to, eg a reduction in future payments or a cash refund.
(d) Disclosure is required of a description of the plan and the amount recognised as an expense in the period.

Accounting for defined benefit plans is more complex.

(a) The future benefit obligations (arising from employee service in the current or prior years) cannot be estimated exactly, but whatever they are, the employer will have to pay them, and the liability should therefore be recognised now. To estimate these future obligations, it is necessary to use actuarial assumptions.
(b) The obligations payable in future years should be valued, by discounting, on a present value basis. This is because the obligations may be settled in many years’ time.
(c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be actuarial gains or losses. A contribution into a fund in any period is not necessarily the total for that period, due to actuarial gains or losses.

An outline of the method used for an employer to account for the expenses and obligation of a defined benefit plan is given below.

**STEP 1**

Determine the deficit or surplus:

(a) Measure the defined benefit obligation (using the projected unit credit method).
(b) The benefit should be discounted to arrive at the present value of the defined benefit obligation and the current service cost.
(c) The fair value of any plan assets should be deducted from the present value of the defined obligation.

**STEP 2**

Determine the amount of the net benefit liability (assets) ie the present value of the defined obligation at the end of the reporting period, minus the fair value of the assets of the plan as at the end of the reporting period (if there are any) out of which the future obligations to current and past employees will be directly settled.

**STEP 3**

Determine the amounts to be recognised in profit or loss:

(a) Current service cost
(b) Any past service cost and gain or loss on settlement
(c) Net interest on the net defined benefit obligations (asset)
Determine the remeasurements of the net defined benefit obligations (asset), to be recognised in other comprehensive income:

(a) Actuarial gains and losses
(b) Return on plan assets (excluding amounts included in net interest on the net defined benefit liability (asset))

In the statement of financial position, the amount recognised as a defined benefit liability (which may be a negative amount, i.e., an asset) should be the following.

(a) The present value of the defined benefit obligation at the year-end, minus
(b) The fair value of the assets of the plan as at the year-end (if there are any) out of which the future obligations to current and past employees will be directly settled.

Plan assets are:

(a) Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits.
(b) Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, as ‘the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date’.

SFRS(I) 1-19.114 includes the following specific requirements:

(a) The plan assets should exclude any contributions due from the employer but not yet paid.
(b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

All of the gains and losses that affect the plan obligation and plan asset must be recognised. The components of defined benefit cost must be recognised as follows in the statement of profit or loss and other comprehensive income:

<table>
<thead>
<tr>
<th>Component</th>
<th>Recognised in:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Service cost</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>(b) Net interest on the net defined benefit liability</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>(c) Remeasurements of the net defined benefit liability</td>
<td>Other comprehensive income</td>
</tr>
</tbody>
</table>

3.2.2 Audit procedures

The audit tests to be carried out on employee benefits are as follows.

**Scheme assets (including quoted and unquoted securities, debt instruments, properties)**
- Ask directors to reconcile the scheme assets valuation at the scheme year-end date with the assets valuation at the reporting entity's date being used for SFRS(I) 1-19 purposes.
- Obtain direct confirmation of the scheme assets from the investment custodian.
- Consider requiring scheme auditors to perform procedures.

**Scheme liabilities**
- Auditors must follow the principles of SSA 620 *Using the Work of an Auditor's Expert* to assess whether it is appropriate to rely on the actuary's work.
Specific matters would include:
- The source data used
- The assumptions and methods used
- The results of actuaries' work in the light of auditors' knowledge of the business and results of other audit procedures

Actuarial source data is likely to include:
- Scheme member data (for example, classes of member and contribution details)
- Scheme asset information (for example, values and income and expenditure items)

Actuarial assumptions (for example, mortality rates, termination rates, retirement age and changes in salary and benefit levels)

Auditors will not have the same expertise as actuaries and are unlikely to be able to challenge the appropriateness and reasonableness of the assumptions. Auditors can, however, through discussion with directors and actuaries:
- Obtain a general understanding of the assumptions and review the process used to develop them
- Compare the assumptions with those which directors have used in prior years
- Consider whether, based on their knowledge of the reporting entity and the scheme, and on the results of other audit procedures, the assumptions appear to be reasonable and compatible with those used elsewhere in the preparation of the entity's financial statements
- Obtain written representations from directors confirming that the assumptions are consistent with their knowledge of the business

Items charged to operating profit (current service cost, past service cost, gains and losses on settlements and curtailments, interest)

Discuss with directors and actuaries the factors affecting current service cost (for example, a scheme closed to new entrants may see an increase year on year as a percentage of pay with the average age of the workforce increasing)

Where the results of actuaries' work is inconsistent with the directors', additional procedures, such as requesting directors to obtain evidence from another actuary, may assist in resolving the inconsistency.

### 3.2.3 Plan amendments, curtailments and settlements

During 2018, IASB published minor changes to IAS 19 Employee Benefits explaining the impact on service costs calculated for a plan from any amendments, curtailments and settlements to those plans. For the impact on SFRS(I) 1-19 you should refer to your FR materials.

### 3.3 Share-based payment

SFRS(I) 2 Share-based Payment sets out rules for the measurement of expenses relating to share-based payment schemes. These arise most commonly in relation to payments for employee services and professional services.

#### 3.3.1 SFRS(I) 2 recap

SFRS(I) 2 requires entities to recognise the goods or services received as a result of share-based payment transactions.
There are three types of share-based payment transactions.

(a) Equity-settled share-based payment transactions, in which the entity receives goods or services in exchange for equity instruments of the entity

(b) Cash-settled share-based payment transactions, in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity

(c) Transactions in which the entity receives or acquires goods or services and either the entity or the supplier has a choice as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments

An entity should recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. They should be recognised as expenses unless they qualify for recognition as assets. Transactions are measured at fair value.

- **Equity-settled transactions:**
  
<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets/expense</td>
<td>Equity</td>
</tr>
</tbody>
</table>

- **Cash-settled transactions:**
  
<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset/expense</td>
<td>Liability</td>
</tr>
</tbody>
</table>

### 3.3.2 Audit risks and evidence

The general audit risk here is that the requirements of SFRS(I) 2 are not adhered to. This is a complex area of financial reporting, particularly in practice, and is therefore risky to audit. The risk is that the share-based payment is not measured correctly in relation to any conditions attached to the scheme.

The auditor will require evidence in respect of all the estimates feeding into the SFRS(I) 2 calculation, in addition to reperforming the calculation itself for the expense for the current year.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of employees in scheme/number of instruments per employee/length of vesting period.</td>
<td>Employees share options scheme details set out in a contractual documentation</td>
</tr>
</tbody>
</table>
| Number of employees estimated to benefit | • Enquire of directors  
• Compare to staffing numbers per forecasts and prediction |
| Fair value of instruments | • For equity-settled schemes check that fair value is estimated at measurement date  
• For cash-settled schemes check that the fair value is recalculated at the year-end and at the date of settlement  
• Check that model used to estimate fair value is in line with SFRS(I) 2  
• May need expert's valuation in line with SSA 620 Using the Work of an Auditor's Expert if the transaction is complex  
• Review of the different kinds of conditions, as these may affect the accounting treatment |
### ISSUE 4: Audit procedures: specific accounting and auditing issues (ii)

#### General
- Obtain written representations from management confirming their view that:
  - The assumptions used in measuring the expense are reasonable, and
  - There are no share-based payment schemes in existence that have not been disclosed to the auditors.

#### SECTION SUMMARY
The key issue the auditor must consider when auditing expenses is measurement. In some instances this may involve complex calculations dependent on the requirements of accounting standards.

### 4 Disclosure

#### SECTION INTRODUCTION
Adequate and appropriate disclosure is a key element of financial information being reasonably presented.

#### 4.1 Segment reporting
The disclosure of segmental information is governed by SFRS(I) 8 *Operating Segments*. This SFRS(I) is only applicable to listed companies.

#### KEY TERM
An **OPERATING SEGMENT** is a component of an entity:
- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
- Whose operating results are reviewed regularly by the entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- For which discrete financial information is available.

(SFRS(I) 8)

---

**SFRS(I) 8 Operating Segments**
SFRS(I) 8 requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria:
- Reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments; or
PART D PERFORMING THE STATUTORY AUDIT | 10: Audit procedures: specific accounting and auditing issues (ii)

- The absolute measure of reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss; or
- Assets are 10% or more of the combined assets of all operating segments.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments must be identified as reportable segments (even if they do not meet the quantitative thresholds set out above) until at least 75% of the entity's revenue is included in reportable segments.

SSA 501 Audit Evidence – Specific Considerations for Selected Items contains specific guidance on segment reporting.

SSA 501.13

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

(a) Obtaining an understanding of the methods used by management in determining segment information, and:
   (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
   (ii) Where appropriate, testing the application of such methods; and
(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

The following procedures on segment reporting are recommended:

- Obtain a client schedule of revenue workings and all segment disclosures.
- Discuss with management the basis for the segmentation and ensure that the basis for segmentation mirrors that used for internal reporting purposes (SFRS(I) 8).
- Reconcile a sample of items to supporting documentation (invoices) to ensure disclosure is correct.

An audit risk here is management bias in disclosure. This risk is particularly pronounced because SFRS(I) 8 Operating Segments takes a management approach to reportable segments, which opens up the possibility of management adjusting its approach in order to change the way segment information is disclosed. Auditors should pay particular attention if management amends the number of operating segments disclosed.

For example there is a risk that loss-making segments could effectively go unreported or be hidden within other segments.

4.2 Earnings per share

Accounting for earnings per share is governed by SFRS(I) 1-33 Earnings Per Share. It requires listed companies (or companies whose shares are quoted) and companies in the process of listing their shares to disclose their earnings per share for the year.

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to ordinary equity holders by the weighted average number of ordinary shares outstanding during the period as follows:

\[
\frac{\text{Net profit/(loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}
\]
Fernhill Ltd has profit of $1.5 million for the year ended 31 December 20X8. On 1 January 20X8 the company had 500,000 shares in issue. During 20X8 the company announced a rights issue as follows:
Rights: 1 new share for every 5 outstanding (100,000 new shares in total)
Exercise price: $5.00
Last date to exercise rights: 1 March 20X8
Market (fair) value of one share in Fernhill Ltd immediately prior to exercise on 1 March 20X8: $11.00
The EPS for 20X7 as originally stated was $2.20

Required
Calculate the Earnings per Share for the year-end 31 December 20X8 and the restated Earnings per Share for the year-end 31 December 20X7.

Diluted earnings per share is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

These include:

- A separate class of equity shares which at present is not entitled to any dividend, but will be entitled in future
- Convertible loan stock or convertible preferred shares
- Options or warrants

The calculation would be as follows:

\[
\begin{align*}
\text{Diluted earnings} & = \text{Basic earnings} \\
& \times \text{Interest saved on convertible debt (net of tax saving)} \\
\text{Diluted shares} & = \text{Basic weighted average} \\
& \times \text{Convertible debt: additional shares on conversion} \\
& \times \text{Share options: potential shares less shares purchasable at FV}
\end{align*}
\]

Finally, if an entity reports a discontinued operation under SFRS(I) 5 (see below), then it must also disclose the basic and diluted EPS for the discontinued operation.

4.2.1 Audit issues

The size of the figure is unlikely to be material in itself, but it is a key investor figure. As it will be of interest to all the investors who read it, it is material by its nature.

When considering earnings per share, the auditor must consider two issues:

- Whether it has been disclosed on a comparable basis to the prior year, and whether any changes in accounting policy have been disclosed
- Whether it has been calculated correctly
An audit risk is that the entity fails to meet the disclosure requirements of SFRS(I) 1-33. These are:

(a) The amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to the net profit or loss for the period

(b) The weighted average number of ordinary shares used as the denominator in calculating basic and diluted EPS, and a reconciliation of these denominators to each other

The following audit procedures for earnings per share are as follows:

- Obtain a copy of the client’s workings for earnings per share. (If a simple calculation has been used, this can be checked by recalculating the fraction on the face of the statement of profit or loss and other comprehensive income.)
- Compare the calculation with the prior year calculation to ensure that the basis is comparable.
- Discuss the basis with the directors if it has changed to ascertain if it is the best basis for the financial statements this year and whether the change has been adequately disclosed.
- Recalculate to ensure that it is correct.

4.3 Discontinued operations

Discontinued operations are accounted for under SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations. The SFRS(I) requires that certain disclosures are made for discontinued operations in the statement of profit or loss and other comprehensive income or in the notes. This may well be material for the following reasons:

- Potentially material through size
- May be inherently material if the change in operations is indicative of the policies adopted by management or a major change in focus of operations

Essentially, the fact that some operations have been discontinued is of interest to shareholders, which is why the SFRS(I) 5 disclosures came about.

SFRS(I) 5 requires that assets which meet the criteria ‘held for sale’ are shown at the lower of carrying amount and fair value less costs to sell, and that held for sale assets are classified separately in the statement of financial position and the results of discontinued operations are presented separately in the statement of profit or loss and other comprehensive income. Held for sale assets are discussed in Chapter 9.

To require separate classification in the statement of profit or loss and other comprehensive income, discontinued operations must be a component (ie separately identifiable) either disposed of or classified as held for sale and:

- represents a separate major line of business/geographical area;
- is part of a single co-ordinated plan to dispose of a separate major line of business/geographical area; or
- is a subsidiary company acquired exclusively with a view to resale

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets or disposal groups.

This allows users to distinguish between operations which will continue in the future and those which will not and makes it more possible to predict future results.

An entity should disclose a single amount in the statement of profit or loss and other comprehensive income comprising the total of:

(a) The post-tax profit or loss of discontinued operations and

(b) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operations.
An entity should also disclose an analysis of this single amount into:

(a) The revenue, expenses and pre-tax profit or loss of discontinued operations

(b) The related income tax expense

(c) The gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets of the discontinued operation

(d) The related income tax expense

This may be presented either in the statement of profit or loss and other comprehensive income or in the notes. If it is presented in the statement of profit or loss and other comprehensive income it should be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary company that has been classified as held for sale.

An entity should disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Recommended audit procedures include:

Review the discontinued operation to ensure it meets the requirements for a discontinued operation as per SFRS(I) 5 by:

- Obtaining accounting records for a component to ensure it is separately identifiable.
- Review company documentation (such as an annual report) to ensure it is separately identifiable.
- Review minutes of meetings/make enquiries of management to ascertain management's intentions.

To audit whether the disclosures have been made correctly, the following audit procedures are recommended:

- Obtain a copy of the client's workings to disclose the discontinued operations.
- Review the workings to ensure that the figures are reasonable and agree to the financial statements.
- Trace a sample of items disclosed as discontinuing items to supporting documentation (invoices) to ensure that they do relate to discontinued operations.

Practical difficulties may occur in auditing a disposed entity, for example obtaining access to the disposed entity and determining the exact cut-off.

4.4 Statements of cash flows

Statements of cash flows are accounted for under the provisions of SFRS(I) 1-7 Statement of Cash Flows. The statement of cash flows is essentially a reconciliation exercise between items in the statement of profit or loss and other comprehensive income (operating profit) and the statement of financial position (cash).

As such, the statement of cash flows is often audited by the auditor recreating the statement himself from the audited figures in the statement of financial position and statement of profit or loss and then comparing his attempt with the original statement of cash flows created by the client. This process can be facilitated by using computer programs.

However, if the auditor wished to audit it another way, they could check and recalculate each reconciliation with the financial statements. This would involve checking each line of the statement by working through the client's workings and agreeing items to the accounting records and supporting documentation (for example, tax paid to the bank statements) and the other financial statements.
Question 10.7

Why is the statement of cash flows relevant to the auditors?

4.5 Changes in accounting policy, estimates and errors

4.5.1 Accounting policies and estimates

Where accounting standards allow alternative treatment of items in the financial statements, then the accounting policy note should declare which policy has been chosen. It should then be applied consistently.

The effect of a change in accounting policy is treated as a retrospective adjustment to the opening balance of each affected component of equity as if the accounting policy had always applied.

SFRS(I) 1-8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that changes in accounting policies are rare, and only allowed if required by statute or if the change results in more reliable and relevant information.

Take care not to confuse a change in accounting policy with a change in accounting estimate. A change in policy is rare, such as a change in depreciation method from straight line depreciation to reducing balance depreciation, and per SFRS(I) 1-8 should typically be accounted for retrospectively. However, a change in estimate is accounted for prospectively. In real life, clients may not want to make a change in accounting policy because of the work involved in retrospectively restating the financial statements (restating opening retained earnings and the comparatives), and the extensive disclosures that are required by SFRS(I) 1-8.

An example of a change in accounting estimate is a change to an entity’s estimate of the useful lives or residual values of its non-current assets.

Changes in accounting policy will be rare and should be made only if:

(a) The change is required by an SFRS(I); or

(b) The change will result in a more appropriate presentation of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

The standard highlights two types of event which do not constitute changes in accounting policy.

(a) Adopting an accounting policy for a new type of transaction or event not dealt with previously by the entity.

(b) Adopting a new accounting policy for a transaction or event which has not occurred in the past or which was not material.

4.5.2 Prior period errors

By ‘error’, SFRS(I) 1-8 means mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

If an error is discovered in the prior period financial statements, then SFRS(I) 1-8 states that it must be corrected retrospectively (like a change in accounting policy). This means restating opening retained earnings and comparatives, and does not affect eg profit in the current period.
Question 10.8

Tinga Ltd is a long-standing client of your AE, but this is the first year that your AE has carried out the audit. The AE also provides a number of other services to Tinga Ltd, including a range of tax planning services and business advisory services. Recently, the AE undertook a review of some forecast financial statements, which Tinga Ltd was required to present to the bank.

You have been asked to plan the forthcoming audit of the financial statements for the period ending 31 March 20X8. You have been given the following draft statement of financial position.

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible non-current assets</td>
<td>10,101</td>
<td>12,378</td>
</tr>
<tr>
<td>Investments</td>
<td>10,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>196</td>
<td>191</td>
</tr>
<tr>
<td>Receivables</td>
<td>1,012</td>
<td>678</td>
</tr>
<tr>
<td>Bank</td>
<td>–</td>
<td>149</td>
</tr>
<tr>
<td>Prepayments</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>1,212</td>
<td>1,023</td>
</tr>
<tr>
<td></td>
<td>21,313</td>
<td>15,401</td>
</tr>
<tr>
<td><strong>EQUITY AND LIABILITIES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Share premium</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>2,000</td>
<td>–</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(5,217)</td>
<td>(8,601)</td>
</tr>
<tr>
<td></td>
<td>(2,117)</td>
<td>(7,501)</td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>12,325</td>
<td>17,002</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>938</td>
<td>900</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>1,168</td>
<td>–</td>
</tr>
<tr>
<td>Bank loan</td>
<td>3,999</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>6,105</td>
<td>900</td>
</tr>
<tr>
<td></td>
<td>21,313</td>
<td>15,401</td>
</tr>
</tbody>
</table>

Required

Comment on any points arising for your planning of the audit for the year end 31 March 20X8. Your comments should include issues relating to risk and materiality, accounting issues and audit evidence issues and any limitations of the review you have undertaken to date. You should also highlight any further information that you intend to seek. You should assume that you have already communicated with the previous auditor and have accepted the engagement.

SECTION SUMMARY

The auditor must ensure that disclosures in the financial statements are fairly stated.
5 Opening balances

SECTION INTRODUCTION

Opening balances are important as they include amounts which affect the current year balances and therefore the current year's profit and loss. Opening balances may also include matters requiring disclosure, such as contingencies and commitments.

5.1 Audit procedures

KEY TERM

**OPENING BALANCES** are those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

(SSA 510.4)

SSA 510 *Initial Audit Engagements – Opening Balances* provides guidance on opening balances:

- When the financial statements for the prior period were not audited
- When the financial statements for the prior period were audited by a predecessor auditor

SSA 510.6

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

   (i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

   (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

   (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence on opening balances depends on matters such as the following:

- The accounting policies followed by the entity
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements
- The significance of the opening balances relative to the current period's financial statements
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified
If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.

5.1.1 Specific audit procedures

For current assets and liabilities some evidence of opening balances may be obtained from the period being audited. For example, post period-end bank statements can provide evidence of the collection of accounts receivable or payment of accounts payable after a period end. This provides some audit evidence of the existence, completeness and valuation of those balances at that period end. So for the accounts receivable (or accounts payable) opening balance, evidence of collection (or payment) in the current year can provide audit evidence.

The bank statements can also provide evidence of opening bank balances or loan statements may provide evidence of opening borrowings.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional procedures may be necessary, such as:

- Observing a current physical inventory count and reconciling it back to the opening inventory quantities
- Performing audit procedures on the valuation of the opening inventory items by reviewing subsequent movement of inventories
- Performing audit procedures on gross profit and cut-off

A combination of these procedures may provide sufficient appropriate audit evidence.

For non-current assets and liabilities, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

5.1.2 Consistency of accounting policies

The auditor shall obtain sufficient appropriate audit evidence about:

- Whether the accounting policies reflected in the opening balances have been applied consistently in the current period's financial statements
- Whether changes in the accounting policies have been accounted for properly and adequately presented and disclosed in accordance with the applicable financial reporting framework

5.1.3 Prior period balances audited by a predecessor auditor

If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor.
SSA 710.13
If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

(a) That the financial statements of the prior period were audited by the predecessor auditor;
(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
(c) The date of that report.

The situation is slightly different if the prior period financial statements were not audited.

SSA 710.14
If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

If there was a modification to the opinion, the current auditor must evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements. If a disclaimer of opinion was issued, the incoming auditor will place less emphasis on a review of the working papers.

5.2 Audit conclusion and reporting
The effects of opening balances on the auditor's opinion in the auditor's report can be summarised as follows. Auditor's reports are covered in more detail in Chapter 16.

<table>
<thead>
<tr>
<th>Problem</th>
<th>Materiality of issue</th>
<th>Effect on auditor's report (SSA 705)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unable to obtain sufficient appropriate audit evidence on opening balances</td>
<td>Material but not pervasive</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td></td>
<td>Material and pervasive</td>
<td>Disclaimer of opinion</td>
</tr>
<tr>
<td>Opening balances contain a misstatement that materially affects the current period's financial statements</td>
<td>Material but not pervasive</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td></td>
<td>Material and pervasive</td>
<td>Adverse opinion</td>
</tr>
<tr>
<td>Accounting policies not applied consistently</td>
<td>Material but not pervasive</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td></td>
<td>Material and pervasive</td>
<td>Adverse opinion</td>
</tr>
<tr>
<td>Predecessor auditor's opinion modified</td>
<td>Consider whether the issue remains relevant and modify opinion accordingly eg if the prior year opinion was qualified on a material misstatement and the financial statements are still misstated this year, then qualify the opinion this year.</td>
<td></td>
</tr>
</tbody>
</table>
Auditor's reports and opinions are covered in more detail in Chapter 16. The auditor's report contains two opinion paragraphs. The first opinion states whether the auditor believes the financial statements show a true and fair view and are drawn up in line with Singapore Financial Reporting Standards (International). The second is the Report on Other Legal and Regulatory Requirements which expresses the auditor's opinion on whether the accounting and other records have been properly kept in accordance with the provisions of the Companies Act.

Opening balances will need to be considered for both opinions in the auditor's report.

5.3 Other matters

Opening balances are considered throughout the audit, not just at the final review stage. Opening balances are relevant because of the way in which they affect the current year's profit or loss. The audit procedures described above can be carried out alongside the current year audit testing.

In addition, opening balances will be one of many factors involved in preparing a fee proposal during the acceptance process which was covered in Chapter 5. Opening balances are also considered during the planning stage as part of the risk assessment.

Question 10.9

You have been appointed auditor of Jurong Castings Ltd for the year ended 30 September 20X0 following the retirement of the company's previous auditor. Jurong Castings Ltd has been trading for about 30 years. The company's revenue is about $500,000 and its normal profit before tax is about $30,000. Comparatives are shown as corresponding figures only.

Required

Explain your responsibilities in relation to the opening balances included in the financial statements for the year ended 30 September 20X0. You should also outline the information you would require from the retiring auditors.

SECTION SUMMARY

Auditors must obtain sufficient, appropriate evidence to ensure that opening balances do not contain misstatements that materially affect the current period's financial statements.

6 Smaller entity audits

SECTION INTRODUCTION

There are a number of practical issues to consider when auditing smaller entities.

6.1 Applying ISAs proportionately with the size and complexity of an entity

In general terms, the IAASB takes the view that 'an audit is an audit', and that all audits should be conducted in accordance with the same auditing standards. However, this does not mean that there will be no special considerations for audits of smaller entities.
In August 2009 the IAASB issued a Questions & Answers publication, *Applying ISAs Proportionately with the Size and Complexity of an Entity*, focusing on matters relevant to the audit of SMEs in the context of implementing the ISAs (on which current SSAs are based). The IAASB reiterated that the text of the ISAs is authoritative and must be followed, even in the audit of SMEs.

However, the IAASB did state that the work that an auditor will need to do in order to comply with an ISA will vary – a small, simple entity being likely to require less work than a large and complex one. The auditor needs to use professional judgment in applying the ISAs, in order to determine the procedures that are necessary to comply with their requirements.

To take a specific example, the IAASB stated that the requirement in ISA 315 to obtain an understanding of the entity and its environment is relevant to smaller entities, but that because smaller entities are typically simpler, it will be much easier to obtain this understanding.

### 6.2 Provisions in SSAs

Individual SSAs include guidance on specific points relating to small entity audits. The purpose of this guidance is to assist in the application of the requirements of the SSA to a small entity audit. It does not limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SSAs.

#### 6.2.1 SSA 210 Agreeing the Terms of Audit Engagements

SSA 210 contains no special provisions for small company audits but the owner of a small company may not be aware of directors’ and auditors’ responsibilities, particularly if the financial statements preparation is outsourced. A primary purpose of the engagement letter is to clarify these responsibilities. The engagement letter may include a reference to the expectation of written representations to be given.

#### 6.2.2 SSA 220 Quality Control for an Audit of Financial Statements

The audit of a smaller entity must still be compliant with SSAs. Most of these audits are conducted using one audit partner, one manager and one audit senior, so although assignment and delegation are taking place, it may be difficult to form an objective view on the judgments made in the audit.

The standard points out that AEs must set their own criteria to identify which audits require a quality review (in addition to audits of listed entities, where such reviews are mandatory). In some cases, none of the AE’s audit engagements may meet the criteria that would subject them to such a review.

#### 6.2.3 SSA 230 Audit Documentation

The standard allows for:

- The documentation being less extensive than for the audit of a larger entity
- Where the engagement partner performs all the audit work, matters that are normally documented solely to instruct or inform members of the team, or to provide evidence of review will not be included
- Various aspects of the audit may be recorded together in a single document

#### 6.2.4 SSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements

Within small companies, the lack of control procedures can contribute to a higher risk of employee fraud and error. On the other hand, a smaller entity may not have a written code of conduct but may have developed a culture of integrity and ethical behaviour through oral communication and management example.

The presence of a dominant owner-manager can be an important factor in the overall control environment with the need for management authorisation compensating for the lack of other controls. This can
however be a potential deficiency in internal control, due to the opportunity for management to override controls.

SSA 240 requires discussion amongst the audit team of the susceptibility of the entity to material frauds or errors. This discussion is still required for a small entity but is often overlooked due to the size of the audit team.

In addition, SSA 240 requires auditors to ask management about their assessment of risk of fraud and error. Even if management do not have a system of assessing risk, the inquiry should still be made as it provides valuable information about the control environment, although in smaller entities management’s assessment may only focus on the risks of employee fraud or misappropriation of assets.

6.2.5 SSA 300 Planning an Audit of Financial Statements

Due to the lack of complexity, audit planning documentation may be scaled back for a small entity. With a smaller team, co-ordination and communication are easier. A planning meeting or general conversation may be sufficient, and notes made about future issues during last year's audit will be particularly useful.

Standard audit programmes or checklists may be used, provided that they are tailored to the circumstances of the engagement, including the auditor's risks assessments.

In the smallest audits, carried out entirely by the audit partner, questions of direction, supervision and review do not arise. Forming an objective view on the appropriateness of judgments made in the course of the audit can present problems in this case, and if particularly complex or unusual issues are involved, it may be desirable to consult with other suitably experienced auditors or the auditor's professional body.

6.2.6 SSA 320 Materiality in Planning and Performing an Audit

The standard highlights that in an owner-managed business the profit before tax for the year may be consistently nominal as the owner may take most of the profits as remuneration, so it may be more appropriate to use profit before remuneration as the basis for estimating materiality.

Another practical issue is that at the planning stage it is often difficult to calculate materiality as a percentage of key figures, eg of assets, revenue or profit, as the draft financial statements may be unavailable for a small business. Trial balance figures may have to be used instead.

The auditor will need to use judgment in applying materiality when evaluating results.

6.2.7 SSA 550 Related Parties

In a small entity, related party transactions between the company and its directors and their families may be significant but smaller entities may have no documented processes or controls for dealing with related party relationships and transactions. The auditor will have to obtain an understanding of the related party relationships and transactions through inquiry of management and observation of management’s oversight and review activities.

The auditor’s in-depth knowledge of the smaller entity will assist in identification of related parties (for example, other entities controlled by the owner management) which will also help the auditor to assess the risk of any transactions being unrecorded or undisclosed.

6.2.8 SSA 570 Going Concern

The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

Risks of particular relevance to small entities are:

- That banks and other lenders may cease to support the entity
- The possible loss of a principal supplier, major customer, key employee, or the right to operate under a licence, franchise or other legal agreement
It is unlikely that budgets and forecasts will be available for the auditor to review. In many businesses the principal source of finance may be a loan from the owner manager.

If an entity is in difficulty, its survival may depend on the owner manager subordinating their loan in favour of banks or other financial institutions. In this case, the auditor would inspect sufficient, appropriate evidence of the subordination.

If an entity depends on funds from the owner manager, the auditor will consider their current financial position and may ask for a written representation to confirm the owner-manager’s understanding.

SECTION SUMMARY

The basic principles of SSAs apply to all audits. However, there are special consideration in certain SSAs on audits of smaller entities, to promote an effective and efficient audit.
Quick Quiz

1. Complete the definition.
   A ………………….. lease is one that transfers substantially all the ………………. and …………….. incident to ownership of an asset.

2. Name three types of contingency often disclosed by companies.
   (1) ……………………………
   (2) ……………………………
   (3) ……………………………

3. The auditor may request information directly from the client's solicitors.
   True □  False □

4. Link the disclosure issue with the accounting guidance
   (a) Segmental information (i) SFRS(I) 15
   (b) EPS (ii) SFRS(I) 8
   (c) Discontinued operations (iii) SFRS(I) 5
   (d) Revenue recognition (iv) SFRS(I) 1-33

5. Why is EPS disclosure likely to be material?

6. Which of the following is not a reason why revenue is often audited by analytical procedures?
   (1) Availability of good, comparable evidence
   (2) Statement of profit or loss and other comprehensive income is not as important as statement of financial position
   (3) It is quicker than detailed substantive testing
   (4) Revenue has logical relationships with other items in the financial statements

7. Auditors do not report on the statement of cash flows (only the statement of financial position and statement of profit or loss and other comprehensive income as recorded in the opinion section of the report).
   True □  False □
Answers to Quick Quiz

1. Finance, risks, rewards

2. Any three from the following:
   - Guarantees
   - Discounted bills of exchange
   - Uncalled liabilities on shares
   - Lawsuits/claims pending
   - Options to purchase assets

3. True. However the letter should be written by management and sent by the auditor.

4. (a)(ii), (b)(iv), (c)(iii), (d)(i)

5. It is of interest to the key users of financial statements – the shareholders.

6. (2) The statement of profit or loss and other comprehensive income is just as important. However, (3) is true, because it is cost effective to use analytical procedures where good evidence is available.

7. False
Answers to Questions

10.1 Audit of leases

Audit issues

The audit risk is that the lease has been inappropriately recognised as a lease. We have no information on whether Hougang has the right to obtain all the economic benefits from leasing the asset or whether it can direct the use of the asset. Further inspection of the lease agreement should be performed to confirm the existence of a lease.

Materiality needs to be considered. The right-of-use asset capitalised in the statement of financial position should be initially recognised at $76,200 (80,000 – 5,800 + 2000). At 31 January 20X2, depreciation of $17,200 will have been applied and the right-of-use asset will be $63,500. At 4.0% of total assets, this balance is material to the statement of financial position.

The period over which the right-of-use asset is being depreciated needs to be considered. In this case the asset is being depreciated over the non-cancellable period of the lease (six years) when it will only be of use to the company for five years.

The treatment of the costs incurred in setting up the lease need to be considered. Direct costs can be capitalised as part of the right-of-use asset and depreciated.

The auditors need to consider whether the right-of-use asset should be impaired as per the requirements of SFRS(I) 1-36 Impairment of Assets.

There should also be a financial lease liability of $65,620 in total (see Working). At 4.1% of total assets the lease liability is also material to the statement of financial position.

Profit figures are required to determine the potential materiality of interest and depreciation charges.

There is a need to check whether the rate implicit in the lease has been calculated correctly. In accordance with SFRS(I) 16 this is the rate that causes the present value of the lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

Disclosures must be inspected to ensure they comply with the requirements of SFRS(I) 16.

Working

<table>
<thead>
<tr>
<th>Year ended 31 December 20X2</th>
<th>$</th>
</tr>
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<tbody>
<tr>
<td>1 January 20X2</td>
<td>Lease liability</td>
</tr>
<tr>
<td>1 January 20X2</td>
<td>Non-refundable deposit</td>
</tr>
<tr>
<td>1 January 20X2 to 31 December 20X2</td>
<td>Interest at 10%</td>
</tr>
<tr>
<td>31 December 20X2</td>
<td>Instalment 1</td>
</tr>
<tr>
<td>Balance at 31 December 20X2</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year ended 31 December 20X3</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 20X3 to 31 December 20X3</td>
<td>Interest at 10%</td>
</tr>
<tr>
<td>31 December 20X3</td>
<td>Instalment 2</td>
</tr>
<tr>
<td>Balance at 31 December 20X3</td>
<td></td>
</tr>
</tbody>
</table>

10.2 Revision: taxable temporary differences

Tax base of the asset is $3,000 – $1,800 = $1,200

Deferred tax liability = $800 (2,000 – 1,200) × 17% = $136
10.3 Revision: deductible temporary differences

Tax base = Nil (carrying amount of $20,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

Deferred tax asset = $20,000 (carrying amount) – Nil (tax base) = 20,000 \times 17% = $3,400.

This should be recognised in accordance with SFRS(I) 1-12 (see Section 2.2.3).

10.4 Audit of deferred tax

(a) Audit issues

(i) The deferred tax balance has not been adjusted to reflect current period balances.

(ii) Adjustment of deferred tax would result in the following balances:

Deferred tax liability $476,000 (see working)
Credit in the statement of profit or loss $482,000 (see working)

(iii) With the change in liability representing approximately 48% of profit before tax and 9% of net assets the adjustment is material to both the statement of profit or loss and the statement of financial position.

(iv) Whether the tax rate of 17% is the correct rate to apply.

(v) Whether the net book values and tax written down values provided are correct.

(vi) Whether there are any additional taxable temporary differences or deductible temporary differences that should be taken account of.

(vii) Whether adequate disclosure is provided in accordance with SFRS(I) 1-12.

(b) Audit procedures

(i) Discuss with management why they have not adjusted the deferred tax liability for the period and request that they do so.

(ii) Agree the brought forward balance for deferred tax to the previous year's financial statements.

(iii) Obtain a schedule of the temporary differences relating to the plant and equipment and agree these to tax computations and asset registers.

(iv) Check that the rate applied of 17% is in accordance with SFRS(I) 1-12, ie the 'substantively enacted' rate of tax.

(v) Enquire of management and review tax computation to establish whether there are any further differences that need to be adjusted for.

(vi) Review disclosure notes to ensure that they comply with SFRS(I) 1-12 including disclosure of the components of the deferred tax liability, the change in the liability and the major components of the income tax expense.

Working

\[
\begin{align*}
\text{Tax base of asset} & \quad 2,400 \\
\text{Carrying amount} & \quad 5,200 \\
2,800 \times 17% & \quad 476 \\
\text{Brought forward liability} & \quad 958 \\
\text{Decrease in liability} & \quad 482
\end{align*}
\]
10.5 Provisions

(a) SFRS(I) 1-37 states that a provision should be recognised in the financial statements if:

(i) An entity has a present obligation (legal or constructive) as a result of a past event.
(ii) A transfer of economic benefits will probably be required to settle the obligation.
(iii) A reliable estimate can be made of the amount of the obligation.

Under SFRS(I) 1-37 contingent liabilities should not be recognised. They should however be disclosed unless the prospect of settlement is remote. The entity should disclose the following:

(i) The nature of the liability
(ii) An estimate of its financial effect
(iii) The uncertainties relating to any possible payments
(iv) The likelihood of any reimbursement

(b) The following tests should be carried out to determine whether the company will have to pay damages and the amount to be included in the financial statements.

(i) Review the director's service contract and ascertain the maximum amount to which they would be entitled and the provisions in the service contract that would prevent them making a claim, in particular those relating to grounds for justifiable dismissal.

(ii) Review the results of the disciplinary hearing. Consider whether the company has acted in accordance with employment legislation and its internal rules, the evidence presented by the company and the defence made by the director.

(iii) Review correspondence relating to the case and determine whether the company has acknowledged any liability to the director that would mean that an amount for compensation should be accrued in accordance with SFRS(I) 1-37.

(iv) Review correspondence with the company's solicitors and obtain legal advice, either from the company's solicitors or another AE, about the likelihood of the claim succeeding.

(v) Review correspondence and contact the company's solicitors about the likely costs of the case.

(vi) Consider the likelihood of costs and compensation being reimbursed by reviewing the company's insurance arrangements and contacting the insurance company.

(vii) Consider the amounts that should be accrued and the disclosures that should be made in the financial statements. Legal costs should be accrued, but compensation payments should only be accrued if the company has admitted liability or legal advice indicates that the company's chances of success are very poor. However the claim should be disclosed unless legal advice indicates that the director's chance of success appears to be remote.

(viii) Obtain written representations that all details relating to actual cases and other possible litigations have been disclosed to the auditor.

10.6 Revision: basic EPS

Computation of theoretical ex-rights price

\[
\frac{\text{Fair value of all outstanding shares} + \text{total received from exercise of rights}}{\text{Number of shares outstanding prior to exercise} + \text{number of shares issued in exercise}} = \frac{($11.00 \times 500,000) + ($5.00 \times 100,000)}{500,000 + 100,000} = $10.00
\]

20X8 EPS

\[
\frac{1,500,000}{(500,000 \times \frac{2}{12} \times \frac{11}{10}) + (600,000 \times \frac{10}{12})} = $2.54
\]
20X7 EPS (restated)

\[ 2.20 \times \frac{10}{11} = \$2.00 \]

10.7 Statement of cash flows

Report on the statement of cash flows

The statement of cash flows is a component of a complete set of financial statements per SFRS(I) 1-1. The auditors are required to opine, amongst others, whether the company’s financial position and performance, changes in equity and cash flows are true and fair in accordance with Section 207(2) of the Companies Act and SSA 700. As such the auditors must therefore assess the truth and fairness of the statement of cash flows as required by SFRS(I) 1-7.

Analytical procedures

The information in the statement of cash flows will be used by the auditors as part of their analytical procedures, for example, by adding further information on liquidity. This will be particularly helpful when comparing the statement to previous periods.

Going concern

The statement of cash flows may indicate going concern problems due to liquidity failings, overtrading and overgearing. However, the statement is an historical document, prepared well after the year-end, and is therefore unlikely to be the first indicator of such difficulties. In practice, the auditor is particularly interested to look at the cash flows from the operating activities (as opposed to cash flows from financing or investing activities) of an entity in conjunction with the auditor’s assessment of the validity of the going concern basis of accounting of that entity.

Audit evidence

The auditors will obtain very little direct audit evidence from the statement of cash flows. It has been prepared by the company (not the auditors or an independent third party) from records which are under scrutiny by the auditors in any case. Thus the auditors will already have most of this information, although in a different format.

However, the statement of cash flows should provide additional evidence for figures in the financial statements, for example, the purchase or sale of tangible non-current assets. Consistency of evidence will be important and reciprocal evidence is always welcome.

10.8 Accounting issues and audit evidence

Matters arising from preliminary review

Going concern

The statements of financial position show a worsening cash position over the year. There are some classic indicators of going concern problems.

- Substantial liabilities
- Excess of current liabilities over current assets
- Bank overdraft
- Substantial increase in receivables
- Bank requiring future profit forecasts, which have been verified by our AE

A profit has been made in the year, but it does not appear that sales are readily being converted into cash.

Sources of audit evidence

- Profit forecasts
- Correspondence with bank
- Any business plans in existence (consult with business advisory department)

Further information required

- We need to confirm in the audit file why the bank required profit forecasts.
- We need to review for audit purposes the results of our work on those forecasts.
- For the purposes of our audit we must satisfy ourselves that Tinga Ltd is a going concern.
Three items on the financial statements stand out as being particularly interesting at the planning stage. These are:

- Deferred tax
- Increase in investments
- Revaluation in the year

**Deferred tax**

We will need to confirm what the deferred tax relates to, particularly as the non-current assets in the statement of financial position do not seem particularly high. The deferred tax balance does not appear to have moved, despite the movements on non-current assets. We will have to check that deferred tax has been accounted for correctly in accordance with SFRS(I) 1-12.

**Increase in investments**

Investments are usually a straightforward area to audit with good audit evidence existing in terms of share certificates and valuation certificates.

However, as investments have increased, we must ensure that they have been accounted for correctly. We must also ensure that the increase does not represent a holding in another company that would require the results being consolidated into group results. We may also need to know the nature of the investments and whether such investments will be within the ambit of SFRS(I) 9 and in which case which category of financial assets does these investments belong to (Note: different subsequent measurement rules for each category of financial assets)?

**Revaluation**

There appears to have been a revaluation in the year, although non-current assets have in fact decreased. We must discover what the revaluation reserve relates to, and ensure that it has been accounted for correctly.

**Materiality**

All the accounting issues discussed above are potentially material to the statement of financial position. As the statement of financial position shows high liabilities, any as yet unrecorded impairment in either tangible non-current assets or investments could make the position of the company significantly worse. Conversely, if the liability shown in deferred tax was overstated, this would have the reverse effect.

**Limitations of current review**

The current review has only taken account of the statement of financial position, so is an incomplete picture. At present, we have not established the accuracy of items in the statement of profit or loss and other comprehensive income which have had implications for the statement of financial position.

As this is a first year audit, and the audit department is not familiar with this client, we have little knowledge of the business to apply to this review.

It is important as part of the planning process that the audit partner and/or manager enter into discussions with the various departments which have dealings with Tinga Ltd to increase their knowledge of the business and to obtain audit evidence on issues such as going concern.

However, it is also important for the audit team to bear in mind that, as auditors, they must maintain their independence towards the audit. There is a danger to the AE of loss of objectivity in respect of this audit due to the other services offered to the client, which must not be forgotten.
10.9 Opening balances

Consideration of the financial statements of the preceding period is necessary in the audit of the current period's financial statements in relation to three main aspects:

(a) Opening position: obtaining satisfaction that those amounts which have a direct effect on the current period's results or closing position have been properly brought forward

(b) Accounting policies: determining whether the accounting policies adopted for the current period are consistent with those of the previous period

(c) Comparatives: determining that the comparatives are properly shown in the current period's financial statements

The auditors' main concern will therefore be to satisfy themselves that there were no material misstatements in the previous year's financial statements which may have a bearing upon their work in the current year.

The new auditors do not have to 're-audit' the previous year's financial statements, but they will have to pay more attention to them than would normally be the case where they had themselves been the auditors in the earlier period. A useful source of audit evidence will clearly be the previous auditors, and, with the client's permission, they should be contacted to see if they are prepared to co-operate. Certainly, any known areas of weakness should be discussed with the previous auditors. The auditor should request to review the previous auditor's work papers and if denied, perform the other procedures as per SSA510.6(c) to obtain evidence on the opening balances as follows:

(i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.
GROUP AUDITS

The concept of a group audit extends from the concept of a single company audit. Business entities may be structured in a number of different ways and that structure has consequences for the auditor in terms of understanding the entity and assessing risk in particular. Where a single entity has complex or autonomous divisions or the entity is a group of companies a number of potentially complex issues may arise such as auditor access to information and evidence and additional accounting issues such as foreign exchange, acquisitions and disposals.

SSA 600 Special Considerations – Audits of Group Financial Statements is designed to help the auditor consider the additional factors involved in auditing a group of companies as opposed to a single one. In addition to accounting issues, including consolidation of financial statements, the auditor may need to consider particular auditing issues such as the need to rely on the work of component auditors (auditors from a different branch of the same AE or from a different AE).

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**Topic list**

1. Group accounting recap
2. Associates and joint ventures accounting recap
3. Audit of groups
4. The consolidation: problems and procedures
5. Joint audits
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Group audits</strong></td>
<td></td>
</tr>
<tr>
<td>Recognise the specific matters to be considered before accepting appointment as auditor of group financial statements.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and explain the matters specific to planning an audit of group financial statements including assessment of the group, its components, and their environments, the impact of non-coterminous year ends within a group and changes in group structure.</td>
<td>2</td>
</tr>
<tr>
<td>Justify the situations where a joint audit would be appropriate.</td>
<td>2</td>
</tr>
<tr>
<td>Recognise the audit issues and describe audit procedures specific to a business combination.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and explain the audit risks and necessary audit procedures relevant to the consolidation process and group-wide controls.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and describe the matters to be considered and the procedures to be performed at the planning stage, when a group engagement team considers the use of the work of component auditors.</td>
<td>3</td>
</tr>
<tr>
<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>
<td>3</td>
</tr>
<tr>
<td>Explain the responsibilities of component auditors in the context of a group audit.</td>
<td>3</td>
</tr>
<tr>
<td>Consider how the group engagement team should evaluate the audit work performed by a component auditor.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the implications for the auditor’s report on the financial statements of an entity where the opinion on a component is qualified or otherwise modified in a given situation.</td>
<td>3</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

- SSA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
- SFRS(I) 1-27 Separate Financial Statements
- SFRS(I) 3 Business Combinations
- SFRS(I) 10 Consolidated Financial Statements
- SFRS(I) 11 Joint Arrangements
- SFRS(I) 12 Disclosure of Interests in Other Entities
- SFRS(I) 1-28 Investments in Associates and Joint Ventures
- ACRA Audit Practice Bulletin No 1 of 2015 Audits of Group Financial Statements (including the work of Component Auditors)
- AGS 11 Comfort Letters and Due Diligence Meetings
1 Group accounting recap

SECTION INTRODUCTION

In order to understand the key issues affecting the audit of group financial statements you must understand the accounting treatment.

You must be familiar with the Singapore Financial Reporting Standards (International) listed in the essential reading list above.

The key points that you should be aware of are summarised below. You can work through this section fairly quickly, as most of the material should already be familiar to you from your financial reporting studies.

1.1 Content of consolidated financial statements

Consolidated (or group) financial statements combine the information contained in the separate financial statements of a parent company and its subsidiary corporations as if they were the financial statements of a single entity.

KEY TERMS

An investor **controls** an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

(SFRS(I) 10 Appendix A)

**Associate** – an entity over which the investor has significant influence.

(SFRS(I) 1-28)

**Significant influence** is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

(SFRS(I) 1-28)

**Joint arrangement** – An arrangement of which two or more parties have joint control.

(SFRS(I) 1-28, SFRS(I) 11)

**Joint control** – The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

(SFRS(I) 1-28, SFRS(I) 11)

**Joint operation** – A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

(SFRS(I) 11)

**Joint venture** – A joint arrangement whereby the parties that have joint control (the joint venturers) of the arrangement have rights to the net assets of the arrangement.

(SFRS(I) 1-28, SFRS(I) 11)

**Contingent consideration** – Usually, an obligation of the acquirer to transfer additional assets or equity (SFRS(I) 3) interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.

(SFRS(I) 3)

**Fair value** – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market at the measurement date.

(SFRS(I) 13)

**Business combination** – A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in this SFRS(I).

(SFRS(I) 3)
Before discussing SFRS(I) 3 in detail, we can summarise the different types of investment and the required accounting for them as follows.

<table>
<thead>
<tr>
<th>Investment</th>
<th>Criteria</th>
<th>Required treatment in consolidated financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary corporation</td>
<td>Control</td>
<td>Full consolidation</td>
</tr>
<tr>
<td>Associate</td>
<td>Significant influence</td>
<td>Equity accounting</td>
</tr>
<tr>
<td>Joint venture</td>
<td>Contractual arrangement</td>
<td>Equity accounting</td>
</tr>
<tr>
<td>Investment which is none of the above</td>
<td>Asset held for accretion of wealth</td>
<td>As for single company accounts per SFRS(I) 9</td>
</tr>
</tbody>
</table>

### 1.2 Identifying a business combination

SFRS(I) 3 *Business Combinations* requires entities to determine whether a transaction or other event is a business combination by applying the definition in the SFRS(I).

### 1.3 The acquisition method

Entities must account for each business combination by applying the acquisition method. This requires:

(a) Identifying the acquirer. This is generally the party that obtains control.

(b) Determining the acquisition date. This is generally the date the consideration is legally transferred, but it may be another date if control is obtained on that date.

(c) Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree (see below).

(d) Recognising and measuring goodwill or a gain from a bargain purchase.

### 1.4 Acquisition-related costs

Under SFRS(I) 3 costs relating to the acquisition must be recognised as an expense at the time of the acquisition. They are not regarded as an asset. (Costs of issuing debt or equity are to be accounted for under the rules of SFRS(I) 9.)

### 1.5 Contingent consideration

SFRS(I) 3 requires recognition of contingent consideration, measured at fair value, at the acquisition date.

#### 1.5.1 SFRS(I) 3

SFRS(I) 3 recognises that, by entering into an acquisition, the acquirer becomes obliged to make additional payments. Not recognising that obligation means that the consideration recognised at the acquisition date is not fairly stated.

SFRS(I) 3 requires recognition of contingent consideration, measured at fair value, at the acquisition date. This is, arguably, consistent with how other forms of consideration are fair valued.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. Debt instruments are presented in accordance with SFRS(I) 1-32. Contingent consideration may occasionally be an asset, for example if the consideration has already been transferred and the acquirer has the right to the return of part of it, an asset may occasionally be recognised in respect of that right.
1.5.2 Post-acquisition changes in the fair value of the contingent consideration

The treatment depends on the circumstances:

(a) If the change in fair value is due to additional information obtained that affects the position at the acquisition date, goodwill is re-measured.

(b) If the change is due to events that took place after the acquisition date, for example, meeting earnings targets or is identified after the measurement period:

(i) Contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity.

(ii) Other contingent consideration that is within the scope of SFRS(I) 3 is measured at fair value at each reporting date and changes in fair value are recognised in profit or loss in accordance with SFRS(I) 3.

(iii) Other contingent consideration that is not within the scope of SFRS(I) 3 is measured at fair value at each reporting date and changes in fair value are recognised in profit or loss in accordance with SFRS(I) 3.

1.6 Goodwill and the non-controlling interest

1.6.1 SFRS(I) 3 methods – an introduction

The SFRS(I) 3 views the group as an economic entity. This means that it treats all providers of equity – including non-controlling interests – as shareholders in the group, even if they are not shareholders of the parent. We now need to consider how SFRS(I) 3 sets out the calculation for goodwill.

1.6.2 SFRS(I) 3 goodwill calculation

SFRS(I) 3 states:

Consideration paid by parent + fair value of non-controlling interest – fair value of the subsidiary corporation's net identifiable assets = consolidated goodwill

1.6.3 Template for goodwill calculation

This Textbook uses the following template to calculate goodwill:

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>X</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>X</td>
</tr>
<tr>
<td>Net assets acquired as represented by:</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>X</td>
</tr>
<tr>
<td>Share premium</td>
<td>X</td>
</tr>
<tr>
<td>Retained earnings on acquisition</td>
<td>X</td>
</tr>
<tr>
<td>Goodwill</td>
<td>X</td>
</tr>
</tbody>
</table>

1.6.4 Valuing non-controlling interest at acquisition

The non-controlling interest may be valued either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

The non-controlling interest now forms part of the calculation of goodwill. The question now arises as to how it should be valued.

The 'economic entity' principle suggests that the non-controlling interest should be valued at fair value. In fact, SFRS(I) 3 gives a choice:
‘For each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest’s proportionate share of the acquiree’s identifiable net assets.’  
(SFRS(I) 3)

SFRS(I) 3 suggests that the closest approximation to fair value will be the market price of the shares held by the non-controlling shareholders just before the acquisition by the parent.

Non-controlling interest at fair value will be different from non-controlling interest at proportionate share of the acquiree’s net assets. The difference is goodwill attributable to non-controlling interest, which may be, but often is not, proportionate to goodwill attributable to the parent.

1.7 Investment in subsidiary corporations

The important point here is control. In most cases, this will involve the parent company owning a majority of the ordinary shares in the subsidiary corporation (to which normal voting rights are attached). There are circumstances, however, when the parent may own only a minority of the voting power in the subsidiary corporation, but the parent still has control.

SFRS(I) 10 Consolidated Financial Statements states that an investor controls an investee if and only if it has all of the following.

(i) Power over the investee;
(ii) Exposure, or rights, to variable returns from its involvement with the investee; and
(iii) The ability to use its power over the investee to affect the amount of the investor’s returns.

Accounting treatment in group financial statements

SFRS(I) 10 requires a parent to present consolidated financial statements, in which the financial statements of the parent and subsidiary corporation (or subsidiary corporations) are combined and presented as a single entity.

1.8 Consolidation process

The following summaries provide revision of the basic consolidation technique.

Summary of technique: consolidated statement of financial position

**STEP 1**
Read the question and draw up the group structure (W1), highlighting useful information:

- The percentage owned
- Acquisition date
- Pre-acquisition reserves

**STEP 2**
Draw up a proforma taking into account the group structure identified:

- Leave out cost of investment
- Put in a line for goodwill
- Put in a line for investment in associate
- Remember to include non-controlling interests
- Leave lines in case of any additions

**STEP 3**
Work methodically down the statement of financial position, transferring:

- Figures to proforma or workings:
- 100% of all assets/liabilities controlled at the year-end aggregated in brackets on face of proforma, ready for adjustments
- Cost of subsidiary corporation/associate and reserves to group workings, setting them up as you work down the statement of financial position
- Share capital and share premium (parent only) to face of proforma answer
- Open up a (blank) working for non-controlling interests
Read through the additional notes and attempt the adjustments showing workings for all calculations.

Do the double entry for the adjustments onto your proforma answer and onto your group workings (where the group workings are affected by one side of the double entry).

**Examples:**

Cancel any intragroup items eg current account balances, loans

Adjust for unrealised profits:

<table>
<thead>
<tr>
<th>Unrealised profit on intragroup sales</th>
<th>% held in inventories at year-end</th>
<th>= Provision for unrealised profit (PUP)</th>
<th>DR Retained earnings</th>
<th>CR Group inventories</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Make fair value adjustments:

<table>
<thead>
<tr>
<th>Acquisition date</th>
<th>Movement</th>
<th>Year-end</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories</td>
<td>X</td>
<td>(X)</td>
</tr>
<tr>
<td>Depreciable non-current assets</td>
<td>X</td>
<td>(X)</td>
</tr>
<tr>
<td>Non-depreciable non-current assets</td>
<td>X</td>
<td>(X)</td>
</tr>
<tr>
<td>Other fair value adjustments</td>
<td>X/(X)</td>
<td>(X)/X</td>
</tr>
</tbody>
</table>

This total appears in the goodwill working

This total is used to adjust the subsidiary corporation’s reserves in the reserves working.

The individual figures here are used to adjust the relevant balances on the consolidated statement of financial position.

Complete goodwill calculation

<table>
<thead>
<tr>
<th>Consideration transferred</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-controlling interests (at % fair value (FV) of net assets or at ‘full’ FV)</td>
<td>X</td>
</tr>
<tr>
<td>Less net fair value of identifiable assets acquired and liabilities assumed:</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>X</td>
</tr>
<tr>
<td>Share premium</td>
<td>X</td>
</tr>
<tr>
<td>Retained earnings at acquisition</td>
<td>X</td>
</tr>
<tr>
<td>Other reserves at acquisition</td>
<td>X</td>
</tr>
<tr>
<td>Fair value adjustments at acquisition</td>
<td>X</td>
</tr>
<tr>
<td>Less impairment losses on goodwill to date</td>
<td>X</td>
</tr>
</tbody>
</table>
Complete the consolidated retained earnings calculation:

<table>
<thead>
<tr>
<th></th>
<th>Parent</th>
<th>Subsidiary corporation</th>
<th>Associate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per question</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Adjustments</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Fair value adjustments movement</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Pre-acquisition retained earnings</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
</tr>
<tr>
<td>Group share of post acq’n ret’d earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsidiary (Y × %)</td>
<td></td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Associate (Z × %)</td>
<td></td>
<td></td>
<td>Z</td>
</tr>
<tr>
<td>Less group share of impairment losses to date</td>
<td>(X)</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

Note: Other reserves are treated in a similar way.

Complete 'Investment in associate' calculation:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of associate</td>
<td>X</td>
</tr>
<tr>
<td>Share of post-acquisition retained reserves (from reserves working Z × %)</td>
<td>X</td>
</tr>
<tr>
<td>Less group impairment losses on associate to date</td>
<td>(X)</td>
</tr>
</tbody>
</table>

Complete the non-controlling interests calculation:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition (from goodwill working)</td>
<td>X</td>
</tr>
<tr>
<td>NCI share of post acq’n reserves (from reserves working Y × NCI %)</td>
<td>X</td>
</tr>
<tr>
<td>Less NCI share of impairment losses (only if NCI at 'full' FV at acq’n)</td>
<td>(X)</td>
</tr>
</tbody>
</table>

Summary of technique: consolidated statement of profit or loss and other comprehensive income

Overview

The statement of profit or loss and other comprehensive income shows a true and fair view of the group's activities since acquisition of any subsidiary corporations.

(a) The top part of the statement of profit or loss and other comprehensive income shows the income, expenses, profit and other comprehensive income controlled by the group.

(b) The reconciliation at the bottom of the statement of profit or loss and other comprehensive income shows the ownership of those profits and total comprehensive income.

Method

Read the question and draw up the group structure and where subsidiary corporations/associates are acquired in the year identify the proportion to consolidate. A timeline may be useful.

Draw up a proforma:

- Remember the non-controlling interests reconciliation at the foot of the statement.
Work methodically down the statement of profit or loss and other comprehensive income, transferring figures to proforma or workings:

- 100% of all income/expenses (time apportioned \( \times \frac{1}{12} \) if appropriate) in brackets on face of proforma, ready for adjustments
- Exclude dividends receivable from subsidiary corporation
- Subsidiary corporation's profit for the year (PFY) and total comprehensive income (TCI) (for NCI) to face of proforma in brackets (or to a working if many adjustments)
- Associate's PFY and other comprehensive income (OCI) to face of proforma in brackets

Go through question, calculating the necessary adjustments showing workings for all calculations, transfer the numbers to your proforma and make the adjustments in the non-controlling interests working where the subsidiary corporation's profit is affected.

Calculate 'Share of profit of associate' and 'Share of other comprehensive income of associate' (where appropriate):

\[
\text{A's Profit for the year (PFY) } \times \text{ Group } \% \times X \\
\text{Any group impairment loss recognised on the associate during the period } (X) \times X
\]

Shown before group profit before tax.

\[
\text{A's Other comprehensive income (OCI) } \times \text{ Group } \% \times X
\]

Both the associate's profit or loss and other comprehensive income are calculated based on after tax figures

Complete non-controlling interests in subsidiary corporation's PFY and TCI calculation:

\[
\begin{array}{ccc}
\text{PFY/TCI per question (time-apportioned } \times \frac{1}{12} \text{ if appropriate) } & \text{PFY} & \text{TCI (if req'd)} \\
\text{Adjustments, eg PUP on sales made by S } & (X)/X & (X)/X \\
\text{Impairment losses (if NCI held at fair value) } & (X) & (X) \\
\times \text{ NCI}\% & (X) & (X)
\end{array}
\]

SECTION SUMMARY

A group of companies will require group financial statements. This entails the audit risk that the SFRS(I) in this area are not complied with.
2 Associates and joint ventures accounting recap

SECTION INTRODUCTION

There are some significant concepts and definitions introduced by SFRS(I) 10, 11 and 1-28.

KEY TERMS

**JOINT ARRANGEMENT** – An arrangement of which two or more parties have joint control.

**JOINT CONTROL** – The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

**JOINT VENTURE** – A joint arrangement whereby the parties that have joint control (the joint venturers) of the arrangement have rights to the net assets of the arrangement.  
(SFRS(I) 1-28, SFRS(I) 11)

2.1 Investments in associates

An associate is not a subsidiary but it is more than just a simple investment. The key criterion here is significant influence. This is defined as the ‘power to participate’, but not to ‘control’ (which would make the investment a subsidiary corporation).

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. SFRS(I) 1-28 *Investments in Associates and Joint Ventures* states that if an investor holds 20% or more of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, unless it can be clearly shown that this is not the case.

Significant influence can be presumed not to exist if the investor holds less than 20% of the voting power of the investee, unless it can be demonstrated otherwise.

The existence of significant influence is evidenced in one or more of the following ways.

(a) Representation on the board of directors (or equivalent) of the investee
(b) Participation in the policy making process
(c) Material transactions between investor and investee
(d) Interchange of management personnel
(e) Provision of essential technical information
Accounting treatment in group financial statements

SFRS(I) 1-28 requires the use of the equity method of accounting for investments in associates:

<table>
<thead>
<tr>
<th>Financial statement</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of profit or loss and other comprehensive income</td>
<td>Profit before tax</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>Group share of associate's other comprehensive income</td>
</tr>
<tr>
<td>Statement of financial position</td>
<td>Interest in associated companies should be stated at:</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>X</td>
</tr>
<tr>
<td>Share of total comprehensive income for the year</td>
<td>X</td>
</tr>
<tr>
<td>Less dividends paid by associate to parent, if any</td>
<td>(X)</td>
</tr>
</tbody>
</table>

Also disclose group's share of post-acquisition reserves of associated companies and movements therein

2.2 Accounting for investments in joint arrangements

SFRS(I) 11 classifies joint arrangements as either joint operations or joint ventures. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

Joint arrangements (joint ventures and joint operations) are dealt with by SFRS(I) 11 Joint Arrangements.

Joint arrangements can be:

<table>
<thead>
<tr>
<th>Type of joint arrangement</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not structured through a separate vehicle</td>
<td>Joint venture or joint operation, depending on:</td>
</tr>
<tr>
<td>Structured through a separate vehicle</td>
<td>(i) Legal form of the separate vehicle</td>
</tr>
<tr>
<td></td>
<td>(ii) Terms of contract</td>
</tr>
<tr>
<td></td>
<td>(iii) Other facts and circumstances</td>
</tr>
</tbody>
</table>

Accounting treatment in group financial statements

Prior to the new group accounting standards issued in 2011, the old standard on joint ventures (FRS 31) permitted either equity accounting or proportionate consolidation to be used for joint ventures. The choice has now been removed, and the equity method must be used. (Proportionate consolidation meant including the investor's share of the assets, liabilities, income and expenses of the joint venture, line by line).

SFRS(I) 11.20 requires that a joint operator recognises line-by-line the following in relation to its interest in a joint operation:

(a) Its assets, including its share of any jointly held assets
(b) Its liabilities, including its share of any jointly incurred liabilities
(c) Its revenue from the sale of its share of the output arising from the joint operation
(d) Its share of the revenue from the sale of the output by the joint operation
(e) Its expenses, including its share of any expenses incurred jointly
IMPORTANT

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

In its consolidated financial statements, SFRS(I) 11 requires that a joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with SFRS(I) 1-28 *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method.

In its separate financial statements, a joint venturer should account for its interest in a joint venture in accordance with SFRS(I) 1-27 *Separate Financial Statements*, namely:

(a) At cost, in accordance with SFRS(I) 9 *Financial Instruments*; or
(b) Using the equity method.

2.3 Other investments

Investments which do not meet the definitions of any of the above should be accounted for according to SFRS(I) 9 *Financial Instruments*.

SECTION SUMMARY

In the audit of a group of companies the group auditor may need to consider the impact of associates and joint arrangements.

3 Audit of groups

SECTION INTRODUCTION

In the audit of a group of companies the group auditor may need to rely on the work of the component auditor.

The group auditor must consider whether it will be possible to obtain sufficient appropriate audit evidence about components.

The standard here is SSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*.

SSA 600 states that the objectives of the auditor are as follows.
The objectives of the auditor are:

(a) Determine whether to act as the auditor of the group financial statements; and

(b) If acting as the auditor of the group financial statements:

(i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and

(ii) To obtain sufficient appropriate audit evidence about the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The group auditor should gain an understanding of the group as a whole and assess risks for the group as a whole and for individually significant components. The group auditor has to ensure other auditors are professionally qualified, meet quality control and ethical requirements and will allow the group auditor access to working papers or components themselves.

3.1 Definitions

**KEY TERMS**

**COMPONENT** – An entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements.

**COMPONENT AUDITOR** – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

**COMPONENT MATERIALITY** – The materiality level for a component determined by the group engagement team.

**GROUP** – All the components whose financial information is included in the group financial statements. A group always has more than one component.

**GROUP AUDIT** – The audit of the group financial statements.

3.2 Responsibilities

Group financial statements may include amounts derived from financial statements which have not been audited by the group auditors, but by different auditors, either from a different AE altogether or from another engagement team of the same AE. These other auditors are known as the component auditors. Components of group financial statements can include subsidiary corporations, associates, joint ventures and branches.

The group auditor is solely responsible for the group audit.

The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor’s report that is issued is appropriate in the circumstances.
3.2.1 Audit opinion

As the group auditor is fully responsible for the group audit, the auditor's report on the group financial statements shall not refer to a component auditor. If a reference to a component auditor is required (eg by local laws or regulations), the report shall indicate that this reference does not diminish the group auditor's responsibility for the group audit opinion.

If the opinion on a component is qualified, the group audit opinion is only affected if the matter is material to the group.

Example: Group audit opinion

Jupiter Lee is the group auditor of the Orchard Group. At the planning stage of the audit, group materiality is determined at $250,000.

Orchard Ltd is the parent company of the group, and has a subsidiary corporation called Woodlands Ltd. The group auditor considers Woodlands Ltd to be a significant component for the purposes of the group audit. Woodlands Ltd is audited by a component auditor.

The component auditor's report on Woodlands Ltd is qualified as a result of a material misstatement. The amount of the misstatement is $120,000.

Required

What is the effect on the auditor's report given on the Orchard Group?

Solution

As group auditor, Jupiter Lee is solely responsible for the audit opinion on the financial statements of the Orchard Group. In this example, the group auditor's report is not modified, as the amount of the misstatement is not material to the group.

3.2.2 Parent company financial statements

Balances contained within only the parent company financial statements (but not the consolidated financial statements) will also have an effect on the group financial statements. For example, the parent's statement of financial position will include investments in subsidiary corporations as non-current assets, and the parent's statement of changes in equity will include dividend receipts from subsidiary corporations. The group auditor must obtain sufficient appropriate evidence in respect of these, in order to express an opinion on the financial statements of the parent as well as on the group.

It is sometimes the case that parent companies are not required to file full individual financial statements and an audit of these full financial statements is not required. For example, the Singapore Companies Act S201 only requires a parent company to file a statement of financial position. However, as parent financial statements are part of the consolidation, the group auditor needs to have assurance that the parent financial statements are reasonably stated. In practice, the parent financial statements would be treated like a component's financial statements (that is, the group auditor would assess whether the parent's financial statements were significant to the group and determine the level of audit work required on them accordingly).

3.3 Objectives

In practical terms in order to achieve the group audit objectives the auditor needs to obtain evidence in relation to the:

1. Individual components of the group – this is covered in the remainder of Section 3.
2. Consolidation process – this is covered in Section 4.

Remember, the audit of a group stems from the concept of the audit of a single entity, so while it is important to consider all the additional aspects considered here, the basis of the audit will also include all the elements you have already considered in Chapters 6 –11.
3.4 Acceptance and continuance

SSA 600 places special emphasis on the need for the group auditor to determine whether or not to accept the appointment. This is particularly important here because it is possible for it to be straightforward to audit the parent company and/or entities in the same country as the parent, but impossible to obtain sufficient appropriate evidence about the rest of the group.

If the group engagement partner concludes that it will not be possible to obtain sufficient appropriate audit evidence on the group and that this is serious enough to result in a disclaimer of opinion, then the engagement should not be accepted (or withdrawn from, if already accepted – SSA 600.13). For this purpose the group engagement partner must obtain an understanding of the group before acceptance (SSA 600.12).

3.4.1 Obtaining an understanding of the group, its components and their environments

Possible sources of information include:
- Information provided by group management
- Communication with group management
- Communication with the previous group engagement team, component manager, or component auditors
- Any other publicly available information

Other matters to consider will include:
- The group structure
- Components’ business activities that are significant to the group (including the industry and regulatory, economic and political environments in which those activities take place)
- The use of service organisations
- A description of group-wide controls
- The complexity of the consolidation process
- Whether component auditors that are not from the group engagement partner’s AE will perform work on the financial information of any of the components
- Whether the group engagement team will have unrestricted access to those charged with governance of the group, those charged with governance of the component, component management, component information and the component auditors (including relevant audit documentation sought by the group engagement team)

In the case of continuing engagements the group engagement team’s ability to obtain sufficient appropriate audit evidence may be affected by significant changes, eg changes in group structure, changes in business activities and concerns regarding the integrity and competence of group or component management.

The group engagement team will also have practical considerations, for example, whether sufficient resources are available at the appropriate time at a group auditor and component auditor level.
The group auditor should agree the terms of the engagement with those charged with governance at a group level in an engagement letter.

ALERT
In addition to these points the group engagement team should consider the general points relating to acceptance of appointment discussed earlier in this Textbook.

3.4.2 Control environment and systems
SSA 600.12 requires the auditor to enhance their understanding of the group, its components and their environments including group-wide controls, obtained during the acceptance or continuance stage.

KEY TERM
**GROUP-WIDE CONTROLS** – Controls designed, implemented and maintained by group management over group financial reporting.

The group engagement team, or component auditor, tests the operating effectiveness of group-wide controls if the nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are working effectively.

If they are not working effectively, substantive procedures would be required to provide sufficient appropriate audit evidence.

Group-wide controls may include a combination of the following:

- Regular meetings between group and component management to discuss business developments and to review performance
- Monitoring of components’ operations and financial results
- Group management's risk assessment process
- Monitoring, controlling, reconciling and eliminating intra-group transactions, unrealised profits and intra-group balances
- A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components
- Monitoring of controls including internal audit

Assessment of the control environment and systems will include assessment of the overall group control environment. Factors to consider include:

- Organisational structure of the group
- Level of involvement of the parent company in components
- Degree of autonomy of management of components
- Supervision of components' management by parent company
- Information systems, and information received centrally on a regular basis

3.5 Planning and risk assessment
The group auditor is required to assess the risks associated with the group audit and plan procedures to address those risks. To do so, the auditor needs to obtain an understanding of the entity and its components, including group-wide controls (as discussed above). In addition, the auditor needs to obtain an understanding of the consolidation process. This is discussed in Section 4.
The planning and risk assessment process will need to take into account the fact that all elements of the group financial statements are not audited by the group auditor directly which increases detection risk. The group auditor will not be able to simply rely on the conclusions of the component auditor without carrying out audit procedures as required by SSA 600 which requires the group auditor to evaluate the reliability of the component auditor and the work performed. This will then determine the extent of further procedures required to give an opinion on the group financial statements and who will carry them out.

3.5.1 Significant components

The SSA distinguishes between significant components and other components which are not individually significant to the group financial statements.

**KEY TERM**

**SIGNIFICANT COMPONENT** – A component identified by the group engagement team: (a) that is of individual significance to the group, or (b) that due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

(SSA 600.9)

SSA 600.A5 states that a significant component can be identified by using a benchmark. If component assets, liabilities, cash flows, profit or turnover (whichever is the most appropriate benchmark) exceed 15% of the related group figure, then the auditor may judge that the component is a significant component. The figure of 15% is given as an example rather than an absolute rule.

If a component is financially significant to the group financial statements then the group engagement team or a component auditor will perform a full audit based on the component materiality level.

The group auditor should be involved in the assessment of risk in relation to significant components. If the component is otherwise significant due to its nature or circumstances, for example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, then the group auditors will require one of the following:

- A full audit using component materiality
- An audit of specified account balances, classes of transactions or disclosures related to identified significant risks
- Specified audit procedures relating to identified significant risks

Components that are not 'significant components' will be subject to analytical procedures at a group level – a full audit is not required.

3.5.2 Understanding the component auditor

SSA 600.19 requires the group engagement team to obtain an understanding of the component auditor. This involves an assessment of the following:

(a) Whether the component auditor is independent and understands and will comply with the ethical requirements that are relevant to the group audit
(b) The component auditor's professional competence
(c) Whether the group engagement team will be involved in the work of the component auditor to the extent that it is necessary to obtain sufficient appropriate audit evidence
(d) Whether the component auditor operates in a regulatory environment that actively oversees auditors

The group engagement team may obtain this understanding in a number of ways. In the first year, for example, the component auditor may be visited to discuss these issues. Alternatively the component auditor may be asked to confirm these matters in writing or to complete a questionnaire. Confirmations from professional bodies may also be sought and the reputation of the AE will be taken into account.
If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has concerns about competence, level of involvement in the component auditors work or regulatory environment, then the group engagement team shall obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component.

The nature, timing and extent of the group engagement team's procedures to obtain an understanding of the component auditor are affected by factors such as previous experience with or knowledge of the component auditor, and the degree to which the group engagement team and the component auditor are subject to common policies and procedures, for example:

Whether the group engagement team and a component auditor share:

- Common policies and procedures for performing the work (for example, audit methodologies);
- Common quality control policies and procedures; or
- Common monitoring policies and procedures.

Whether there is consistency or similarity in:

- Laws and regulations or legal system
- Professional oversight, discipline, and external quality assurance
- Education and training
- Professional organisations and standards
- Language and culture

### 3.5.3 Materiality

The group auditor is responsible for setting the materiality level for the group financial statements as a whole. Materiality levels should also be set for components which are individually significant. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality should be set at a lower level than the materiality level of the group as a whole.

### 3.5.4 Involvement in the work of a component auditor

The extent of involvement by the group auditor at the planning stage will depend on the:

- Significance of the component
- Risks of material misstatement of the group financial statements
- The group engagement team's evaluation of the design of group-wide controls and determination whether they have been implemented
- Extent of the group engagement team's understanding of the component auditor

The basic rule is that where the component is significant, the group auditor must be involved in the component auditor's work.

The group auditor may perform the following procedures:

(a) Meeting with the component management or the component auditors to obtain an understanding of the component and its environment.

(b) Reviewing the component auditor's overall audit strategy and audit plan.

(c) Performing risk assessment procedures to identify and assess risks of material misstatement at the component level. These may be performed with the component auditor or by the group auditor.
Where the component is a significant component, the nature, timing and extent of the group auditor's involvement is affected by their understanding of the component auditor but at a minimum should include the following procedures:

(a) Discussion with the component auditor or component management of the component's business activities that are significant to the group.

(b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error.

(c) Reviewing the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditors.

WEBSITE
Involvement in the work of the component auditor was highlighted in ACRA's Practice Monitoring Programme (PMP) Public Report 2012. Such reports aim to improve audit quality by reporting on common deficiencies found in quality reviews.

You can read ACRA's findings in Section 3 of the report.


Example: Component audit

Orchard Group has recently established a new subsidiary corporation, Forest Ltd. The group auditor does not consider Forest Ltd to be a significant component in accordance with SSA 600. The auditor of Forest Ltd has not communicated any of the findings of its audit to the group auditor. Jupiter Lee, the group auditor, has performed analytical procedures on the final financial statements of Forest Ltd, and is satisfied that there are unlikely to be any misstatements therein that are material to the group.

Required

What is the effect on the auditor's report given on the Orchard Group?

Solution

The group auditor's report is not modified, and the auditor's opinion is unmodified. SSA 600.29 specifies that where a component is not a significant component, then analytical procedures performed at a group level are sufficient.

3.6 Access to information about components

The group auditor may not be able to access all the information it needs about components or component auditors, eg because of laws relating to confidentiality or data privacy. The effect on the group audit opinion depends on the significance of the component.

If the component is not significant, then it may be sufficient just to have a complete set of financial statements, the component auditor's report, and information kept by group management documented in the audit working papers.

If the component is significant then it is possible that there will be an inability to obtain sufficient appropriate audit evidence about the component, in which case the audit opinion is either qualified or a
disclaimer of opinion is issued. In this case it would also be impossible to comply with SSA 600’s requirement to be involved with the work of the component auditor (for significant components), which would also lead to an inability to obtain sufficient appropriate audit evidence. In practice this can be a real problem, for example when the component itself is a listed company. If there is a limitation in scope this will have an effect on the audit opinion.

3.7 Evaluating the work of the component auditor

For all companies in the group the group auditor is required to perform a review of the work done by the component auditor. This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit or a direct review of the component auditor’s audit work papers. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review the group auditor then needs to determine whether any additional procedures are necessary. These may include:

- Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group auditor.
- Participating in the closing and other key meetings between the component auditors and component management.
- Reviewing other relevant parts of the component auditors’ documentation.

**KEY POINT**

Section 207(6) of the Companies (Amendment) Act 2014 states:

(6) An auditor of a parent company for which consolidated financial statements are required has a right of access at all times to the accounting and other records, including registers, of any subsidiary corporation, and is entitled to require from any officer or auditor of any subsidiary corporation, at the expense of the parent company, such information and explanations in relation to the affairs of the subsidiary corporation as he requires for the purpose of reporting on the consolidated financial statements.

In co-operating with the group auditor the component auditor would be expected to provide access to audit documentation unless prohibited from doing so by law.

3.8 Communication with the component auditor

SSA 600 prescribes the types of information that must be sent by the group auditor to the component auditor and *vice versa*.

**SSA 600.40**

The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, the use to be made of that work and the form and content of the component auditor’s communication with the group engagement team.
These communications include the following:

- Reporting timeline.
- A request that the component auditor confirms their co-operation with the group engagement team.
- The ethical requirements that are relevant to the group audit and in particular independence requirements.
- In the case of an audit or review of the financial information of the component, component materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.
- Identified significant risks of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor. The group engagement team requests the component auditor to communicate any other identified significant risks of material misstatement, due to fraud or error, in the component, and the component auditor's responses to such risks.
- A list of related parties prepared by group management and any other related parties of which the group engagement team is aware. Component auditors are requested to communicate any other related parties not previously identified.

The group engagement team’s requirements are often communicated in a letter of instruction. Appendix 5 to SSA 600 lists the required and additional non-compulsory matters included in a letter of instruction. It includes matters relevant to the conduct of the work of the component auditor as follows.

- The findings of the group engagement team’s tests of control activities of a processing system that is common for all or some components, and tests of controls to be performed by the component auditor.
- Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor, and a request that the component auditor communicates on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, identified in the component and the component auditor’s response to such risks.
- The findings of the internal audit function, based on work performed on controls at or relevant to components.
- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level.
- A request for a written representation on component management’s compliance with the applicable financial reporting framework, or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed.
- Matters to be documented by the component auditor.

SSA 600.41

The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit.

These communications include the following:

- Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional acceptance
- Whether the component auditor has complied with the group engagement team's requirements
PART D PERFORMING THE STATUTORY AUDIT

11: Group audits

- Identification of the financial information of the component on which the component auditor is reporting
- Information on instances of non-compliance with laws and regulations that could give rise to material misstatement of the group financial statements
- A list of uncorrected misstatements of the financial information of the component (the list need not include items that are below the threshold for clearly trivial misstatements)
- Indicators of possible management bias
- Description of any material deficiencies identified in internal control over financial reporting at the component level
- Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component
- Any other matters that may be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management
- The component auditor’s overall findings, conclusions or opinion
- Subsequent events reporting

The component auditor's communication with the group engagement team often takes the form of a memorandum or report of work performed.

3.9 Communicating with group management

SSA 600 identifies the following as matters which should be communicated to group management.

- Material deficiencies in the design or operating effectiveness of group-wide controls
- Material deficiencies that the group engagement team has identified in internal controls at components that are judged to be significant to the group
- Material deficiencies that component auditors have identified in internal controls at components that are judged to be significant to the group
- Fraud identified by the group engagement team or component auditors or information indicating that a fraud may exist

Where a component auditor is required to express an audit opinion on the financial statements of a component the group engagement team will request group management to inform component management of any matters that they, the group engagement team, have become aware of that may be significant to the financial statements of the component. If group management refuses to pass on the communication the group engagement team will discuss the matter with those charged with governance of the group. If the matter is still unresolved the group engagement team shall consider whether to advise the component auditor not to issue the auditor's report on the component financial statements until the matter is resolved.

3.10 Communication with those charged with governance of the group

The following matters shall be communicated to those charged with governance of the group:

- An overview of the type of work to be performed on the financial statements of the component
- An overview of the nature of the group engagement team’s planned involvement in the work to be performed by the component auditors on significant components
 Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work

 Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted

 Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where fraud resulted in a material misstatement of the group financial statements

3.11 Other aspects of the audit requiring consideration in a group context

3.11.1 Differing year-ends and accounting policies

It is possible that all of the entities within a group will not have the same reporting periods. In this case, SSA 600.37 requires the group auditor to evaluate whether appropriate adjustments have been made to the financial statements, in accordance with the relevant financial reporting framework. From an accounting perspective, SFRS(I) 10 requires that the difference between period-end dates of the parent and a subsidiary corporation is no more than three months. Adjustments must be made for any significant events which occur between the date of the subsidiary corporation's and the parent's financial statements. The subsidiary corporation prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent. The auditor would request the component auditor to audit this additional financial information and would ensure that all appropriate adjustments are made in the financial statements.

In practice, it may be that the component auditor is asked to audit the subsidiary corporation at the year-end of the holding company for the purpose of the group audit. This will be in addition to the statutory audit of the subsidiary company using its own year-end.

If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.

3.11.2 Changes in group structure

The group structure may have changed in the course of the period being audited. For instance, there may have been acquisitions, disposals, reorganisations, or changes in how the group financial reporting system is organised (SSA 600.A12). The auditor must obtain an understanding of any such changes, and must consider their impact on the auditor's understanding of the group.

For example, it is possible that a new subsidiary corporation has been acquired, in which case the auditor needs to consider whether or not it is a 'significant component' in accordance with SSA 600, in order to determine the extent of audit work that will be required on the subsidiary corporation. It may then also be necessary to obtain evidence regarding the application of SFRS(I) 3, including the assessment of fair values in accordance with SFRS(I) 13 Fair Value Measurement, which will carry audit risk because it may involve the exercise of judgment on the part of the audited entity.

There may be 'hidden' changes in the group structure. For instance, it may be that there has been a part-disposal of a subsidiary corporation, in which case the auditor will need to obtain evidence regarding the extent to which control is present, in addition to the evidence it will need in relation to the actual transactions involved.

A further possibility is that an already-existing subsidiary corporation, which the auditor had not considered to be 'significant' in previous periods in accordance with SSA 600, might suddenly become so in the current period. In this case the auditor would need to assess carefully the audit evidence it will need to obtain in relation to the subsidiary corporation.
3.11.3 Financial support letters

It sometimes happens that a component, when considered in isolation, does not appear to be a going concern, even though the group as a whole is a going concern. In such a case, the auditor may request a 'financial support letter' from the management of the parent company. This letter must be addressed to the subsidiary corporation and states that the intention of the parent is to continue to support the subsidiary corporation, which makes it a going concern. In practice the letter should be dated on the date of the auditor's report. This is written evidence from the management of the parent.

From the auditor's perspective, if the financial support letter is crucial to the assessment of the going concern of the subsidiary corporation, then it will usually be necessary to obtain some further evidence on going concern. This would usually include obtaining evidence about whether the parent company (and the group as a whole) is indeed able to provide the support that the subsidiary corporation will need.

IMPORTANT

Financial support letters are sometimes referred to as 'comfort letters' in commercial settings, such as banks. Although these two terms are often used interchangeably, they do have different meanings for auditors. There is no formal definition of 'comfort letter' for auditors which in practice are issued by an auditor in the case of an IPO or bonds issue to assist an underwriter with due diligence work. AGS 11 Comfort Letters and Due Diligence Meetings explains the purpose and contents of a comfort letter and also provides an example comfort letter.

3.11.4 Overseas subsidiary corporations and outsourcing overseas

Dealing with subsidiary corporations that are overseas can cause a variety of additional issues for the auditor. In addition, there are increasingly corporations that outsource their functions to service organisations outside of their home countries to lower operating costs, for example to India or the Philippines. Both these issues pose a challenge to the auditor in the gathering of audit evidence and involvement of overseas auditors.

These might include language barriers, if component management and auditors (or in the case of outsourcing a service organisation and service auditor) speak a language that the group auditor does not share, and financial and audit information is prepared in that language. The group auditor might have to obtain translation services to communicate properly with the component or service auditor and to understand audit information presented.

There may also be issues with the accounting standards and auditing standards in that country being different from those relevant to the group entity and the consolidated financial statements. The group auditor needs to ensure both that the audit work performed for the benefit of the group audit meets the requirements of SSAs. How the financial information has been 'translated' to the appropriate financial reporting framework for the purposes of the consolidated financial statements will be considered as part of the audit of the consolidation.

This may particularly be an issue when consolidating a subsidiary corporation from a developing country, as the basis of preparation of the subsidiary corporation's financial statements may be so different from SFRS(I) that the group auditor will not be able to conclude that the financial statements show a true and fair view.

This is only a problem if the financial statements, or the differences caused by the basis of preparation, are material to the group.

The problem can be averted by asking the directors to restate the financial statements under SFRS(I). The group auditors might require that this restatement process is audited to ensure it is fairly stated.

Increased internationalisation of accounting and auditing practice is reducing the risk of the problems associated with different standards arising on group audits.
3.12 ACRA Audit Practice Bulletin No. 1 of 2015

In 2015 ACRA issued Audit Practice Bulletin No 1 of 2015 Audits of Group Financial Statements (including the work of Component Auditors). This aim of this bulletin is to provide guidance and clarity on the audit procedures necessary prior to placing reliance on the work performed by component auditors, and to reiterate the need to increase the level of rigour and professional scepticism expected of the public accountant when acting as the group engagement auditor.

Due to globalisation and increase in overseas investments, it is common for Singapore incorporated companies to have overseas operations, thus creating complexity in managing audits of foreign subsidiaries. Group audits can be even more complex when several component auditors are involved and overseas operations are equally significant. The group engagement team must ensure there is proper planning involving the component auditors, timely involvement and communication throughout the audit process, and audit evidence obtained and retained is sufficient and appropriate.

Question 11.1

You are the main auditor of Somerset Trading Limited, a listed company, which has subsidiary corporations in Singapore and overseas, many of which are audited by other AEs. All subsidiary corporations are involved in the manufacture or distribution of plastic goods and have accounting periods that are the same as the parent company.

Required

(a) State why you would wish to review the work of the auditors of the subsidiary corporations not audited by you.

(b) Describe the principal audit procedures you would carry out in performing such a review.

SECTION SUMMARY

The group engagement partner is responsible for the direction, supervision and performance of the group audit. The group auditor also takes sole responsibility for the group audit opinion.

4 The consolidation: problems and procedures

SECTION INTRODUCTION

Consolidation procedures include checking consolidation adjustments have been correctly made, checking treatment of additions and disposals have been accounted for correctly and arithmetical checks.

4.1 Audit procedures

SSA 600.17 requires the auditor to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. Part of that process involves obtaining an understanding of the consolidation process, including the instructions issued by group management to components. This will include a consideration of who is carrying out the consolidation (the competence of that party should be considered) and how it is being carried out, for example, whether spreadsheets or particular software packages are being used, which could allow the use of computer-assisted audit techniques as part of the audit of the consolidation.
The group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls if the nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

The group engagement team shall design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statement arising from the consolidation process. This shall include evaluating whether all components have been included in the group financial statements.

The group engagement team shall evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and shall evaluate whether any fraud risk factors or indicators of possible management bias exist.

To achieve uniformity and comparability of financial information group management will normally issue instructions to components. The instructions ordinarily cover:

- The accounting policies to be applied
- Statutory and other disclosure requirements including:
  - The identification and reporting of segments
  - Related party relationships and reporting of segments
  - Intra-group transactions and unrealised profits
  - Intra-group account balances
- A reporting timetable

The group engagement team should obtain the instructions to components and consider:

- The clarity and practicality of the instructions for completing the reporting package
- Whether the instructions:
  - Adequately describe the applicable financial reporting framework
  - Provide for adequate disclosures
  - Adequately provide for the identification of consolidation adjustments
  - Provide for the approval of the financial information by component management

The group auditor is also responsible for the audit of the consolidation process itself.

After receiving and reviewing all the subsidiary corporations’ (and associates’) financial statements, the group auditors will be in a position to audit the consolidated financial statements. An important part of the work on the consolidation will be checking the consolidation adjustments. Consolidation adjustments generally fall into two categories:

- Permanent consolidation adjustments
- Consolidation adjustments for the current year
The audit steps involved in the consolidation process may be summarised as follows.

**STEP 1**

Compare the audited financial statements of each subsidiary corporation/associate with the consolidation schedules to ensure figures have been transposed correctly, and that all components have been included.

**STEP 2**

Review the adjustments made on consolidation to ensure they are appropriate and comparable with the previous year. This will involve, for example:

- Recording the dates and costs of acquisitions of subsidiary corporations and the assets acquired
- Calculating goodwill and pre-acquisition reserves arising on consolidation
- Preparing an overall reconciliation of movements on reserves and non-controlling interests
- Reconciling or eliminating any inter-company balances, and eliminating intra-group items from profit or loss
- Verifying that where relevant, subsidiary corporation balances have been included in the consolidated financial statements at fair value, e.g., properties, which may be carried at depreciated cost in the subsidiary corporation, must be at fair value in the consolidated financial statements
- Verifying that the deferred tax consequences of consolidation and fair value adjustments have been accounted for correctly
- Verifying equity accounting entries (purchase price allocation)

For business combinations determine:

- Whether the combination has been appropriately treated as an acquisition
- The appropriateness of the date used as the date of combination
- The treatment of the results of investments acquired during the year
- If acquisition accounting has been used, that the fair value of acquired assets and liabilities is reasonable (to ascertainable market value by use of an expert)
- Goodwill has been calculated correctly and reviewed annually for impairment. SFRS(I) 3 requires goodwill to be reviewed annually for impairment, in accordance with SFRS(I) 1-36. This is the responsibility of management, and the auditor's role is to obtain audit evidence regarding the impairment review that management has already conducted. Impairment reviews were covered in Chapter 9 of this Textbook.

**STEP 3**

For disposals:

- Agree the date used as the date for disposal to sales documentation
- Review management accounts to ascertain whether the results of the investment have been included up to the date of disposal, and whether figures used are reasonable
- Verify the mathematical accuracy of gain or loss on disposal

**STEP 4**

Consider whether previous treatment of existing subsidiary corporations or associates is still correct (consider level of influence, degree of support), and that any part-disposals or acquisitions during the period are properly accounted for and non-controlling interests properly reflected.
Verify the arithmetical accuracy of the consolidation workings by recalculating them.

**STEP 6**

Review the consolidated financial statements for compliance with the legislation, accounting standards and other relevant regulations. Care will need to be taken where:

- Group companies do not have the same accounting periods
- Accounting policies of group members differ because foreign subsidiary corporations operate under different rules
- Where the financial statements of a foreign subsidiary corporation have been translated in accordance with SFRS(I) 1-21

Other important areas include:

- Treatment of associates
- Treatment of goodwill and intangible assets
- Taxation
- Treatment of loss-making subsidiary corporations
- Treatment of restrictions on distribution of profits of a subsidiary corporation

**STEP 7**

Review the consolidated financial statements to confirm that they give a true and fair view in the circumstances and comply with SFRS(I) disclosure requirements.

**STEP 8**

**Question 11.2**

Goodwill

Your AE is the auditor of Aladdin Group Pte Ltd ('Aladdin'), a manufacturer of children's toys for the year ending 31 December 20X5. During the year, Aladdin acquired 100% of the share capital of Jasmin Pte Ltd ('Jasmin'), a chain of children's toy shops, for $100 million. The purchase price included $20 million of goodwill. Aladdin was advised by Abu Limited ('Abu') on the valuation of the transaction, including goodwill.

Aladdin has concluded that goodwill relating to Jasmin is not impaired for the year ending 31 December 20X5.

**Required**

List audit procedures your AE could perform on the goodwill of Jasmin for the year ending 31 December 20X5.

**4.2 Finalisation**

Step 8 in the consolidation audit outlined above will include the reviews as required as part of a single entity audit, for example, reviewing the disclosures relating to going concern, subsequent events and related parties.

The group auditor must determine if it is appropriate to prepare the group financial statements on the going concern basis. This will involve assessing the audit evidence obtained concerning going concern in relation to the components and assessing whether there is any issue at the group level. It is possible that one component of a group might not be performing well, but this does not mean that the group itself is not a going concern, and, as noted earlier, a component which is performing poorly may be supported by the group such that even it does not have going concern problems by the issuing of a financial support letter.
The group auditor must ensure that component auditors are performing procedures as required by SSA 560 Subsequent Events to ensure that subsequent events relevant to the group are responded to by the auditor. The group auditor should request that component auditors communicate any subsequent events that the component auditor becomes aware of that might require adjustment to or disclosure in the group financial statements.

The audit of related party transactions was considered earlier in this Textbook. Remember that when auditing a consolidation, the relevant related parties are those related to the consolidated group. Transactions with consolidated subsidiary corporations need not be disclosed, as they are eliminated in the financial statements.

As set out in Section 3.8, the component auditors are required to communicate matters of audit significance to the group auditors. An aspect of finalisation on the group audit is determining which of these are significant to the group financial statements and acting on them and which are not significant to the group financial statements.

Question 11.3

Your AE is the auditor of Beeston Industries, a company, which has a number of subsidiary corporations in your country (and no overseas subsidiary corporations), some of which are audited by other AEs. You have been asked to consider the work which should be carried out to ensure that inter-company transactions and balances are correctly treated in the consolidated financial statements.

Required

(a) Describe the audit work you would perform to check that intra-group balances agree, state why intra-group balances should agree, and the consequences of them not agreeing.

(b) Describe the audit work you would perform to verify that intra-group profit in inventory has been correctly accounted for in the consolidated financial statements.

SECTION SUMMARY

Specific audit procedures will be performed on the consolidation process.

5 Joint audits

SECTION INTRODUCTION

In joint audits, more than one auditor is responsible for the audit opinion and it is made jointly.

The relationship between group and component auditors discussed in the previous sections is not the same as that between the auditors involved in a joint audit.
5.1 Reasons for joint audits

Two or more AEs could act as joint auditors for a number of reasons.

(a) Takeover. The parent company may insist that their auditors act jointly with those of the new subsidiary corporation.

(b) Locational problems. A company operating from widely dispersed locations may find it convenient to have joint auditors.

(c) Political problems. Overseas subsidiary corporations may need to employ local auditors to satisfy the laws of the country in which they operate. It is sometimes found that these local auditors act jointly with those of the parent company.

(d) Companies may prefer to use local Chartered Accountants, while at the same time enjoying the wider range of services provided by a large international AE.

Joint audits are not common in Asia. However, they are an emerging trend, and it is important to be aware of the issues associated with them.

5.2 Accepting a joint audit

There are several practical points that must be borne in mind before accepting a joint audit. In particular it will be necessary to assess the experience and standards of the other AE by looking at the audit techniques used, by scrutinising their working papers and establishing whether they have had experience in similar jobs.

Where there are joint auditors, the audit engagement should be explained in similar terms by each set of auditors. The auditors should agree whether joint or separate letters should be sent to the client. Separate letters would normally need to be sent where other services are provided.

Once a joint position has been accepted the programme to be undertaken and the split of the detailed work will have to be discussed.

5.3 Problems with joint audits

One of the major criticisms of joint audits is that they may be expensive. This is probably true, but if the two AEs have organised the work between them properly the difference should be minimal. Furthermore, an increase in the fees may be justified by improved services not least because the two AEs are likely to work as efficiently as possible from a sense of professional pride.
5.4 Benefits of joint audits

Joint audits can lead to increased audit quality as both AEs must sign the auditor's report and both are responsible for the whole audit whether or not they carried out a particular area of the audit programme. It follows that both AEs will be jointly liable in the event of litigation.

They can also lead to greater auditor independence by enhancing competition and reducing market concentration.

SECTION SUMMARY

Both parties to a joint audit are responsible for the audit opinion and will have to assess the extent to which the other party can be relied on.
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- Apply principles of SFRS(I) 3
- Equity accounting
- > 20% of voting power

Control
- Joint operations
- Joint ventures
- Significant influence

Subsidiary
- Joint arrangements
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Group Accounting
- Group Audits
- Obtaining evidence

Components
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- Significant
- Not significant

Responsibilities
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  - Planning
    - Evaluate reliability of CAs
    - Set materiality
  - Communicate with CAs
- Component auditor (CA)
  - Group engagement partner has right to require co-operation
- Inform CAs
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- Advise CAs
  - Independence requirements
  - Accounting, auditing and reporting requirements

Obtain sufficient appropriate evidence that work of CAs is adequate

Analytical procedures at group level

Equity accounting
- Assistant
  - Area for special consideration
  - Audit timetable
  - Related parties
  - Independence requirements
  - Accounting, auditing and reporting requirements
Quick Quiz

1. Define the term ‘component auditor’.

2. Outline the responsibilities of the component auditor regarding co-operation with the group auditor.

3. If a component is significant due to its nature or circumstances one of three procedures will be required. List these three procedures.
   (1) ........................................
   (2) ........................................
   (3) ........................................

4. List five matters which the component auditor should communicate to the group auditor.
   (1) ........................................
   (2) ........................................
   (3) ........................................
   (4) ........................................
   (5) ........................................

5. What is a financial support letter?

6. List the eight steps involved in auditing a consolidation.

7. If two AEs undertake a joint audit, they shall be jointly liable in the event of litigation.
   True  
   False
Answers to Quick Quiz

1. An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

2. SSA 600 gives a professional responsibility to the component auditor to co-operate unless there are legal restrictions on their ability to do so. In Singapore, component auditors have a legal responsibility to co-operate in certain circumstances.

3. (1) A full audit using component materiality
   (2) An audit of specified account balances related to identified significant risks
   (3) Specified audit procedures related to identified significant risks

4. Any five from the following:
   - Compliance with ethical requirements
   - Compliance with group engagement team’s requirements
   - Identification of component financial information
   - Material non-compliance with laws and regulations
   - Uncorrected misstatements
   - Indicators of management bias
   - Material deficiencies of internal control
   - Other matters including fraud or suspected fraud
   - Overall findings, conclusions or opinion

5. A letter to the auditors from the parent company of a subsidiary corporation which individually does not appear to be a going concern, stating that it intends to continue to support the subsidiary corporation, rendering it a going concern.

6. **STEP 1**
   Check the transposition from individual audited financial statements to the consolidation workings.

   **STEP 2**
   Check consolidation adjustments are correct and comparable with prior years.

   **STEP 3**
   Check for, and audit, business combinations.

   **STEP 4**
   Check for, and audit, disposals.
Consider whether previous treatment of subsidiary corporations and associates is still correct.

Verify the arithmetical accuracy of the workings.

Review the consolidated financial statements for compliance with laws and standards.

Review the consolidated financial statements to ensure they give a true and fair view.

7 True
11.1 Component auditors

(a) Reasons for reviewing the work of other auditors

The main consideration which concerns the audit of all consolidated financial statements is that the parent company's auditors are responsible to the members of that company for the audit opinion on the whole of the consolidated financial statements.

It may be stated (in the notes to the financial statements) that the financial statements of certain subsidiary corporations have been audited by other AEs, but this does not absolve the group auditors from any of their responsibilities.

The auditors of a parent company have to report to its members that the financial statements of the company and its subsidiary corporations give a true and fair view of the financial performance and position of the group. The group engagement team should have powers to obtain such information and explanations as they reasonably require from the subsidiary corporations and their auditors, or from the parent company in the case of overseas subsidiary corporations, in order that they can discharge their responsibilities as parent company auditors.

The auditing standard SSA 600 Special Considerations – Audit of Group Financial Statements (Including the Work of Component Auditors) clarifies how the group auditors can carry out a review of the audits of components in order to satisfy themselves that, with the inclusion of figures not audited by themselves, the consolidated financial statements give a true and fair view.

The scope, standard and independence of the work carried out by the auditors of subsidiary corporations (the 'component' auditors) are the most important matters which need to be examined by the group auditors before relying on financial statements audited by them. The group auditors need to be satisfied that sufficient appropriate audit evidence has been obtained and that all material areas of the financial statements of subsidiary corporations have been audited satisfactorily and in a manner compatible with that of the group auditors themselves.

(b) Work to be carried out by group auditors in reviewing the component auditors' work

(i) Send a questionnaire to all other auditors requesting detailed information on their work, including:

(1) An explanation of their general approach (in order to make an assessment of the standards of their work)
(2) Details of the accounting policies of major subsidiary corporations (to ensure that these are compatible within the group)
(3) The component auditors' opinion of the subsidiary corporations' overall level of internal control, and the reliability of their accounting records
(4) Any limitations placed on the scope of the auditors' work
(5) Any modifications, and the reasons for them, made or likely to be made to their auditor's reports

(ii) Carry out a detailed review of the component auditors' working papers on each subsidiary corporation whose results materially affect the view given by the group financial statements. This review will enable the group auditors to ascertain whether:

(1) Instructions provided to the component auditor by the group auditor have been complied with. The group auditor will have communicated such items as the component materiality and a list of related parties to the component auditor.
(2) The component auditor's overall audit strategy and plan are appropriate for the purposes of the group audit.
(3) An up-to-date permanent file exists with details of the nature of the subsidiary corporation's business, its staff organisation, its accounting records, previous year's financial statements and copies of important legal documents.

(4) The systems examination has been properly completed, documented and reported on to management after discussion.

(5) Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed as evidence of review.

(6) All working papers are sufficient and appropriate.

(7) Any related party transactions have been identified from the list of related parties provided to the component auditors in the group auditor's instructions. Any related parties not previously identified have been communicated to the group auditor.

(8) Any instances of fraud or suspected fraud in the component have been notified to the group auditors.

(9) The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit.

(10) The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards.

(11) Minutes of board and general meetings have been scrutinised and important matters noted.

(12) The audit work has been carried out in accordance with approved auditing standards.

(13) The audit work has been properly reviewed within the AE and any laid-down quality control procedures adhered to.

(14) Any points requiring discussion with the parent company's management have been noted and brought to the group auditor's attention (including any matters which might warrant a modification of the auditor's report on the subsidiary corporation's financial statements).

(15) Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiary corporations' financial statements and those of the group.

(16) Any uncorrected misstatements, other than those that are clearly trivial, have been notified to the group auditor.

(iii) Discuss audit related issues with engagement partner of the component auditors.

If the group engagement partner is not satisfied as a result of the above review, he should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them. The component auditors are fully responsible for their own work; any additional tests are those required for the purpose of the audit of the group financial statements.

11.2 Goodwill

- Inspect the sales agreement or contract for Jasmin and agree the purchase price of $100 million to this agreement.
- Assess the reasonableness of the business valuation performed by Abu by reviewing the valuation methodology, data and assumptions used and consider the use of experts.
- Assess the competence, objectivity and independence of Abu to ensure they have expertise in advising on the valuation of Jasmin.
- Review appropriateness of/recalculate the purchase price allocation among tangible and intangible assets acquired, liabilities assumed, and goodwill allocated.
- Check purchased goodwill is calculated correctly and does not include any internally-generated goodwill.
- Review the goodwill impairment review performed by Aladdin for reasonableness.
11.3 Intra-group balances/profits

(a) Intra-group balances should agree because, in the preparation of consolidated financial statements, it is necessary to cancel them out. If they do not cancel out then the consolidated financial statements will be displaying an item which has no value outside of the group and profits may be correspondingly under or over-stated. The audit work required to check that intra-group balances agree would be as follows.

(i) Obtain and review a copy of the parent company's instructions to all group members relating to the procedures for reconciliation and agreement of year-end intra-group balances. Particular attention should be paid to the treatment of ‘in-transit’ items to ensure that there is a proper cut-off.

(ii) Obtain a schedule of intra-group balances from all group companies and check the details therein to the summary prepared by the parent company. The details on these schedules should also be independently confirmed in writing by the other auditors involved.

(iii) All balances, including nil amounts, should be confirmed by both the group companies concerned and their respective auditors.

(iv) The details on the schedules in (iii) above should also be agreed to the details in the financial statements of the individual group companies which are submitted to the parent company for consolidation purposes.

(b) Where one company in a group supplies goods to another company at cost plus a percentage, and such goods remain in inventory at the year-end, then the group inventory will contain an element of unrealised profit. In the preparation of the consolidated financial statements, best accounting practice requires that an elimination of this unrealised profit should be made. In order to verify that intra-group profit in inventory has been correctly accounted for in the consolidated financial statements, the audit work required would be as follows.

(i) Confirm the group's procedures for identification of such inventory and their notification to the parent company who will be responsible for making the required elimination.

(ii) Obtain and review schedules of intra-group inventory from group companies and confirm that the same categories of inventory have been included as in previous years.

(iii) Select a sample of invoices for goods purchased from group companies and check to see that, where necessary, these have been included in year-end intra-group inventory. Obtain confirmation from other auditors that they have satisfactorily completed a similar exercise.

(iv) Check the calculation of the reversal of unrealised profit and confirm that this has been arrived at on a consistent basis with that used in earlier years, after making due allowance for any known changes in the profit margins operated by various group companies.

(v) Check the schedules of intra-group inventory against the various inventory sheets and consider whether the level of intra-group inventory appears to be reasonable in comparison with previous years, ensuring that satisfactory explanations are obtained for any material differences.
The review stage of the audit is one of the most important stages as the conclusions formed will be the basis of the audit opinion. During the audit fieldwork the auditor will have been looking at individual components of the financial statements and coming to initial conclusions about these. During the review stage the auditor must consider the financial statements as a whole in the light of all the audit evidence collected to date.

The auditor must also conduct a review of other information to establish whether it contradicts the financial statements. If there are inconsistencies the auditor must consider the implications for the financial statements and the auditor's report.

Reviews of subsequent events and going concern are a vital part of the review stage and in some instances the two issues may be linked as events after the reporting period may provide evidence as to the appropriateness of the going concern basis of preparation of the financial statements. When assessing management's assessment of going concern the auditor must use professional judgment and professional scepticism, particularly in respect of future plans proposed by management.
### Syllabus Handbook

<table>
<thead>
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<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Evaluation and review</strong></td>
<td></td>
</tr>
<tr>
<td>Explain the use of analytical procedures in evaluation and review.</td>
<td>3</td>
</tr>
<tr>
<td>Explain and demonstrate how the auditor's responsibilities for corresponding</td>
<td>3</td>
</tr>
<tr>
<td>figures, comparative financial statements, and 'other information' are discharged.</td>
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<tr>
<td>Discuss the courses of action available to an auditor when documents containing</td>
<td>2</td>
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<tr>
<td>audited financial statements and the auditor's report include other information</td>
<td></td>
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<tr>
<td>that is inconsistent with or undermines the credibility of those financial</td>
<td></td>
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<tr>
<td>statements and the auditor's report.</td>
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<tr>
<td>Specify audit procedures designed to identify subsequent events that may require</td>
<td>2</td>
</tr>
<tr>
<td>adjustment to, or disclosure in, the financial statements of a given entity or steps</td>
<td></td>
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<td>to be taken for subsequent discovery of facts.</td>
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<tr>
<td>Identify and explain indicators that the going concern basis may be in doubt and</td>
<td>2</td>
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<tr>
<td>evaluate mitigating factors.</td>
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<tr>
<td>Recommend audit procedures to evaluate the evidence that might be expected to be</td>
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<tr>
<td>available and assess the appropriateness of the going concern basis in given</td>
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<tr>
<td>situations.</td>
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<tr>
<td>Assess the adequacy of disclosures in financial statements relating to going</td>
<td>2</td>
</tr>
<tr>
<td>concern and explain the implications of the auditor's report with regard to the</td>
<td></td>
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<tr>
<td>going concern basis.</td>
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### ESSENTIAL READING

- SSA 450 *Evaluation of Misstatements Identified During the Audit*
- SSA 560 *Subsequent Events*
- SSA 570 (Revised) *Going Concern*
- SSA 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*
- SSA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*
- Audit Practice Bulletin No 1 of 2009 *Audit Considerations in the Current Economic Environment*
- Audit Practice Bulletin 2 of 2011 *Audit Considerations in an Uncertain Economic Environment*
- Audit Practice Bulletin No 2 of 2016 *The Enhanced Auditor Reporting Standards: Communicating Key Audit Matters and Addressing Going Concern in “Close-Call” Situations*
1 Review procedures and evaluation of findings

SECTION INTRODUCTION

The review stage of the audit is important as the conclusions drawn will form the basis of the audit opinion given.

Once the bulk of the substantive procedures have been carried out, the auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence. This is known as the completion stage of the audit. It is a requirement of SSA 220 Quality Control for an Audit of Financial Statements that the auditor conducts an overall review of the audit evidence obtained in relation to the financial statements.

This review, in conjunction with the conclusions drawn from the other audit evidence obtained, gives the auditors a reasonable basis for their opinion on the financial statements. It should be carried out by a senior member of the audit team who has the appropriate skills and experience.

1.1 Compliance with accounting standards

The auditors should consider whether:

(a) The information presented in the financial statements is in accordance with the relevant financial reporting framework

(b) The accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity

When examining the accounting policies, auditors should consider:

- Policies commonly adopted in particular industries
- Policies for which there is wide acceptance
- Whether any departures from applicable accounting standards are necessary for the financial statements to conform to SFRS(I) 1-1’s requirement of ‘fair presentation’
- Whether the financial statements reflect the substance of the underlying transactions and not merely their form

When compliance with statutory requirements and accounting standards is considered, the auditors may find it useful to use a checklist developed and constantly updated by the internal technical team.

1.2 Review for consistency and reasonableness

The auditors should consider whether the financial statements are consistent with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is reasonable. The principal considerations are as follows.

(a) Whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit

(b) Whether the review reveals any new factors which may affect the presentation of, or disclosure in, the financial statements

(c) Whether analytical procedures applied when completing the audit, such as comparing the information in the financial statements with other pertinent information, produce results which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business
(d) Whether the presentation adopted in the financial statements may have been unduly influenced by the directors’ desire to present matters in a favourable or unfavourable light

(e) The potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period’s audit, if any

1.3 Analytical procedures

In Chapter 7 we discussed how analytical procedures are used as part of the overall review procedures at the end of an audit. The financial statements should be reviewed in line with the requirements of SSA 520 Analytical Procedures.

The analytical procedures performed at the completion stage are no different from those performed elsewhere in the audit process. The only difference is that by this time the auditor should know enough about the client to be able to point to evidence explaining the issues highlighted by the analytical procedures.

If the auditor finds a previously unrecognised risk of material misstatement at this stage, then it will have to revise its assessment of audit risk. This may affect materiality, and may mean that further audit evidence is needed in certain areas.

You should be familiar with all of the calculation of key ratios. You should revisit the material in Chapter 7 if necessary.

1.4 Summarising misstatements

Singapore Standard on Auditing SSA 450 Evaluation of Misstatements Identified During the Audit defines a misstatement.

**KEY TERMS**

A **MISSTATEMENT** is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

**UNCORRECTED MISSTATEMENTS** are misstatements that the auditor has accumulated during the audit and that have not been corrected.

(During the course of the audit, misstatements will be discovered which may be material or immaterial to the financial statements. It is very likely that the client will adjust the financial statements to take account of material and immaterial misstatements during the course of the audit. At the end of the audit, however, some misstatements may still be outstanding, and the auditors will summarise these uncorrected misstatements.

Cumulative misstatements may also be shown, which have increased from year to year. It is normal to show both the statement of financial position and the statement of profit or loss and other comprehensive income effect, as in the example given here.)
SCHEDULE OF UNCORRECTED MISSTATEMENTS

<table>
<thead>
<tr>
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<td></td>
<td>Dr</td>
<td>Cr</td>
<td>Dr</td>
<td>Cr</td>
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<tr>
<td>(a) ABC Ltd receivable un-provided</td>
<td>10,470</td>
<td>10,470</td>
<td>4,523</td>
<td>4,523</td>
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<tr>
<td>(b) Opening/ closing inventory undervalued*</td>
<td>21,540</td>
<td>21,540</td>
<td>21,540</td>
<td>21,540</td>
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<tr>
<td>(c) Closing inventory undervalued</td>
<td>34,105</td>
<td>34,105</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(d) Opening unaccrued expenses Telephone*</td>
<td>453</td>
<td>453</td>
<td>453</td>
<td>453</td>
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</tr>
<tr>
<td></td>
<td>905</td>
<td>905</td>
<td>905</td>
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<tr>
<td>(e) Closing unaccrued expenses Telephone</td>
<td>427</td>
<td>427</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>1,128</td>
<td>1,128</td>
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<tr>
<td>(f) Obsolete inventory write off</td>
<td>2,528</td>
<td>2,528</td>
<td>3,211</td>
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<td></td>
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<tr>
<td>Total</td>
<td>36,093</td>
<td>35,463</td>
<td>34,105</td>
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<td>*Cancelling items</td>
<td>21,540</td>
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<td>453</td>
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<td>905</td>
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<td>14,553</td>
<td>34,105</td>
<td>34,105</td>
<td>14,553</td>
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</table>

The summary of uncorrected misstatements will not only list misstatements from the current year (adjustments (c) and (e)), but also those in the previous year(s). This will allow misstatements to be highlighted which are reversals of misstatements in the previous year. For example in this instance last year's closing inventory was undervalued by $21,540 (adjustment (b)). Inventory in the prior year statement of financial position should be increased (DR) and profits increased (CR). At the start of the current accounting period the closing inventory adjustment is reversed out so that the net effect on the cumulative position is zero. This also applies to the adjustment to last year's accrued expenses (adjustment (d)). Cumulative misstatements may also be shown, which have increased from year to year for example adjustment (f). It is normal to show both the statement of financial position and the statement of profit or loss effect, as in the example given here. This may also be extended to the entire statement of profit or loss and other comprehensive income.

1.4.1 Evaluating the effect of misstatements

SSA 450.11

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate.

To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

(a) Factual misstatements are misstatements about which there is no doubt. For example, where the auditor has discovered a mathematical error in the client's depreciation calculation.

(b) Judgmental misstatements are differences arising from the judgments of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate. For example, where management and auditors disagree on the appropriate depreciation rate for a non-current asset.
(c) Projected misstatements are the auditors' best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. For example, if the auditor discovers revenue has not been deferred for all customers in the sample where twelve month contracts began two weeks before year-end. This can be extrapolated for all customers whose contracts began in the last two weeks of the accounting period to calculate the projected misstatement in revenue and deferred revenue.

If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.

The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity;
- Affects other information that will be communicated in an annual report that may reasonably be expected to influence the economic decisions of the users of the financial statements. SSA 720 deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements; or
- Changes the entity's results from a profit to a loss or vice versa.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.
When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

If the auditors consider that the aggregate of misstatements may be material, either by looking at a class of transaction or in relation to the financial statements as a whole, they must consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements (which management may wish to do anyway).

**SSA 450.A5**

If the aggregate of the uncorrected misstatements that the auditors have identified approaches the materiality level, the auditors should consider whether it is likely that undetected misstatements, when taken with aggregated uncorrected misstatements, could exceed the materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditors should consider reducing the risk by:

- Performing additional audit procedures
- Requesting management to adjust the financial statements for identified misstatements

The schedule of uncorrected misstatements will be used by the audit manager and partner to decide whether the client should be requested to make adjustments to the financial statements to correct the misstatements.

For listed companies, uncorrected misstatements should be reported to the Audit Committee, and written representations should be received from management for all companies.

### 1.5 Completion checklists

AEs frequently use checklists, which must be signed off to ensure that all final procedures have been carried out, all material amounts are supported by sufficient appropriate evidence, etc. Whilst checklists are useful for quality control purposes the auditor must use judgment to ensure that all relevant issues have been addressed. This judgment will be based on all the knowledge and evidence which the auditor has obtained throughout the course of the audit.

Some AEs now use electronic audit files. Checklists are no longer required as the electronic files keep track of the audit process to ensure all procedures are carried out and signed off.

### 1.6 Audit clearance meeting

At the end of the audit it is usual for a meeting to be held between the auditor and management (or those charged with governance). This is not a requirement of SSAs, but it is a good way of ensuring that there are no misunderstandings about the financial statements or the auditor's report to be issued. This meeting will allow the auditor to discuss with management the adequacy of internal controls; proposed adjustments to the financial statements; any difficulties encountered during the audit; ethical matters to be clarified; confirmation of management's written representations. It allows the auditor and management to come to a resolution on any outstanding auditing or accounting matters.

The audit clearance meeting can also provide an opportunity for the auditor to fulfil the requirements of SSA 260 (Revised) *Communication with Those Charged with Governance*. This standard requires the auditor to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process. The specific requirements of this standard are discussed further in Chapter 16 Section 4.
SECTION SUMMARY
Auditors must perform and document an overall review of the financial statements before they can reach an opinion. As part of their completion procedures, auditors should consider whether the cumulative effect of uncorrected misstatements is material.

2 Comparatives

SECTION INTRODUCTION
The financial information presented by a company normally includes comparative information. The auditor must ensure that comparative information has been correctly reported and appropriately classified in accordance with the applicable financial reporting framework.

2.1 Auditor objectives

SSA 710 Comparative Information – Corresponding Figures and Comparative Financial Statements provides guidance on the auditor's responsibilities regarding comparative information.

SSA 710.5
The objectives of the auditor are:
(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework, and
(b) To report in accordance with the auditor's reporting responsibilities.

KEY TERM
COMPARATIVE INFORMATION is the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

2.2 What type of comparative information?

SSA 710 distinguishes between two types of comparative information: corresponding figures and comparative financial statements.
KEY TERMS

**CORRESPONDING FIGURES** are amounts and other disclosures for the prior period included as an integral part of the current period financial statements, which are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as ‘current period figures’). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

**COMPARATIVE FINANCIAL STATEMENTS** are amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparatives are presented in compliance with the relevant financial reporting framework. The auditor's procedures are similar in respect of corresponding figures and comparative financial statements. The key difference is in the auditor's report:

- For corresponding figures, the auditor’s report only refers to the financial statements of the current period, because the corresponding figures are part of the current period's financial statements.
- For comparative financial statements, the auditor's report refers to each period that financial statements are presented.

2.2.1 The auditor's responsibilities

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and
- The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

When the financial statements of the prior period:

- Have been audited by other auditors; or
- Were not audited.

The incoming auditor assesses whether the comparative information meet the conditions specified above and also follow the guidance in SSA 510.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

The auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

In the case of comparative financial statements, the written representations are requested for all periods referred to in the auditor's opinion because management needs to reaffirm that the written representations it previously made with respect to the prior period remain appropriate. In the case of corresponding figures, the written representations are requested for the financial statements of the current period only because the auditor's opinion is on those financial statements, which include the corresponding figures.
2.3 Corresponding figures

SSA 710.10
When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures.

The auditor's report will only make specific reference to corresponding figures when there is a problem in relation to them, in the circumstances described below. We will look at specific examples of the wording of the auditor's report in such circumstances.

<table>
<thead>
<tr>
<th>Problem</th>
<th>Status in current period</th>
<th>Effect on auditor's report (current period)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified opinion in prior period or disclaimer of opinion/adverse opinion</td>
<td>Matter is still unresolved</td>
<td>Modified opinion as appropriate*</td>
</tr>
<tr>
<td></td>
<td>Matter has been resolved</td>
<td>Modified opinion based on the possible effects of opening balances on this year's profit or loss</td>
</tr>
<tr>
<td>Unmodified opinion in prior period, but auditor becomes aware of a material misstatement in the prior period</td>
<td>Corresponding figures not restated</td>
<td>Modified opinion as appropriate (qualified or adverse) – see also Chapter 10 on opening balances</td>
</tr>
<tr>
<td></td>
<td>Corresponding figures restated with appropriate disclosures</td>
<td>No effect on current year opinion, but possible Emphasis of Matter referring to restatement and disclosures</td>
</tr>
</tbody>
</table>

* In the Basis for Modification paragraph in the auditor's report, either:

(a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2.4 Comparative financial statements

2.4.1 Reporting

SSA 710.15
When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

The auditor may therefore express a modified opinion or include an emphasis of matter paragraph with respect to one or more financial statements for one or more period, whilst issuing a different report on the other financial statements.

The auditor may become aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit for the current period.
2.4.2 Incoming auditors: additional requirements

Again, there are additional considerations where the prior period financial statements have been audited by another auditor.

SSA 710.16

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph.

SSA 710.17

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

(a) That the financial statements of the prior period were audited by a predecessor auditor;
(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
(c) The date of that report.

Unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

In performing the audit on the current period financial statements, the incoming auditor may become aware of a material misstatement that affects the prior period financial statements on which the predecessor auditors had previously reported without modification.

SSA 710.18

... the auditor shall communicate the misstatement with the appropriate level of management and, unless all of those charged with governance are involved in managing the entity, those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

In certain circumstances the prior period financial statements may not have been audited.

SSA 710.19

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.
3 Other information

3.1 What other information?

SSA 720 (Revised) *The Auditor’s Responsibilities Relating to Other Information* sets out the requirements of the auditor with respect to other information, on which the auditor has no obligation to report, included in a company’s annual report. The standard was revised in November 2015 and the revised standard applies to audits of financial statements for periods ending on or after 15 December 2016.

**KEY TERMS**

**Other information** is financial or non-financial information (other than financial statements and the auditor’s report thereon) included in an entity’s annual report.

A **misstatement of the other information** exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

Here are some examples of other information. Further examples can be found in Appendix 1 of SSA 720.

- Director’s report
- Chairman’s statement
- Corporate governance statement
- Internal control and risk assessment reports
- Financial highlights or current year’s performance

Auditors have no responsibility to report that other information is properly stated because an audit is only an expression of opinion on the truth and fairness of the financial statements. However, they may be engaged separately, or required by law or regulation, to report on other information. In any case, the auditors should give consideration to other information as inconsistencies with the audited financial statements may undermine their opinion.

3.2 Access to other information

The auditors will need to determine which documents comprise the other information in the annual report through discussion with management. Timely access to other information will be required. The auditors therefore must make arrangements with management to obtain such information prior to the date of their auditor’s report.
3.3 Material inconsistencies

The auditor is required to read the other information and in doing so, consider whether there is a material inconsistency between the other information and:

(a) The financial statements; and
(b) The auditor's knowledge obtained during the audit (in the context of audit evidence obtained and conclusions reached).

SSA 720.16

If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:

(a) A material misstatement of the other information exists;
(b) A material misstatement of the financial statements exists; or
(c) The auditor's understanding of the entity and its environment needs to be updated.

3.4 Material misstatements

The auditors must ask management to correct any material misstatements in the other information and then determine this correction has been made. If management refuses to make the necessary revisions, then the auditor shall communicate the matter to those charged with governance and request that the correction be made.

The auditor's response where the auditor concludes there is a material misstatement in the other information may be summarised as follows.

<table>
<thead>
<tr>
<th>Other information obtained</th>
<th>Other information is corrected after communicating to those charged with governance</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to date of auditor's report</td>
<td>Yes</td>
<td>Determine the correction has been made</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>Communicate implications for the auditor's report to those charged with governance Including a statement that there is an uncorrected material misstatement in the other information and a description of the matter in the Other Information section of the auditor's report Withdraw from the engagement, where withdrawal is possible under applicable law or regulation (as a last resort) Consider whether appropriate to seek legal advice Consider whether law, regulation or other professional standards require communication of the matter to a regulator or relevant professional body</td>
</tr>
</tbody>
</table>
If the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor shall respond appropriately in accordance with guidance given in other SSAs.

If a material misstatement exists in the financial statements, the auditor will need to apply SSA 450 Evaluation of Misstatements Identified during the Audit or SSA 560 Subsequent Events (see Section 4).

Where the auditor's understanding of the entity and its environment needs updating, the guidance given in SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment applies (see Chapter 6).

### 3.5 Reporting

A separate section in the auditor's report headed “Other Information” or another appropriate heading is included in the following situations.

<table>
<thead>
<tr>
<th>Other information</th>
<th>Other information section in auditor's report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtained at the date of the auditor's report</td>
<td>Listed and unlisted companies</td>
</tr>
<tr>
<td>Obtained after the date of the auditor's report</td>
<td>Listed companies only</td>
</tr>
</tbody>
</table>

When the auditor's report is required to include an Other Information section, this section shall include the following:

- A statement that management is responsible for the other information
- An identification of other information, if any, obtained by the auditor prior to the date of the auditor's report and, for an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report
- A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an auditor's opinion or any form of assurance conclusion thereon
- A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this SSA
- When other information has been obtained prior to the date of the auditor's report, either a statement that the auditor has nothing to report or, if the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.
Appendix 2 of SSA 720 contains illustrative examples of the Other Information section in the auditor's report. The following is an example of an Other Information section taken from this Appendix which illustrates where there is an unmodified opinion for a listed or unlisted company and the auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.

Other Information [or another title if appropriate, such as “Information Other than the Financial Statements and Auditor's Report Thereon”]

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

The Appendix also contains an example for a listed or unlisted company containing an unmodified opinion where the auditor has obtained all of the other information prior to the date of the auditor's report and has concluded that a material misstatement of the other information exists.

Other Information [or another title if appropriate, such as “Information Other than the Financial Statements and Auditor's Report Thereon”]

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described below, we have concluded that such a material misstatement of the other information exists.

[Description of material misstatement of the other information]

**SECTION SUMMARY**

Auditors should always seek to resolve inconsistencies between financial statements and other information.
4 Subsequent events

SECTION INTRODUCTION

Events occurring after the end of the reporting period may affect the results and the position of the company at that date. Auditors have a responsibility to review subsequent events before they sign the auditor’s report, and in certain circumstances may have to take action as a result.

4.1 Events after the reporting period

’Subsequent events’ include:

- Events occurring between the period end and the date of the auditor’s report
- Facts discovered after the date of the auditor’s report

SSA 560 Subsequent Events deals with this issue. It is also worth recalling basic requirements of the accounting standard in this area, SFRS(I) 1-10 Events after the Reporting Period identifies two types of event:

<table>
<thead>
<tr>
<th>Type of event</th>
<th>Definition (SFRS(I) 1-10)</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusting</td>
<td>Events that provide further evidence of conditions that existed at the end of the reporting period</td>
<td>Customer becomes insolvent after period end – trade receivable at period end is uncollectible. Settlement of a court case after period end – confirms entity's obligation at the period end.</td>
</tr>
<tr>
<td>Non-adjusting</td>
<td>Events that are indicative of conditions that arose after the reporting period</td>
<td>Inventory lost in fire after period end – non-adjusting because the inventory still existed at the period end (but needs to be disclosed, with possible Emphasis of Matter).</td>
</tr>
</tbody>
</table>

Between the end of the reporting period and the date the financial statements are authorised (i.e., for issue outside the organisation), events may occur which show that assets and liabilities at the end of the reporting period should be adjusted, or that disclosure of such events should be given.

Note that, while they may be non-adjusting, some events after the reporting period will require disclosure.

4.2 Events occurring up to the date of the auditor’s report

SSA 560.6

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified.

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, e.g., cut-off tests. They should be performed as near as possible to the date of the auditor’s report.

In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:
### Procedures to identify subsequent events

| Inquiries of management | New commitments, borrowings or guarantees  
Sales or acquisitions of assets occurred or planned  
Issues of shares or debt instruments, or an agreement to merge or liquidate made or planned  
Assets destroyed or appropriated by government  
Developments regarding contingencies  
Unusual accounting adjustments made or contemplated  
Events (eg going concern problems) bringing into question appropriateness of accounting policies  
Events relevant to measurement of estimates and provisions  
Events relevant to the recoverability of assets |
| Other procedures | Consider procedures of management for identifying subsequent events  
Read minutes of general board/committee meetings  
Review latest accounting records and financial information |

#### SSA 560.8

If... the auditor identifies events that require adjustment of, or disclosure in the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Written representations will be sought that all events occurring subsequent to the date of the financial statements which require adjustment or disclosure have been adjusted or disclosed.

### 4.3 Facts discovered after the date of the auditor's report but before the financial statements are issued

The financial statements are management's responsibility. They should therefore inform the auditor of any material subsequent events between the date of the auditor's report and the date the financial statements are issued. The auditor does not have any obligation to perform procedures, or make enquiries regarding the financial statements after the date of their report.

#### SSA 560.10

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance  
(b) Determine whether the financial statements need amendment and, if so  
(c) Inquire how management intends to address the matter in the financial statements

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.

The situation may arise where the statements are not amended but the auditors feel that they should be.
If the auditor's report has already been issued to the entity then the auditor should notify those who are ultimately responsible for the entity (the management or possibly a parent company in a group), not to issue the financial statements or auditor's report to third parties. If management issues the financial statements despite the auditor's notification the auditor will take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the advice of the auditor's lawyer.

4.4 Facts discovered after the financial statements have been issued

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

However, when after the financial statement have been issued, the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report may have caused the auditor to amend the auditor's report, the auditor will carry out the following procedures:

(a) Discuss the matter with management and, where appropriate, those charged with governance
(b) Determine whether the financial statements need amendment and, if so
(c) Inquire how management intends to address the matter in the financial statements

The SSA gives the appropriate procedures which the auditors should undertake when management revises the financial statements:

(a) Carry out the audit procedures necessary in the circumstances.
(b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
(c) Extend the audit procedures to the date of the new auditor's report.
(d) Issue a new report on the revised financial statements.

SSA 560.16

The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matters paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

Where local regulations allow the auditor to restrict the audit procedures on the financial statements to the effects of the subsequent event which caused the revision, the new auditor's report should contain an emphasis of matter paragraph referring to a note in the financial statements which explains the situation fully.

Where management does not revise the financial statements but the auditors feel they should be revised, or if management does not intend to take steps to ensure anyone in receipt of the previously issued financial statements is informed of the situation, then the auditors should consider steps to take, on a timely basis, to prevent reliance on their report. The actions taken will depend on the auditors' legal rights and obligations (for example, to contact the shareholders directly) and legal advice received.

4.5 Subsequent events in uncertain economic conditions

The uncertain economic environment can cause financial conditions to change rapidly increasing the relevance of subsequent events. The ACRA Audit Practice Bulletin 2 of 2011 *Audit Considerations in an Uncertain Economic Environment* reminds the auditor of the importance of the application of SSA 560 Subsequent Events.
**Example: Subsequent events**

You were the external auditor of Woodlands Trading Limited ("Woodlands") for the year ended 31 December 20X4, a construction company. Your AE signed an unmodified auditor's opinion on the financial statements on 28 March 20X5.

Five days later, you receive a call from the finance director at Woodlands. The finance director explains that Queenstown, a key client, have gone into liquidation. It is unlikely that Woodlands will be able to recoup any of the still outstanding year-end receivable of $200k. This amount is 12% of the profit before tax and 10% of total assets at 31 December 20X4. Audit procedures at Woodlands had shown there was no reason to believe Queenstown would not pay any outstanding receivables balances.

Woodlands management would like to amend the financial statements for the year ending 31 December 20X4. After a discussion with management you determine that the financial statements should be amended. Audit procedures are performed to the date of the new auditor's report and no issues were found. The matter is not considered to impact upon the going concern of Woodlands.

**Required**

What would be the impact on the auditor's report for the amended financial statements in this situation if:

(a) The financial statements had already been issued to Woodlands shareholders; and
(b) The financial statements had not yet been issued to Woodlands shareholders.

**Solution**

The receivable in question is 10% of total assets and 12% of profit before tax so is material. Had the auditors known this receivable was uncollectable, they would not have signed an unmodified auditor's report on the financial statements, since trade receivables contains a material misstatement. The receivable represents an adjusting subsequent event in line with SFRS(I) 1-10 Events After the Reporting Period as it is unlikely that Queenstown could have paid the amount due at year-end. Woodlands have amended the financial statements to address the issue and the auditors agree with management's amendments.

(a) If the financial statements had already been issued, the auditor's will need to express an unmodified opinion on the amended financial statements and include an Emphasis of Matter paragraph in the auditor's report. This paragraph must highlight the reason for the amendment of the previously issued financial statements and refer to the earlier auditor's report provided on those financial statements. It would also indicate that the auditor's opinion is not modified in respect of this matter and be included immediately after the Opinion paragraph in the auditor's report.

(b) If the financial statements not yet been issued, the auditor's will need to provide a new auditor's report on the amended financial statements. The new report should not be dated earlier than the date of approval of the amended financial statements. The auditor's report would not be modified and would not need to contain an Emphasis of Matter paragraph.

**Question 12.1**

You are auditing the financial statements of Hope Engineering, a limited company, for the year ending 31 March 20X8. The partner in charge of the audit instructs you to carry out a review of the company's activities since the financial year-end. The CEO of Hope Engineering, overhears the conversation with the partner and is surprised that you are examining accounting information which relates to the next accounting period.
Required

(a) Explain the nature and purpose of a subsequent events review.

(b) Describe the audit procedures which would be carried out in order to identify any material subsequent events.

The CEO was appointed on 1 March 20X8 as a result of which the contract of the previous CEO was terminated. Compensation of $500,000 was paid to the previous CEO on 2 March 20X8.

As a result of your investigations you find that the company is going to bring an action against the previous CEO for the recovery of the compensation paid, as it has come to light that two months prior to dismissal, the previous CEO had contractually agreed to join the board of directors of a rival company. The company's lawyer had informed Hope Engineering that the previous CEO's actions constituted a breach of contract with them, and that an action could be brought against the former CEO for the recovery of the money paid to him.

Required

(c) Discuss the audit implications of the company's decision to sue the former CEO for the recovery of the compensation paid.

SECTION SUMMARY

Auditors should consider the effect of subsequent events (after the reporting period) on the financial statements.

5 Going concern

SECTION INTRODUCTION

Under the concept of going concern, an entity is assumed to continue in business for the foreseeable future. Auditors have a responsibility to consider the future plans of directors and any signs of going concern problems as this might impact on the audit opinion.
5.1 The going concern basis of accounting

Going concern is covered by SSA 570 (Revised) Going Concern. SSA 570 was revised in July 2015 and is effective for audits of financial statements for periods ending on or after 15 December 2016.

KEY TERM

Under the **GOING CONCERN BASIS OF ACCOUNTING**, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. (SSA 570.2)

Accounting treatment is explained in SFRS(I) 1-1 *Presentation of Financial Statements*.

**SFRS(I) 1-1 Presentation of Financial Statements**

When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern. (SFRS(I) 1-1.25)

The preparation of the financial statements requires management to assess the entity's ability to continue as a going concern, even if the financial reporting framework does not include an explicit requirement to do so.

When management are making the assessment, the following factors are relevant.

(a) The degree of uncertainty about the events or conditions being assessed increases significantly the further into the future the assessment is made.

(b) Judgments are affected by the size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors.

(c) Judgments are made on the basis of the information available at the time.

**SSA 570.9**

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To report in accordance with this SSA.

Whilst it is management's responsibility to make the assessment the auditor cannot simply accept management's conclusions. The auditor must obtain sufficient, appropriate audit evidence to support these. Due to the nature of this audit issue, this will not necessarily be straightforward and will require
the auditor to use professional judgment. These difficulties do not however diminish the auditor's responsibility to form an independent opinion.

The following are examples of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern.

(a) Financial
   (i) Net liabilities or net current liability position
   (ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets
   (iii) Indications of withdrawal of financial support by lenders
   (iv) Negative operating cash flows indicated by historical or prospective financial statements
   (v) Adverse key financial ratios
   (vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
   (vii) Arrears or discontinuance of dividends
   (viii) Inability to pay creditors on due dates
   (ix) Inability to comply with the terms of loan agreements
   (x) Change from credit to cash-on-delivery transactions with suppliers
   (xi) Inability to obtain financing for essential new product development or other essential investments

(b) Operating
   (i) Management intends to liquidate the entity or to cease operations
   (ii) Loss of key management without replacement
   (iii) Loss of a major market, key customer(s), franchise, licence, or principal supplier(s)
   (iv) Labour difficulties or shortages of important supplies
   (v) Emergence of a highly successful competitor

(c) Other
   (i) Non-compliance with capital or other statutory or regulatory requirements
   (ii) Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
   (iii) Changes in law or regulation or government policy expected to adversely affect the entity
   (iv) Uninsured or underinsured catastrophes when they occur
   (v) Changing consumer behaviour, for example customers downloading music instead of buying CDs

The significance of such events and conditions often can be mitigated by other factors. For example, the loss of a key supplier may be mitigated by the availability of a suitable alternative source of supply. It is worth noting that the size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to react quickly to exploit opportunities but may lack reserves to sustain operations.
5.2 Evaluating management's assessment

SSA 570.10

When performing risk assessment procedures as required by SSA 315 (Revised), the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

These procedures allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues. The auditor must remember the importance of professional scepticism throughout the audit. For example, when discussing management plans the auditor must consider how realistic they are and how likely they are to go ahead. The plans should also be considered in the light of the auditor's other knowledge and understanding of the business.

SSA 570.11

The auditor shall remain alert throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. It may be necessary to revise the auditor's assessment of the risks of material misstatement if these are found.

SSA 570.12

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

The auditors may evaluate:

- The process management followed to make its assessment
- The assumptions on which management's assessment is based
- Management's plans for future action and whether these are feasible in the circumstances

The extent of the evaluation will depend on the circumstances and on the perceived risk involved. Management do not need to make a detailed analysis, and auditors should not need to carry out detailed procedures, if the entity has a history of profitable operations and ready access to financial resources and other audit procedures have resulted in sufficient evidence.

In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period.

If management's assessment covers a period of less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least 12 months from that date.

In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.
The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.

The period beyond management's assessment is distant and so the indications of potential going concern problems would have to be significant. Auditors do not have to carry out specific procedures to identify potential problems which may occur after the period covered by management's assessment. However, they should be alert during the course of the audit for any indications of future problems.

5.2.1 Additional audit procedures

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as 'material uncertainty') through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
   (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
   (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

When events or conditions are identified which cast doubt on the appropriateness of the going concern basis of accounting, auditors may also have to carry out additional procedures. The SSA lists various procedures which the auditors may carry out in this context.

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reading the terms of debentures and loan agreements and determining whether any have been breached
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties
- Enquiring of the entity's legal counsel regarding litigation and claims
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
### 5.3 Audit conclusions

**SSA 570.17**

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

#### 5.3.1 Adequacy of disclosures

SSA 570 requires the auditor to assess the adequacy of disclosures in the financial statements if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern.

<table>
<thead>
<tr>
<th>Events and conditions have been identified and a material uncertainty exists</th>
<th>The auditor must determine whether the financial statements:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions</td>
<td></td>
</tr>
<tr>
<td>Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Events or conditions have been identified but no material uncertainty exists</th>
<th>The auditor must evaluate whether the financial statements provide adequate disclosures about these events or conditions</th>
</tr>
</thead>
</table>
5.4 Implications for the auditor’s report

5.4.1 Use of going concern basis of accounting is inappropriate

SSA 570.21
If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with SSA 706 (Revised) in the auditor’s report to draw the user's attention to that alternative basis of accounting and the reasons for its use. Modifications to auditor's reports and Emphasis of Matter paragraphs are covered in detail in Chapter 16.

5.4.2 Use of going concern basis of accounting is appropriate but a material uncertainty exists

In this situation, the impact on the auditor’s report is dependent on whether adequate disclosure has been made in the financial statements.

<table>
<thead>
<tr>
<th>Adequate disclosure of a material uncertainty is made in the financial statements</th>
<th>Unqualified opinion</th>
</tr>
</thead>
</table>
| *Auditor's report includes a separate section under the heading 'Material Uncertainty Related to Going Concern' to:*
| - Draw attention to the note in the financial statements that discloses the matter  
  - State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter |

<table>
<thead>
<tr>
<th>Adequate disclosure of a material uncertainty is not made in the financial statements</th>
<th>Qualified opinion or adverse opinion, as appropriate</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.</em></td>
<td></td>
</tr>
</tbody>
</table>
In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion on the grounds of an inability to obtain sufficient appropriate audit evidence, or a disclaimer of opinion in the auditor's report may be appropriate.

5.5 Communication with those charged with governance

Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. This communication must include the following:

- Whether the events or conditions constitute a material uncertainty
- Whether the use of the going concern basis of accounting is appropriate in the preparation of the financial statements
- The adequacy of related disclosures in the financial statements
- Where applicable, the implications for the auditor's report

5.6 Significant delay

When there is a significant delay in approving the financial statements, auditors shall enquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty.

5.7 Going concern considerations in an uncertain economic environment

The global recession and the resulting credit crisis experienced in many countries after 2008 may have affected management's assessment of going concern for many companies. Increased uncertainty and difficult economic conditions could mean the going concern basis is therefore no longer appropriate. Auditors should take extra care when reviewing management's assessment of going concern in such circumstances.

5.7.1 ACRA Audit Practice Bulletin No 2 (2011)

In 2011 ACRA issued Audit Practice Bulletin 2 of 2011 Audit Considerations in an Uncertain Economic Environment. The aim of this Bulletin is to remind the profession of the potentially higher risks of material misstatement in financial reports during uncertain economic times as compared to when economic conditions are more favourable. The auditor must exercise vigilance, professional scepticism and judgment when performing the audit procedures to address the identified risk areas. The Bulletin covers the following key areas:

- Communicating with clients
- Fraud considerations
- Impairment of non-financial assets
- Financial statement disclosures
- Subsequent events
- The independent auditor's report
- Involvement of experienced auditors in the audit
5.7.2 Audit Practice Bulletin No 1 (2009)

ACRA issued Audit Practice Bulletin No 1 *Audit Considerations in the Current Economic Environment*. The annexure of this Bulletin highlights the key areas within an audit which may be of concern during a time of economic uncertainty and the main actions which the auditor should carry out. Key areas covered are as follows.

- Planning considerations
- Fraud considerations
- Cash at bank
- Going concern
- Valuation of financial instruments held at fair value
- Impairment of assets
- Deferred tax asset recognition
- Provision for onerous contracts and restructuring
- Disclosures in the financial statements and off-balance sheet items
- Communication with those charged with governance

Note that since this Audit Practice Bulletin was published in 2009, there have been significant changes to SSA 540 *Audit of Accounting Estimates*. This standard has been revised and redrafted as SSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. The revised and redrafted standard combined the previous version of SSA 540 with SSA 545 *Auditing Fair Value Measurements and Disclosures*. SSA 545 has now been withdrawn.

### Question 12.2

**Going concern**

You are planning the audit of Truckers Ltd, whose principal activities are road transport and warehousing services, and the repair of commercial vehicles. You have been provided with the draft financial statements for the year ended 31 October 20X5.

<table>
<thead>
<tr>
<th>Draft 20X5 ($'000)</th>
<th>Actual 20X4 ($'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Summary statement of profit or loss</strong></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>10,971</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(10,203)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>768</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(782)</td>
</tr>
<tr>
<td>Interest payable and similar charges</td>
<td>(235)</td>
</tr>
<tr>
<td>Net (loss) profit</td>
<td>(249)</td>
</tr>
<tr>
<td><strong>Summary statement of financial position</strong></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td>5,178</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventory (parts and consumables)</td>
<td>95</td>
</tr>
<tr>
<td>Receivables</td>
<td>2,975</td>
</tr>
<tr>
<td></td>
<td>3,070</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>250</td>
</tr>
<tr>
<td>Overdraft</td>
<td>1,245</td>
</tr>
<tr>
<td>Trade payables</td>
<td>1,513</td>
</tr>
<tr>
<td>Lease liability</td>
<td>207</td>
</tr>
<tr>
<td>Other payables</td>
<td>203</td>
</tr>
<tr>
<td></td>
<td>3,418</td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>750</td>
</tr>
<tr>
<td>Lease liability</td>
<td>473</td>
</tr>
<tr>
<td></td>
<td>1,223</td>
</tr>
<tr>
<td>Net assets</td>
<td>3,607</td>
</tr>
</tbody>
</table>
You have been informed by the CEO that the fall in revenue is due to:

1. The loss, in July, of a long-standing customer to a competitor
2. A decline in trade in the repair of commercial vehicles

During the year, the company replaced a number of vehicles, funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed in January 20X6 after the audited financial statements are available.

The draft financial statements show a loss for 20X5 but the forecasts indicate a return to profitability in 20X6 as the CEO is optimistic about generating additional revenue from new contracts.

Required

(a) What matters would the auditors consider when assessing whether Trucker Ltd's use of the going concern basis of accounting is appropriate or whether a material uncertainty exists? Explain why each of these matters give cause for concern.

(b) Describe the audit work to be performed in respect of going concern at Truckers Ltd.

SECTION SUMMARY

Auditors should consider whether the going concern basis of accounting is appropriate, and whether disclosure of any going concern problems is sufficient.
Chapter Roundup

Audit completion
- Governance issues
- Review of financial statements
  - Analytical procedures
  - Summarising misstatements

Subsequent events
- Responsibilities:
  - Up to date of auditor’s report
  - After date of auditor’s report but before financial statements issued
  - After financial statements issued

Going concern
- Reporting implications
- Managements’ responsibilities
- Auditors’ responsibilities
- Current issues

Comparatives
- Corresponding figures
- Comparative financial statements

Other information
- Material misstatements
- Reporting
Quick Quiz

1. The auditor will maintain a schedule of uncorrected misstatements. This will include:
   - Specific misstatements identified by the auditors
   - Best estimate of other misstatements
   
   True  [ ]
   False [ ]

2. Where prior period financial statements were unaudited, the auditor should make no reference to the comparatives in the auditor's report.

   True  [ ]
   False [ ]

3. Which of the items on the following list are not part of the 'other information' within the scope of SSA 720?
   - Directors' statement
   - Financial ratios
   - Statement of cash flows
   - Auditor's report
   - Financial summaries

   True  [ ]
   False [ ]

4. Name two types of 'subsequent events'.
   (1) ........................................ .......
   (2) ........................................ .......

5. List five enquiries which may be made of management in identifying subsequent events.
   (1) ........................................ .......
   (2) ........................................ .......
   (3) ........................................ .......
   (4) ........................................ .......
   (5) ................................................

6. Complete the definition.
   Under the ...................... .................. basis of accounting an entity is viewed as continuing in business for the ...................... ..................

   True  [ ]
   False [ ]

7. The ‘foreseeable future’ is always a period of 12 months.

   True  [ ]
   False [ ]
Answers to Quick Quiz

1. True
2. False
3. Statement of cash flows and auditor's report
4. (1) Adjusting events
   (2) Non-adjusting events
5. Any five from the following:
   - Status of items involving subjective judgment
   - Any new commitments
   - Sales of assets
   - Issues of shares or debentures
   - Developments in risk areas
   - Unusual accounting adjustments
   - Other major events
6. Going concern, foreseeable future
7. False
12.1 Subsequent events

(a) The auditor's active responsibility extends to the date on which they sign their auditor's report. As this date is inevitably after the year-end, it follows that in order to discharge their responsibilities, the auditors must extend the audit work to cover the period after the year-end.

The objective of this review is to ascertain whether management has dealt correctly with any events, both favourable and unfavourable, which occurred after the end of the reporting period and which need to be reflected in the financial statements, if those statements are to show a true and fair view.

The general rule is that, in the preparation of year-end financial statements, no account should be taken of subsequent events unless to do so is required by statute or to give effect to retrospective legislation, or to take into account an event which provides information about a condition existing at the end of the reporting period, for example realisable values of inventory, or indicates that the going concern concept is no longer applicable. Additionally, certain events may have such a material effect on the company's financial condition, for example a merger, that disclosure is essential to give a true and fair view.

(b) (i) Ask management if there have been any material subsequent events.

(ii) Identify and evaluate procedures implemented by management to ensure that all events after the end of the reporting period have been identified, considered and properly evaluated as to their effect on the financial statements.

(iii) Review relevant accounting records to identify subsequent cash received in relation to accounts receivable, to check items un-cleared at the year-end on the bank reconciliation, and to check NRV of inventories from sales invoices.

(iv) Review budgets, profit forecasts, cash flow projections and management accounts for the new period to assess the company's trading position.

(v) Consider known 'risk' areas and contingencies, whether inherent in the nature of the business or revealed by previous audit experience, or by lawyers' letters.

(vi) Read minutes of shareholders' and management meetings, and correspondence and memoranda relating to items included in the minutes to identify any matters arising.

(vii) Consider relevant information which has come to the auditors' attention from sources outside the entity, including public knowledge of competitors, suppliers and customers.

(viii) Obtain written representations concerning subsequent events from management.

(ix) Carry out an updated search for unrecorded liabilities.

(x) Review journal vouchers after the reporting date.

(xi) Review of credit notes after the period end.

(c) The compensation paid to the previous CEO would be disclosed as part of directors' remuneration for the year ended 31 March 20X8. However, the question then arises as to whether or not the financial statements need to take any account of the possible recovery of the compensation payment.

The auditors should first ascertain from the board minutes that the directors intend to proceed with the lawsuit and should then attempt to assess the outcome by consulting the directors and the company's legal advisers. Only if it seems probable that the compensation will be recovered should a contingent gain be disclosed in the notes to the financial statements, along with a summary of the facts of the case. A prudent estimate of legal costs should be deducted.

It could be argued that the former CEO's breach of contract existed at the year-end and that the compensation should therefore be treated as a current asset, net of recovery costs. However, given the uncertainties over the court case it would be inappropriate to recognise an asset.
12.2 Going concern

(a)

<table>
<thead>
<tr>
<th>Matters</th>
<th>Why cause for concern?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fall in gross profit % achieved</td>
<td>Whilst the fall in absolute revenue has been explained the fall in gross profit margin is more serious. This will continue to be a problem as expenses seem constant and interest costs are growing. This will make a future return to profitability difficult.</td>
</tr>
<tr>
<td>Losses $249,000</td>
<td>Such levels of losses by comparison to 20X4 profits will make negotiations with the bank difficult, especially with the loss of a major customer.</td>
</tr>
<tr>
<td>Increased receivables balance and increased ageing</td>
<td>Worsening debt collection is bad news when the company is making losses and has a deteriorating liquidity position. The increase in average debt collection period may be due to an irrecoverable receivable on the account of the major customer lost in the year. An irrecoverable receivable write-off would cause increased losses.</td>
</tr>
<tr>
<td>20X4 74.8 days 20X5 98.9 days</td>
<td></td>
</tr>
<tr>
<td>Worsening liquidity ratio</td>
<td>This is a significant fall which will worsen further if an allowance for irrecoverable receivables is required. The company has loan and lease commitments which possibly may not be met.</td>
</tr>
<tr>
<td>20X4 1.03 20X5 0.87</td>
<td></td>
</tr>
<tr>
<td>Increasing reliance on short-term finance</td>
<td>This does not secure the future. With the company going through so much change this may cause difficulties for the bank overdraft facility negotiations.</td>
</tr>
<tr>
<td>Gearing will have increased</td>
<td>This leads to an interest commitment which is a drain on future profits. This may also cause a problem in negotiating new finance arrangements.</td>
</tr>
<tr>
<td>Loss of major customer to competitor</td>
<td>Risk of irrecoverable receivables not provided for within the financial statements. Other customers could follow suit worsening the company's future prospects.</td>
</tr>
<tr>
<td>Fall in commercial customers</td>
<td>Commercial customers normally provide regular income which is important for a company with repayment commitments.</td>
</tr>
<tr>
<td>Draft financial statements – final adjustments are outstanding</td>
<td>The company's net asset position could be worsened considerably if non-current assets are written down to their recoverable amount, and the repairs inventory is written down to net realisable value. As mentioned before further allowances for irrecoverable receivables may be necessary. The closure may necessitate redundancy provisions. All of these factors could increase losses considerably.</td>
</tr>
<tr>
<td>Overdraft facility to be reviewed three months after the year-end</td>
<td>This time period is probably not long enough to see a real improvement in the company's fortunes. This represents a fundamental uncertainty. Trying to anticipate the bank's likely reaction to the financial statements would be a high risk.</td>
</tr>
</tbody>
</table>
### Matters

<table>
<thead>
<tr>
<th>Future return to profits anticipated at a time when competitors are achieving success</th>
<th>Why cause for concern?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The concern should be whether this is over optimistic. If so, too much reliance being placed upon written representations would be a high risk strategy.</td>
</tr>
</tbody>
</table>

**Summary** — If the company is not a going concern the financial statements would be more appropriately presented if prepared on a liquidation (break-up) basis. Material adjustments may then be required to the financial statements.

(b) At the planning stage, the auditor’s risk assessment procedures will have identified subsequent events and going concern as specific risks at Truckers Ltd. These will need to be addressed via varying the nature, timing and extent of the related audit procedures. The following procedures shall be performed:

1. Analyse sale proceeds for non-current assets, inventory and cash received from customers occurring after the end of the reporting period.
2. Review the debt ageing and cash collection lists. Ask directors if outstanding amounts from lost customer are recoverable.
3. Discuss the optimistic view of likely future contracts with the MD. Orders received after the end of the reporting period should be reviewed to see if they substantiate the MD's opinion. The MD’s assessment should be corroborated by other means.
4. Obtain the MD's opinion about future contracts in a written representation letter. The MD's opinion should be corroborated by other means.
5. Review bank/loan records to assess the extent to which the company has met its loan and lease commitments in the period after the end of the reporting period.
6. Review sales orders/sales ledger for evidence of additional lost custom after the year-end.
7. Obtain cash flow and profit forecasts:
   - Discuss assumptions with the directors.
   - Perform sensitivity analysis flexing the key assumptions ie interest rates, date of payment of payables and receipts from customers.
   - Check all commitments have been cleared in accordance with legal agreements.
   - Agree budgets to any actual results achieved after the year-end.
   - Assess reasonableness of assumptions in the light of the achievement of the company's budgets set for 20X5. Discuss with the directors any targets not achieved.
   - Re-perform calculations.
   - Ensure future budgeted profits are expected to meet likely interest charges.
8. Review bank records to ensure that the company is operating within its overdraft facility after the end of the reporting period. Review bank certificate for terms and conditions of the facility. Review bank correspondence for any suggestion the bank is concerned about its current position.
9. Ask management whether the new vehicle fleet is attracting new contracts as anticipated. Scrutinise any new contracts obtained and check improved gross profit margins will be achieved.
10. Obtain written representations as to the likelihood of the company operating for 12 months from the date of approval of the financial statements. Note that written representations are not a substitute for evidence obtained via the performance of audit procedures.

If further events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern are identified after the auditor’s risk assessments are made, in addition to performing the procedures above, the auditor’s assessment of the risks of material misstatement may need to be revised.
PART E
OTHER ASSIGNMENTS
In this chapter we look at audit-related services and other assurance services.

Most AEs provide a range of services besides audit. Audit-related services include review engagements, compilation engagements and agreed-upon procedures. The provision of these services may require additional knowledge either of the service itself or the AE’s procedures in respect of those services. In practical terms, the provision of other services may enable the Chartered Accountant to provide more comprehensive client services suited to their clients.

Other assurance services are also considered in this chapter and we examine the different levels of assurance that can be provided on such engagements. Of particular importance is risk assessment and performance measurement.

**Topic list**

1. Review engagements and audit-related services
2. Other assurance engagements
3. Risk assessments
4. Combined assurance
## Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Review engagements and audit-related services</strong></td>
<td></td>
</tr>
<tr>
<td>Describe the nature of a review engagement and audit-related services, the</td>
<td>2</td>
</tr>
<tr>
<td>circumstances in which they might be required and the comparative levels of</td>
<td></td>
</tr>
<tr>
<td>assurance provided by public accounting entities and distinguish between:</td>
<td></td>
</tr>
<tr>
<td>• A review engagement, audit-related services and an audit of historical</td>
<td></td>
</tr>
<tr>
<td>financial statements; and</td>
<td></td>
</tr>
<tr>
<td>• An attestation, review or compilation engagement including compiling</td>
<td></td>
</tr>
<tr>
<td>proforma financial information for a prospectus.</td>
<td></td>
</tr>
<tr>
<td>Plan review engagements, for example:</td>
<td>2</td>
</tr>
<tr>
<td>• A review of interim financial information; and</td>
<td></td>
</tr>
<tr>
<td>• A review of historical financial information.</td>
<td></td>
</tr>
<tr>
<td>Explain the nature and extent of enquiry and analytical procedures in review</td>
<td>3</td>
</tr>
<tr>
<td>engagements and apply these procedures.</td>
<td></td>
</tr>
<tr>
<td><strong>Assurance services other than statutory audit</strong></td>
<td></td>
</tr>
<tr>
<td>Describe the main categories of assurance services that public accounting</td>
<td>3</td>
</tr>
<tr>
<td>entities can provide and assess the benefits of providing these services to</td>
<td></td>
</tr>
<tr>
<td>management and external users.</td>
<td></td>
</tr>
<tr>
<td>Justify a level of assurance (reasonable or limited) for an engagement</td>
<td>3</td>
</tr>
<tr>
<td>depending on the subject matter evaluated, the criteria used, the procedures</td>
<td></td>
</tr>
<tr>
<td>applied and the quality and quantity of evidence obtained.</td>
<td></td>
</tr>
<tr>
<td>Recognise the ways in which different types of risk (eg strategic, operating,</td>
<td>3</td>
</tr>
<tr>
<td>information) may be identified and analysed and how it is communicated to</td>
<td></td>
</tr>
<tr>
<td>management.</td>
<td></td>
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<tr>
<td>Explain the usefulness to management and other stakeholders of combined</td>
<td>3</td>
</tr>
<tr>
<td>assurance, especially in the context of risk management.</td>
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<tr>
<td><strong>Other reports</strong></td>
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<tr>
<td>Discuss the effectiveness of the ‘negative assurance’ form of reporting and</td>
<td>3</td>
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<tr>
<td>evaluate situations in which it may be appropriate to express a reservation or</td>
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<td>deny a conclusion.</td>
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</table>
13: Review engagements, audit-related services and other assurance services

ESSENTIAL READING

- SSRE (Singapore Standard on Review Engagements) 2400 (Revised) 
  Engagements to Review Historical Financial Statements
- SSRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity
- SSRS (Singapore Standard on Related Services) 4410 (Revised) Compilation Engagements
- SSRS 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information
- SSAE (Singapore Standards on Assurance Engagements) 3000 (Revised) 
  Assurance Engagements Other than Audits or Reviews of Historical Financial Information
- SSAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

1 Review engagements and audit-related services

SECTION INTRODUCTION

A Chartered Accountant can be engaged to perform a review of historical financial statements or interim financial information. Audit-related services include compilation engagements or agreed-upon procedures.

1.1 Reviews of historical financial statements

SSRE (Singapore Standard on Review Engagements) 2400 (Revised) Engagements to Review Historical Financial Statements contains guidance on the review of historical financial statements where the Chartered Accountant is not the auditor of the entity's financial statements. Note that the standard uses the term ‘practitioner’ to describe the Chartered Accountant carrying out this work.

The review of historical financial statements is a limited assurance engagement.

KEY TERM

LIMITED ASSURANCE – The level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion in accordance with SSRE 2400. The combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users’ confidence about the financial statements.

In a limited assurance engagement, the practitioner expresses the conclusion in the negative form. For example, ‘Based on our review, nothing has come to our attention that causes us to believe that the
financial statements do not present fairly, in all material respects in accordance with the applicable financial reporting framework.

Many small and medium sized entities (SMEs) are not required to have their financial statements audited by law or regulation. In recent years, there has been a growing need to provide assurance services to enhance the credibility of the financial statements of SMEs. A review of historical financial statements of a SME in line with SSRE 2400 can provide that credibility and assurance to the users of their financial statements.

Many of the requirements of SSRE 2400 are similar to the requirements of an audit. An engagement letter must be sent to the client to confirm understanding of the engagement. (This would be similar to an audit engagement letter, see Chapter 5.) Prior to performing procedures, the Chartered Accountant is required to determine materiality for the financial statements as a whole. However, unlike an audit, the Chartered Accountant is not required to determine performance materiality for a review.

The Chartered Accountant must also obtain an understanding of the entity and its environment, and the applicable financial reporting framework, in order to identify areas where material misstatements are likely to arise. Procedures are then designed to address those areas.

When carrying out procedures during a review of historical financial statements, the Chartered Accountant performs primarily inquiry and analytical procedures, rather than more detailed substantive testing or validation of controls, to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements. The reasons for this are as follows:

(a) The Chartered Accountant is seeking a lower level of assurance than for an audit where reasonable assurance is required, so these forms of procedures provide sufficient appropriate evidence due to risk being lower.

(b) Such techniques provide indicators that direct work to risk areas and from which to draw conclusions, and they are quick and, therefore, cost effective.

**SSRE 2400.48**

The practitioner's inquiries of management and others within the entity, as appropriate, shall include the following.

(a) How management makes the significant accounting estimates required under the applicable financial reporting framework

(b) The identification of related parties and related party transactions, including the purpose of those transactions

(c) Whether there are significant, unusual or complex transactions, events or matters that have affected or may affect the entity's financial statements, including:
   (i) Significant changes in the entity's business activities or operations
   (ii) Significant changes to the terms of contracts that materially affect the entity's financial statements, including terms of finance and debt contracts or covenants
   (iii) Significant journal entries or other adjustments to the financial statements
   (iv) Significant transactions occurring or recognised near the end of the reporting period
   (v) The status of any uncorrected misstatements identified during previous engagements
   (vi) Effects or possible implications for the entity of transactions or relationships with related parties

(d) The existence of any actual, suspected or alleged:
   (i) Fraud or illegal acts affecting the entity; and
   (ii) Non-compliance with provisions of laws and regulations that are generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations
(e) Whether management has identified and addressed events occurring between the date of the financial statements and the date of the practitioner's report that require adjustment of, or disclosure in, the financial statements

(f) The basis for management's assessment of the entity's ability to continue as a going concern

(g) Whether there are events or conditions that appear to cast doubt on the entity's ability to continue as a going concern

(h) Material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements, including disclosures; and

(i) Material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration

The Chartered Accountant is also required to perform the following.

- Procedures to address related parties
- Procedures addressing an indication of fraud or non-compliance with laws and regulations
- A consideration of the entity's ability to continue as a going concern
- Procedures to ensure that any work performed by others is adequate
- Obtain evidence that the financial statements agree with, or reconcile to, the entity's underlying accounting records
- Additional procedures if the Chartered Accountant becomes aware of any matters that indicate the financial statements are materially misstated
- Procedures relating to subsequent events occurring between the date of the financial statements and the date of the Chartered Accountant's report
- Request written representations from management
- Evaluate whether sufficient appropriate evidence has been obtained from the procedures performed to form a conclusion on the financial statements

1.1.1 Reporting and levels of assurance

Limited assurance is given on review assignments.

SSRE 2400.73

The practitioner shall express an unmodified conclusion in the practitioner's report on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.
An example of an unmodified review report is given in Appendix 2 of SSRE 2400 and is reproduced here.

**Form of Unmodified Review Report**

INDEPENDENT PRACTITIONERS' REVIEW REPORT [Appropriate addressee]

**Report on the Financial Statements**

We have reviewed the accompanying financial statements of ABC Company that comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Singapore Financial Reporting Standards for Small Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Practitioner's Responsibility**

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Singapore Standard on Review Engagements (SSRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SSRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SSRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Singapore Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at 31 December 20X1, and (of) its financial performance and cash flows for the year then ended, in accordance with the Singapore Financial Reporting Standard for Small Entities.

**Report on Other Legal and Regulatory Requirements**

[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

AE

Public Accountants and Chartered Accountants Singapore

Date
The report can only be signed by a public accountant where a public accountant is a person registered or deemed to be registered in accordance with the Accountants Act (Chapter 2) as a public accountant. This is the signing convention for all reports issued under Singapore Standards on Assurance Engagements (SSAEs).

If the Chartered Accountant determines that the financial statements are materially misstated or is unable to obtain sufficient appropriate audit evidence or when the financial effects of a misstatement cannot be quantified, a modified conclusion will be expressed in the Chartered Accountant’s report.

If the Chartered Accountant determines that the financial statements are materially misstated there will be the following modifications to the Chartered Accountant’s conclusion.

<table>
<thead>
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<th>Impact</th>
<th>Modification</th>
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<tbody>
<tr>
<td>Material, but not pervasive</td>
<td>Express a qualified conclusion</td>
</tr>
<tr>
<td>Material and pervasive</td>
<td>Express an adverse conclusion</td>
</tr>
</tbody>
</table>

Note that pervasive is a term used to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements;
- If so confined, represent or could represent a substantial proportion of the financial statements; or
- In relation to disclosures, are fundamental to users’ understanding of the financial statements.

So, even though a misstatement could be confined to one area of the financial statements, it may still be deemed pervasive if it fits into the either of the second bullet points above.

If the Chartered Accountant has been unable to form a conclusion on the financial statements due to inability to obtain sufficient appropriate audit evidence, the following modifications will need to be made to the conclusion.

<table>
<thead>
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<th>Impact</th>
<th>Modification</th>
</tr>
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<tbody>
<tr>
<td>Material but not pervasive</td>
<td>Express a qualified conclusion</td>
</tr>
<tr>
<td>Material and pervasive</td>
<td>Disclaim a conclusion</td>
</tr>
</tbody>
</table>

For all modifications, the Chartered Accountant must include a basis for conclusion paragraph inserted before the modified conclusion.

Where a material misstatement has given rise to the modification, the basis for conclusion paragraph must describe and quantify the financial effects of the misstatement. Where a modification has arisen due to an inability to obtain sufficient appropriate evidence, the basis for conclusion paragraph must include the reason the Chartered Accountant was unable to obtain sufficient appropriate evidence.
1.2 Review of interim financial information performed by the independent auditor of the entity

This subject is covered by SSRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity. Note that the scope of this SSRE is limited to a review of interim financial information performed by the auditor of the financial statements of the same entity.

1.2.1 General principles

The auditor should comply with ethical requirements relevant to the audit of the annual statements of the entity when carrying out an interim review and should implement quality control procedures applicable to the individual engagement. In addition, the auditor should plan and perform the review engagement with an attitude of professional scepticism similar to an audit engagement.

The auditor should agree the terms of the engagement with the client in an engagement letter which can be combined with the audit engagement letter. However, the terms will not be the same terms as for the audit, as the review will result in a lower level of assurance than the annual audit and limited assurance will be given. A review, in contrast to audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

1.2.2 Procedures

The procedures outlined below is similar to that of an audit, but, because this is a review not an audit they are not as detailed as audit procedures.

The auditor should have sufficient understanding of the entity and its environment, including its internal controls, to understand the types of misstatement that might arise in interim financial information and to plan the relevant procedures (mainly enquiry, analytical and other review procedures) to cause him to believe that the financial information is not prepared in accordance with the applicable financial reporting framework. This will usually include:

- Reading last year's audit files and previous review files, if any
- Considering any significant risks that were identified in the prior year audit
- Reading the most recent and comparable prior period interim financial information
- Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatement
- Considering the nature of any corrected or uncorrected misstatements in last year's financial statements
- Considering significant financial accounting and reporting matters of ongoing importance
- Considering the results of any audit procedures performed with respect to the current year's financial statements
- Considering the work of internal audit performed and the subsequent actions taken by management
- Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud
- Inquiring of management about the effect of changes in the entity's business activities
Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information

Inquiring of management about the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled

A recently appointed auditor should obtain an understanding of the entity and its environment, including its internal control, as it relates to both the interim review and final audit.

The key elements of the review will be:

- Enquiries of primarily accounting and finance staff and possibly management
- Analytical and other procedures

Ordinarily procedures would include:

- Reading the minutes of meetings of shareholders, those charged with governance and other appropriate committees
- Considering the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits or reviews
- If relevant, communicating with other auditors auditing/reviewing the interim financial information of the reporting entity’s significant components
- Carrying out analytical procedures designed to identify relationships and unusual items that may reflect a material misstatement
- Reading the interim financial information and considering whether anything has come to the auditors’ attention indicating that it is not prepared in accordance with the applicable financial reporting framework
- Agreeing the interim financial information to the underlying accounting records

The auditor should make enquiries of members of management responsible for financial and accounting matters about:

- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework
- Whether there have been changes in accounting policies
- Whether new transactions have required changes in accounting policies
- Whether there are any known uncorrected misstatements
- Whether there have been unusual or complex transactions, eg disposal of a business segment
- Significant assumptions relevant to fair values – measurement or disclosures and management’s intention and ability to carry out specific courses of action on behalf of the entity
- Whether related party transactions have been accounted for and disclosed correctly
- Significant changes in commitments and contractual obligations
- Significant changes in contingent liabilities including litigation or claims
- Compliance with debt covenants
- Matters about which questions have arisen in the course of applying the review procedures
- Significant transactions occurring in the last days of the interim period or the first days of the next period
- Knowledge or suspicion of any fraud or suspected fraud
Review engagements, audit-related services and other assurance services

13: Review engagements, audit-related services and other assurance services | PART E OTHER ASSIGNMENTS

- Knowledge of any allegations of fraud or suspected fraud
- Knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information
- Whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified
- Whether management has changed its assessment of the entity being a going concern

The auditor should evaluate discovered misstatements individually and in aggregate to see if they are material.

The auditor should obtain written representations from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatements are immaterial (a summary of these should be attached to the representations). The auditor should also obtain representations that all significant facts relating to frauds, suspected frauds or non-compliance with law and regulations has been disclosed to the auditor and that all significant subsequent events up to the date of the review report have been disclosed to the auditor.

The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.

If the auditors believe a matter should be adjusted in the financial information, they should inform management as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the appropriate level of management. The auditors should communicate matters of interest arising to those charged with governance.

1.2.3 Reporting

The SSRE gives the following example standard report in Appendix 4. All review reports issued under SSRE 2410 must be signed by a public accountant.

Note: SSRE 2410 has not yet been updated for the changes in terminology introduced by the revision of SFRS(I) 1-1 Presentation of Financial Statements.
Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or ‘does not present fairly, in all material respects,’) the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Singapore Financial Reporting Standards (International)).

AE
Public Accountants and Chartered Accountants Singapore
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It also gives examples of modified reports in Appendix 5 & 6:

**Review report: Departure from the applicable financial reporting framework**

Previous paragraphs as per standard report.

*Basis for Qualified Conclusion*

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with (indicate applicable financial reporting framework). This information indicates that if these lease obligations were capitalised at March 31, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by ($______, $______, and $______, respectively for the three-month period then ended.

*Qualified Conclusion*

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that caused us to believe that the accompanying interim financial information does not give a true and fair view of (or ‘does not present fairly, in all material respects,’) the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Singapore Financial Reporting Standards (International)).

AE
Public Accountants and Chartered Accountants Singapore
Date

**Review report: Limitation on scope not imposed by management**

Introduction paragraph – as per standard report

*Scope paragraph*

Except as explained in the following paragraph... – as per standard report.

*Basis for Qualified Conclusion*

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totalling $______ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.
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Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or 'does not present fairly, in all material respects,') the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Singapore Financial Reporting Standards (International)).

AE
Public Accountants and Chartered Accountants Singapore

Date

1.3 Agreed-upon procedures

KEY TERM

AGREED-UPON PROCEDURES – In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. Materiality is not a consideration in an agreed-upon procedures report. All findings, regardless of materiality have to be reported.

Agreed upon procedures assignments are discussed in SSRS 4400 Engagements to Perform Agreed Upon Procedures Regarding Financial Information.

1.3.1 Accepting appointment

SSRS 4400.9

The auditor should ensure with representatives of the entity, and ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

1.3.2 Defining the terms of the engagement

SSRS 4400.9

The auditor should ensure that there is a clear understanding regarding the agreed upon procedures and conditions of the engagement. The following matters should be agreed:

- Nature of the agreement including the fact that the procedures performed will not constitute an audit or review and that therefore no assurance will be expressed
- Stated purpose for the engagement
- Identification of the financial information to which the agreed upon procedures will be applied
- Anticipated form of the report of factual findings
- Limitations on distribution of the report of factual findings
1.3.3 Carrying out procedures and reporting

The auditors should plan the assignment so that an effective engagement will be performed. The auditors should carry out the agreed-upon procedures, documenting their process and findings.

The procedures applied in an engagement to perform agreed-upon procedures may include:

- Inquiry and analysis
- Re-computation, comparison and other clerical accuracy checks
- Observation
- Inspection
- Obtaining confirmations

An example of an agreed-upon procedures engagement is described in Appendix 2 of SSRS 4400. This appendix lists the following procedures performed in an evaluation of the validity of accounts payable.

- We obtained and checked the addition of the trial balance of accounts payable as at [date] prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
- We compared the attached list (not shown in this example) of major suppliers and the amounts owing at [date] to the related names and amounts in the trial balance.
- We obtained suppliers' statements or requested suppliers to confirm balances owing at [date].
- We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding cheques, each of which was greater than $xxx. We located and examined such invoices and credit notes subsequently received and cheques subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

SSRS 4400.18

The report of factual findings should contain:

(a) Title
(b) Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures)
(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied
(d) A statement that the procedures performed were those agreed upon with the recipient
(e) A statement that the engagement was performed in accordance with the Singapore Standard on Related Services applicable to agreed-upon procedure engagements, or with relevant national standards or practices
(f) When relevant a statement that the auditor is not independent of the entity
(g) Identification of the purpose for which the agreed-upon procedures were performed
(h) A listing of the specific procedures performed
(i) A description of the auditor's factual findings including sufficient details of errors and exceptions found
(j) Statement that the procedures performed do not constitute either an audit or a review, and, as such, no assurance is expressed
(k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported
(l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed
13: Review engagements, audit-related services and other assurance services

PART E OTHER ASSIGNMENTS

(m) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity’s financial statements taken as a whole

(n) Date of the report

(o) Auditor’s address

(p) Auditor’s signature

The report must be signed by a professional accountant who is in public practice and holds the Chartered Accountant of Singapore (CA (Singapore)) professional designation conferred by ISCA (CA (Singapore)).

KEY TERM

A PROFESSIONAL ACCOUNTANT IN PUBLIC PRACTICE is a professional accountant, irrespective of functional classification (for example, audit, tax or consulting) in a firm that provides professional services. Professional services are professional activities requiring accountancy or related skills including accounting, auditing, taxation, management consulting, and financial management.

(ISCA Clarification on Appropriate Signing Convention for Reports Issued Under the Assurance, Review and Related Services Frameworks)

The professional accountant may or may not be a public accountant and this will impact the report as follows:

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<tr>
<th>Signing Convention</th>
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<tr>
<td>Professional Accountant is a public accountant</td>
</tr>
<tr>
<td>____________________________ (AE) Public Accountants and Chartered Accountants Singapore</td>
</tr>
<tr>
<td>____________________________ (Date)</td>
</tr>
<tr>
<td>Professional Accountant is not a public accountant</td>
</tr>
<tr>
<td>____________________________ (AE) Chartered Accountants Singapore</td>
</tr>
<tr>
<td>____________________________ (Date)</td>
</tr>
</tbody>
</table>

This is the signing convention for all reports issued under the related services framework (SSRSs) including SSRS 4410 which we will look at in the next section.

1.4 Compilation engagements

1.4.1 Scope

Guidance regarding compilation engagements is provided in SSRS 4410 Compilation Engagements. The SSRS applies to compilation engagements for historical financial information however it may be applied to compilation engagements for financial information other than historical financial information and to compilation engagements for non-financial information if adapted as necessary.
1.4.2 Definition

SSRS 4410 defines a compilation engagement as follows:

**KEY TERM**

A **COMPILATION ENGAGEMENT** is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by this SSRS.

Management may request assistance with the preparation and presentation of financial information. The benefit of this is that users know that the information has been compiled by a Chartered Accountant with professional expertise accounting and financial reporting and in compliance with professional standards including ethical requirements. Financial information that is the subject of a compilation engagement may be required for various purposes including:

- To comply with mandatory financial reporting requirements under law or regulation
- For management or those charged with governance eg preparation of financial information for internal use
- For periodic financial reporting for external parties under a contract or other form of agreement eg financial information provided to a funding body to support the provision or continuation of a grant
- For transactional purposes eg to support a merger or acquisition

For example, the Chartered Accountant may be required to assist in the compilation of financial information for a prospectus for a listing on the Mainboard or Catalist of the SGX. Financial information may include interim financial information and a profit forecast or it may be liquidity and capital resources or trend information.

1.4.3 Responsibilities of the Chartered Accountant and management

The compilation engagement is not an assurance engagement and as a result the Chartered Accountant is not required to verify the accuracy or completeness of the information provided by management which forms the basis of the compilation. The Chartered Accountant does not gather evidence or express an audit opinion or a review conclusion on the financial information prepared.

Management retains responsibility for the financial information and the basis on which it is prepared and presented. This includes applying the judgment required, including the selection and application of accounting policies and the development of reasonable accounting estimates.

1.4.4 Engagement acceptance and conduct of a compilation engagement

**SSRS 4410.25**

The practitioner shall record the agreed terms of the engagement in an engagement letter or other suitable form of written agreement, prior to performing the engagement.

The terms of the engagement must be agreed with management including the following:

- The intended use and distribution of the financial information
- Identification of the applicable financial reporting framework
- The objective and scope of the compilation engagement
The responsibilities of management to include:
(i) The preparation and presentation of financial information in accordance with a financial reporting framework
(ii) The accuracy and completeness of the records, documents, explanations and other information
(iii) Judgments needed in the preparation and presentation of the financial information

The responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements
The expected form and content of the practitioner's report

The Chartered Accountant must also:
- Comply with relevant ethical requirements ie the ACRA Code
- Exercise professional judgment
- Ensure that it is conducted in accordance with the AE's quality control procedures.

1.4.5 Obtaining an understanding

**SSRS 4410.28**
The practitioner shall obtain an understanding of the following matters sufficient to be able to perform the compilation engagement:
(a) The entity's business and operations, including the entity's accounting system and accounting records; and
(b) The applicable financial reporting framework, including its application in the entity's industry.

**SSRS 4410.44**
Example of matters that the Chartered Accountant may consider to obtain an understanding of the entity include:
- The size and complexity of the entity and its operations
- The complexity of the financial reporting framework
- The entity's financial reporting obligations or requirements
- The level of development of the entity's management and governance structure regarding management and oversight of the entity's accounting records and financial reporting systems that underpin the preparation of financial information of the entity
- The level of development and complexity of the entity's financial accounting and reporting systems and related controls
- The nature of the entity's assets, liabilities, revenues and expenses

1.4.6 Compiling the financial information

**SSRS 4410.29**
The practitioner shall compile the financial information using the records, documents, explanations and other information, including significant judgments, provided by management.

If in the course of the work the Chartered Accountant becomes aware that the information provided by management is incomplete, inaccurate or unsatisfactory in any way, this must be brought to the attention of management and request the additional or corrected information obtained.
If it is not possible to complete the engagement because management fail to provide adequate information, the Chartered Accountant should withdraw from the engagement and inform those charged with governance of the reason for this action.

In certain situations the Chartered Accountant may propose amendments during the course of the engagement. This may be the case where:

- The compiled information does not adequately refer to or describe the applicable financial reporting framework
- Amendments to the compiled financial information are required for it not to be materially misstated
- The compiled financial information is misleading

If management does not permit the changes to be made the Chartered Accountant should withdraw from the engagement, again informing those charged with governance of the reason. If withdrawal is not possible the Chartered Accountant should consider the legal and professional responsibilities applicable.

### SSRS 4410.37

The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled information.

### 1.4.7 Reporting

### SSRS 4410.39

An important purpose of the practitioner's report is to clearly communicate the nature of the compilation engagement and the practitioner's role and responsibilities in the engagement. The practitioner's report is not a vehicle to express an opinion or conclusion on the financial information in any form.

The report must be in writing and must include the following elements:

(a) Title
(b) The addressee
(c) A statement that the Chartered Accountant has compiled the financial information based on information provided by management
(d) A description of the responsibilities of management, or those charged with governance
(e) Identification of the applicable financial reporting framework
(f) Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates
(g) A description of the Chartered Accountant's responsibilities in compiling the financial information, including that the engagement was performed in accordance with SSRS 4410 and that the Chartered Accountant complied with relevant ethical requirements
(h) A description of what a compilation engagement entails
(i) Explanations that:
   - Since a compilation engagement is not an assurance engagement, the Chartered Accountant is not required to verify the accuracy and completeness of the information provided by management
2 Other assurance engagements

2.1 SSAE 3000 (Revised) Assurance Engagements Other than Audits or Reviews of Historical Financial Information

2.1.1 Types of assurance engagement

A client would generally engage a practitioner to undertake an assurance engagement either because the client needs to make use of expertise that the practitioner possesses but the client itself does not, or because it needs a relatively independent third party to provide an independent opinion regarding some specific matter. For example, the client may lack the expertise to carry out a financial due diligence assignment on a potential acquisition, and may therefore engage the practitioner to do this for them.
SSAE 3000 refers to two types of engagement:

- Reasonable assurance engagements, which result in a positive expression of opinion, for example, 'In our opinion, the company has complied, in all material respects, with XYZ law'.

- Limited assurance engagements, which result in a negative form of expression of assurance, for example, 'Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe the company has not complied, in all material respects, with XYZ law'.

The level of assurance given in a limited assurance engagement is therefore lower than that given in a reasonable assurance engagement. These levels of assurance were discussed in Chapter 1. Remember that absolute assurance can never be given on an assurance engagement due to the inherent limitations of such engagements.

Assurance engagements are also classified as either an attestation engagement or a direct engagement. Both reasonable and limited assurance engagements can be either attestation or direct engagements as each assurance engagement is classified in two dimensions.

**KEY TERM**

An **ATTESTATION ENGAGEMENT** is an assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. In an attestation engagement, the practitioner's conclusion addresses whether the subject matter information is free from material misstatement. The practitioner's conclusion may be phrased in terms of:

i. The underlying subject matter and the applicable criteria;  
ii. The subject matter information and the applicable criteria; or  
iii. A statement made by the appropriate party(ies).

A **DIRECT ENGAGEMENT** is an assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report. In a direct engagement, the practitioner's conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria.

(SSAE 3000.12)

SSAE 3000 contains requirements and application and other explanatory material specific to reasonable and limited assurance attestation engagements. The standard allows application to reasonable and limited direct assurance engagements.

An example of an attestation engagement could be a sustainability engagement where the intended user wishes to obtain assurance on a report prepared by management on the sustainability performance of the company. Other examples include the user obtaining assurance on a statement by another party that it has complied with a law or regulation, and obtaining assurance on an evaluation of value for money.

### 2.1.2 Accepting and continuing appointment

Before accepting or continuing an assurance engagement, the engagement partner must be satisfied that the appropriate acceptance and continuance procedures have been followed by the AE. The practitioner needs to consider the relevant ethical requirements and whether the AE has the competence and
capability to carry out the engagement. This is similar to the acceptance of audit engagements you studied in Chapter 5.

The practitioner shall accept or continue an assurance engagement only when:

(a) The practitioner has no reason to believe that relevant ethical requirements, including independence, will not be satisfied;
(b) The practitioner is satisfied that those persons who are to perform the engagement collectively have the appropriate competence and capabilities; and
(c) The basis upon which the engagement is to be performed has been agreed, through:
   (i) Establishing that the preconditions for an assurance engagement are present; and
   (ii) Confirming that there is a common understanding between the practitioner and the engaging party of the terms of the engagement, including the practitioner's reporting responsibilities.

SSAE 3000 states that a practitioner can only accept or continue an engagement where the following preconditions are present:

- Suitable roles and relationships of the appropriate parties (at least a three party relationship involving a practitioner, a responsible party and intended users)
- An appropriate underlying subject matter
- Suitable, available criteria
- Access to sufficient, appropriate evidence
- A rational purpose
- A written assurance report containing the practitioner's conclusion will be produced

The agreed terms of the engagement shall be specified in sufficient detail in an engagement letter or other suitable form of written agreement, written confirmation, or in law or regulation. A new engagement letter or written agreement does not need to be provided for recurring agreements, however, the practitioner must assess whether circumstances require the terms of the engagement to be revised or if there is a need to remind the engaging party of the existing terms of the engagement.

2.1.3 Quality control

Quality control within firms that perform assurance engagements is widely recognised as being in the public interest and an integral part of high-quality assurance engagements. SSAE 3000 prescribes quality control procedures relating to the following:

- Characteristics of the engagement partner
- Assignment of the team
- Responsibilities of the engagement partner
- Engagement quality control review

2.1.4 Planning and performing the engagement

As with audits of historical financial information, the practitioner shall plan and perform an engagement with professional scepticism. The practitioner shall exercise professional judgment in planning and performing an assurance engagement, including determining the nature, timing and extent of procedures.

The practitioner shall plan the engagement so that it will be performed in an effective manner, including setting the scope, timing and direction of the engagement, and determining the nature, timing and extent of planned procedures that are required to be carried out in order to achieve the objective of the practitioner.
Materiality shall be assessed at the planning and performing stage of an assurance engagement, including when determining the nature, timing and extent of procedures.

At this stage of the assurance engagement, the practitioner is required to obtain an understanding of the underlying subject matter and other engagement circumstances. SSAE 3000 shows how the requirement differs for limited and reasonable assurance engagements.

<table>
<thead>
<tr>
<th>SSAE 3000.46-47</th>
<th>Limited Assurance</th>
<th>Reasonable Assurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>The practitioner shall obtain an understanding of the underlying subject matter and other engagement circumstances sufficient to:</td>
<td>The practitioner shall obtain an understanding of the underlying subject matter and other engagement circumstances sufficient to:</td>
<td></td>
</tr>
<tr>
<td>(a) Enable the practitioner to identify areas where a material misstatement of the subject matter information is likely to arise; and</td>
<td>(a) Enable the practitioner to identify and assess the risks of material misstatement in the subject matter information; and</td>
<td></td>
</tr>
<tr>
<td>(b) Thereby, provide a basis for designing and performing procedures to address the areas identified… and to obtain limited assurance to support the practitioner's conclusion.</td>
<td>(b) Thereby, provide a basis for designing and performing procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's conclusion.</td>
<td></td>
</tr>
</tbody>
</table>

In obtaining an understanding of the underlying subject matter and other engagement circumstances… the practitioner shall consider the process used to prepare the subject matter information.

In obtaining an understanding of the underlying subject matter and other engagement circumstances… the practitioner shall obtain an understanding of internal control over the preparation of the subject matter information relevant to the engagement. This includes evaluating the design of those controls relevant to the engagement and determining whether they have been implemented by performing procedures in addition to inquiry of the personnel responsible for the subject matter information.

2.1.5 Obtaining Evidence

Based on the practitioner's understanding of the underlying subject matter and other engagement circumstances, the requirements of the practitioner are as follows.

<table>
<thead>
<tr>
<th>SSAE 3000.48</th>
<th>Limited Assurance</th>
<th>Reasonable Assurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Identify areas where a material misstatement of the subject matter information is likely to arise; and</td>
<td>(a) Identify and assess the risks of material misstatement in the subject matter information; and</td>
<td></td>
</tr>
<tr>
<td>(b) Design and perform procedures to address the areas identified and to obtain limited assurance to support the practitioner's conclusion.</td>
<td>(b) Design and perform procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's conclusion. In addition to any other procedures on the subject matter information that are appropriate in the engagement circumstances, the practitioner's procedures shall include obtaining sufficient appropriate evidence as to the operating effectiveness of relevant controls over the subject matter information when:</td>
<td></td>
</tr>
</tbody>
</table>
Practitioners may decide to use an expert to obtain evidence for an assurance engagement. Practitioners are not expected to have the same degree of skill or expertise as experts, or there would be no point in using them. However, practitioners are supposed to ensure that the expert has the competence, capability and objectivity to do the required work. The procedures are very similar to those for auditor's experts which you studied in Chapter 8. For example, information regarding the competence and capability of the expert could be gained from experience of working with the expert in the past, checking the expert's qualifications, checking whether the expert is a member of a professional body or by observing books or papers published by the expert.

When an expert is used, the practitioner must obtain a sufficient understanding of their field of expertise in order to allow the practitioner to agree the nature, scope and objectives of the expert's work. The practitioner must also evaluate the adequacy of the expert's work for the practitioner's purposes.

The practitioner may also decide to use the work of the internal audit function. If so, the practitioner must evaluate the following:

- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors
- The level of competence of the internal audit function
- Whether the internal audit function applies a systematic and disciplined approach, including quality control
- Whether the work of the internal audit function is adequate for the purposes of the engagement

2.1.6 Written representations

The practitioner shall request from the appropriate party(ies) a written representation:

(a) That it has provided the practitioner with all information of which the appropriate party(ies) is aware that is relevant to the engagement.

(b) Confirming the measurement or evaluation of the underlying subject matter against the applicable criteria, including that all relevant matters are reflected in the subject matter information.

The practitioner may also request written representations to support other evidence relevant to the subject matter information but, as with an audit of financial statements, they do not form sufficient appropriate audit evidence on their own. Written representations must be dated as near as practicable, but not after, the date of the auditor's report.

2.1.7 Subsequent events

When relevant to the engagement, the practitioner shall consider the effect on the subject matter information and on the assurance report of events up to the date of the assurance report, and shall respond appropriately to facts that become known to the practitioner after the date of the assurance report, that, had they been known to the practitioner at that date, may have caused the practitioner to amend the assurance report.
The extent of consideration of subsequent events depends on the potential for such events to affect the subject matter information and to affect the appropriateness of the practitioner’s conclusion. However, the practitioner has no responsibility to perform any procedures regarding the subject matter information after the date of the assurance report.

2.1.8 Other information

When documents containing the subject matter information and the assurance report thereon include other information, the practitioner shall read that other information to identify material inconsistencies, if any, with the subject matter information or the assurance report and, if on reading that other information, the practitioner:

(a) Identifies a material inconsistency between that other information and the subject matter information or the assurance report; or

(b) Becomes aware of a material misstatement of fact in that other information that is unrelated to matters appearing in the subject matter information or the assurance report,

the practitioner shall discuss the matter with the appropriate party(ies) and take further action as appropriate.

2.1.9 Forming a conclusion

The practitioner must evaluate the sufficiency and appropriateness of the evidence obtained. You should be aware of the meaning of sufficient and appropriate evidence from Chapter 8.

The practitioner must form a conclusion about whether the subject matter information is free from material misstatement. If the practitioner is unable to obtain sufficient appropriate evidence, a scope limitation exists and the practitioner shall express a qualified conclusion, disclaim a conclusion, or withdraw from the engagement, where withdrawal is possible under applicable law or regulation, as appropriate.

2.1.10 Reporting

The assurance report will include as a minimum the following:

(a) A title that clearly indicates that the report is an independent assurance report

(b) An addressee

(c) An identification or description of the level of assurance obtained by the practitioner, the subject matter information and, when appropriate, the underlying subject matter

(d) Identification of the applicable criteria

(e) A description of any significant, inherent limitation associated with the evaluation or measurement of the underlying subject matter against the applicable criteria

(f) When the applicable criteria are designed for a specific purpose, a statement alerting readers to this fact and that, as a result, the subject matter information may not be suitable for another purpose

(g) A statement to identify the responsible party and to describe the responsible party’s and practitioner’s responsibilities

(h) A statement that the engagement was performed in accordance with SSAE 3000

(i) A statement that the firm of which the practitioner is a member applies SSQC 1, or other professional requirements, or requirements in law or regulation, that are at least as demanding as SSQC 1
(j) A statement that the practitioner complies with the independence and other ethical requirements of the ACRA Code, or other professional requirements, or requirements imposed by law or regulation, that are at least as demanding as the ACRA Code related to assurance engagements

(k) An informative summary of the work performed

(l) The practitioner's conclusion

(m) The practitioner's signature

(n) The assurance report date

(o) The location of the practitioner

The report can only be signed by a public accountant where a public accountant is a person registered or deemed to be registered in accordance with the Accountants Act (Chapter 2) as a Public Accountant. This is the signing convention for all Singapore Standards on Assurance Engagements (SSAEs) including SSAE 3420 which we will look at later in this chapter.

### 2.2 Due diligence

**Example: Assurance engagement**

An example of an assurance engagement is a 'due diligence' engagement.

**KEY TERM**

**Due diligence** is a specific type of assurance engagement. A typical due diligence engagement is where an advisor (often an AE) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts and that the perceived business opportunities are in fact real. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers.

Although many of the techniques used in a due diligence assignment are similar to those used in an audit, a due diligence assignment differs from an audit in a number of ways. The scope of the work is normally determined by agreement between the parties and confirmed in an engagement letter rather than by statute and will be more varied depending on the circumstances. It will concentrate on aspects specific to an individual transaction or respond to the needs of a particular user group. Although information used to form the basis of the engagement may be historical, the focus of the work will generally be with respect to the future. It may include some or all of the following aspects:

- Financial due diligence (scrutiny of the financial position and obligations of a target company to identify and report such matters as covenants and contingent obligations)

  The practitioner will normally scrutinise the following:

  - Financial statements
  - Management accounts
  - Projections
  - Assumptions
  - Operating data
  - Working capital analysis
  - Major contracts by product line
  - Actual and potential liabilities
  - Debt and lease agreements
PART E OTHER ASSIGNMENTS  |  13: Review engagements, audit-related services and other assurance services

- Litigation
- Banking facilities and covenants
- Property and other capital commitments

- Operational and IT due diligence (extent of operational and IT risks, including quality of systems, associated with a target business and possible improvements which might be made)
  The practitioner may consider the following:
  - Business relationships
  - Potential risk areas
  - Growth areas
  - Procurement costs and possible savings
  - Supplier networks
  - Use of assets
  - IT security
  - IT compatibility and possible synergies
  - IT skills
  - Business continuity plan/Disaster recovery plan

- People (or HR) due diligence (key staff positions under the new structure, contract termination costs and costs of integration)
  The practitioner may consider the following:
  - Employment contracts
  - Personnel files
  - Training
  - Costs of redundancies/cost savings

- Regulatory due diligence (scrutiny of the target company's level of compliance with relevant regulation). The practitioner may review the following:
  - Company documents evidencing compliance with relevant laws and regulations

  Regulatory due diligence may also involve placing reliance on lawyers (often referred to as legal due diligence).

- Environmental due diligence (environmental, health and safety and social issues in a target)
  The practitioner may consider the following:
  - Environmental legislation affecting the target company
  - Environmental policies and statements
  - Health and safety record
  - Social policy statements

- Tax due diligence (assessment of the tax risks and benefits of the target company)
  The practitioner may consider the following:
  - Liquidation method
  - Previous tax filling and computations
  - Correspondence with tax authorities and tax accountants
  - Information regarding tax warranties
  - Details of sales and social tax arrangements
  - Transfer pricing and withholding tax issues
  - Any international cross-border tax issues
2.3 References for a client

Sometimes a practitioner will be asked for a reference concerning a client, particularly in relation to their ability to service a loan. Where no additional work is required to provide a reference, the following matters should be considered:

- Inherent uncertainty of future income and expenditure
- The difficulty of reporting on present solvency (given that the audit is a historic exercise. Such information might be available if a separate engagement was made)
- The possibility of a duty of care arising
- That clarification might be required (there has been no engagement and no fees, and that liability might have to be expressly disclaimed)

However, the practitioner might be able to provide certain information without difficulty:

- The length of time they have acted for the client
- The results declared to the taxation authorities over past years
- A statement of a level of limited assurance with a negative form of expression given past performance

Where it is necessary to create a separate engagement in order to provide the relevant information, the practitioner should consider the guidance in SSAE 3000, discussed above.

2.4 Financial information included in a prospectus

SSAE 3420 Assurance Engagements to Report on the Compilation of Proforma Financial Information Included in a Prospectus was issued in May 2013.

The key points made by the standard are as follows:

- Assurance engagements to report on the compilation of the proforma financial information give reasonable assurance that the applicable criteria used by the responsible party in the compilation of the proforma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction.

- Proforma financial information is defined as financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of illustration. This is achieved by applying proforma adjustments to the unadjusted financial information.

- The Chartered Accountant's sole responsibility is to report on whether the proforma financial information has been compiled in all material respects by the responsible party on the basis of applicable criteria. The Chartered Accountant has no responsibility to compile the proforma information. In this way, SSAE 3420 differs from SSRS 4410 which covers where the Chartered Accountant assists management in the preparation and presentation of financial information for various situations including a prospectus.

- The Chartered Accountant must perform procedures to assess whether the applicable criteria used in the compilation of the proforma information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction. The work must also involve an evaluation of the overall presentation of the proforma financial information.
The standard prescribes the wording of the opinion although it allows two alternative forms:

– The proforma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

– The proforma financial information has been properly compiled on the basis stated.

SAP 2 (Revised) Auditors and Public Offering Documents provides guidance on the general principles governing engagements in the context of public offering documents. In addition to offers of listed shares, this SAP also applies to offers of securities that require a prospectus under the Securities and Futures Act. SAP 2 establishes generic matters of principle rather than details of statutory, regulatory and stock exchange requirements.

SECTION SUMMARY
Assurance engagements may give reasonable assurance or limited assurance.

3 Risk assessments

SECTION INTRODUCTION
Risk assessment is important to investors and managers and therefore is an important area for assurance services.

We discussed business risk earlier in this Textbook. It has three elements: financial, operational and compliance. There are a number of specific risks within these elements, some of which are shown in the diagram below.

![BUSINESS RISK Diagram]

3.1 Need for assurance
Why is there a need for assurance in relation to risk assessment? For what reason would people want an independent opinion that gives them assurance? What criteria should this assurance be in relation to?

The key answer to the first question is that the risk that the company enters into has a direct impact on the risk of the investment that anyone purchasing shares in a company or loaning money to a company is
making. For example the recent world-wide financial crash has been attributed to excessive risk-taking by the banking sector.

Interested stakeholders, particularly investors, need assurance that the risk taken by the company, in effect with their investment, is acceptable to them and that the returns that they receive are in accordance with that level of risk.

It is this need for assurance about the risks the company enters into that has led to the importance of the issue of corporate governance and internal control effectiveness that we looked at earlier and will continue to look at in Chapter 15 in the context of internal audit.

Other stakeholders will also be interested in the effectiveness of risk management in a company. Examples are lenders and employees. This is because the ultimate risk is that a company might fail.

3.2 Possible assurance criteria

The criteria by which risk assessment is evaluated will depend on the specific needs of the company and the user. However, some possibilities are:

- Corporate governance guidelines
- Management's policy on risk management

There are no universally recognised criteria suitable for evaluating the effectiveness of an entity's risk evaluation. Assurance is likely to be limited to whether evaluation is carried out, rather than the quality of the evaluation.

3.3 Responsibility for risk assessment

There are three sets of people who can be involved in risk assessment in a company:

- Directors/management
- Internal audit
- External audit

We shall discuss the role of the internal audit function in Chapter 15. The responsibility of the directors was discussed earlier in Chapter 3, and the role of the external auditor in risk assessment has been discussed in Chapter 7.

It is vital that you distinguish between the risk assessment carried out by the auditors and the directors. The directors are responsible for assessing and then managing the risks arising to the business, that is, the business risks.

As part of their audit, the auditors assess audit risk. Audit risk is the risk that the auditors make an inappropriate opinion on the financial statements. The auditors may consider business risk as part of their audit risk assessment. However, the auditors are not responsible for risk management of their clients.

3.4 Communication

SSA 260 (Revised) Communication with Those Charged with Governance requires the auditor to communicate significant findings from the audit. Significant findings include business conditions affecting the entity, and business plans and strategies that may affect the risk of material misstatement. SSA 265 Communicating Deficiencies in Internal Control to those Charged with Governance and Management also requires effective communication. Significant deficiencies in internal control identified during the audit must be communicated in writing to those charged with governance and management at an appropriate level of responsibility (unless it would be inappropriate to communicate directly to management). Other deficiencies that have not been communicated to management by other parties but which merit management's attention should also be communicated.

SSA 260 and SSA 265 are covered in more detail in Chapter 16.
3.5 Assessing risk

Methods of identifying risk were outlined in Chapter 7. You should be familiar with methods such as SWOT or PEST analysis. In practice, risk identification is likely to be done in all the various departments of a business.

These risks could include, for example:

- Contractual risks (important customers not agreeing to given contractual terms)
- Operational risks (scarce raw materials, risks arising through storage and use)
- Physical risks (for example, health and safety compliance)
- Product distribution (logistics, networks, outlets)
- Regulation (different jurisdictions, internet trading)
- Reputation (brands and staff profile)

The directors of a company need to determine guidelines for assessing risk. Risk might be assessed in terms of

- Impact
- Likelihood

Mathematical methods could be used to assess risk, for instance using probability factors. Risks can be analysed using a grid such as the example given:

<table>
<thead>
<tr>
<th>Low likelihood</th>
<th>Low likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low impact</td>
<td>High impact</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>High likelihood</th>
<th>High likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low impact</td>
<td>High impact</td>
</tr>
</tbody>
</table>

3.6 Responses to risk

There are several responses that management take to risk:

- Accept risk (particularly if it is low likelihood, low impact)
- Mitigate risk (by setting up a system of internal control to prevent the risk arising)
- Avoid risk (by not entering that market or not accepting certain contracts)
- Transfer risk (by taking out insurance)

If management choose to accept risk, they must set risk thresholds, that is, determine levels of risk where they will stop accepting risk and choose one of the other strategies. These thresholds are important because if directors or management are reckless with regard to risk they may be breaching their fiduciary duties.

3.7 Assurance

As stated above, assurance services may be provided. These may relate to the reliability of systems of internal control, which is important both for the financial statements and for the general running of the business. Assurance services could also relate to performance management.

SECTION SUMMARY

Management is responsible for the assessment and management of risk. The auditor must communicate significant business risk factors identified during the audit to those charged with governance.
4 Combined assurance

SECTION INTRODUCTION
A combined assurance model provides a co-ordinated approach to assurance.

KEY TERM
COMBINED ASSURANCE – Integrating and aligning processes in a company to maximise risk and governance oversight and control efficiencies, and optimise overall assurance to the audit and risk committee, considering the company’s risk appetite. (King III)

4.1 Concept
The concept of ‘combined assurance’ stems from the King Code and Report on Governance in South Africa (King III).

As explained in the Deloitte White Paper Combined Assurance: Taking corporations to the next level of maturity issued in November 2011, assurance providers are both internal and external people who provide managers with information about the risks (hazards and opportunities) within an entity. They provide information about the steps which are being taken to prevent the hazards and exploit the opportunities. The problem can be the volume of information which is created much of which is duplicated and overlaps. The adoption of the ‘combined assurance’ approach clarifies what assurance is provided and by whom within an organisation. It also facilitates an assessment of the adequacy of the assurance provided. According to King III it should seek to:

- Maximise risk and governance
- Maximise control efficiencies
- Optimise overall assurance to the audit and risk committee

4.2 Combined assurance model
The Deloitte White Paper describes the process as requiring the identification of all assurances and the mapping of these to the key risks facing the organisation. This process can be summarised as follows:

<table>
<thead>
<tr>
<th>Management assurance</th>
<th>Strategy</th>
<th>Operations</th>
<th>Finance and treasury</th>
<th>Information technology</th>
<th>Human resources</th>
<th>Product development</th>
<th>Sales</th>
<th>Supply chain/Distribution production</th>
</tr>
</thead>
</table>
### Internal assurance
- Risk management
- Legal and compliance
- Internal audit
- Company secretary
- Health and safety
- Other

### External assurance
- External audit
- Sustainability
- Actuarial
- Project management
- Process improvement
- Other

As a result gaps and overlaps can be identified and addressed. The Deloitte White Paper on Combined Assurance indicates that the audit committee would be responsible for ensuring that a combined assurance approach is adopted although the internal audit function will also be heavily involved.

### SECTION SUMMARY

Combined assurance integrates management assurance, internal assurance and external assurance to manage risk and maximise business opportunities.
Chapter Roundup

**Audit-related services and other assurance services**

- **Review Engagements**
  - Historical financial statements
    - Limited assurance
      - SSRE 2400
        - Inquiry and analytical procedures
          - Performed by Chartered Accountant who is not the auditor of FS
  - Interim financial information statements
    - Limited assurance
      - SSRE 2410
        - Inquiry and analytical procedures
        - Performed by the auditor of FS

- **Related Services**
  - Agreed-upon procedures
    - SSRS 4400
  - Compilation engagement
    - SSRS 4410
  - No assurance: A report on factual findings
    - SSRE 2410
  - Assistance with preparation of financial information
    - SSRS 3000
    - Reasonable assurance: eg. audit
    - Limited assurance
    - Financial information included in a prospectus
    - SSAE 3420
    - Reasonable assurance
  - Agreement-upon procedures
  - SSRE 2410
  - Inquiry and analytical procedures

- **Assurance Engagements**
  - Financial information included in a prospectus
    - SSAE 3420
  - SSRS 3000
  - Reasonable assurance
  - Limited assurance
  - Inquiries and analytical procedures
  - Performance by the auditor of FS
    - SSRS 4410
  - Preparations for financial information
  - Agreed-upon procedures
  - Compilations engagement
  - Financial statements
  - Historical financial statements
  - Interim financial statements

Risk assessment
Quick Quiz

1 Name the two types of engagement which comprise audit-related services.
   (1) ..........................................
   (2) ..........................................

2 Link the assurance engagement with its description.
   Assurance engagement:
   (a) Attestation engagement
   (b) Direct engagement
   Descriptions:
   (i) An assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria.
   (ii) An assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report.

3 In an assurance engagement, the responsible party can also be an intended user.
   A Never
   B If there is more than one intended user
   C If there are more than ten intended users
   D In exceptional circumstances

4 When carrying out an assurance engagement the practitioner must assess the appropriateness of the subject matter and the criteria.
   True [ ]
   False [ ]

5 The assurance report should be in writing.
   True [ ]
   False [ ]
Answers to Quick Quiz

1. (1) Agreed-upon procedures assignments
   (2) Compilation engagements

2. (a)(i)
   (b)(ii)

3. B

4. True

5. True
Forecasts and projections such as budgets, estimates, offers to sell, other predictions of future income and expenses are all examples of prospective financial information (PFI). Reporting on PFI is covered by SSAE 3400 The Examination of Prospective Financial Information. Forecasts and projections are of significant interest to users of financial information and this is an area in which auditors can provide an alternative service to audit, in the form of a review or assurance engagement. This chapter looks at the factors that should be considered by the auditor during a PFI engagement.

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**ESSENTIAL READING**

- SSAE (Singapore Standard on Assurance Engagements) 3400 *The Examination of Prospective Financial Information*

1 Reporting on prospective financial information

**SECTION INTRODUCTION**

Prospective financial information is, by nature, based on estimates and assumptions.

**KEY TERM**

**PROSPECTIVE FINANCIAL INFORMATION (PFI)** is information based on assumptions about events that may occur in the future and possible actions by an entity. (SSAE 3400.3)

Providing assurance on estimates and assumptions of potential future events and information creates a very different challenge to reporting on historical financial information. Guidance is provided in SSAE 3400 *The Examination of Prospective Financial Information*. The key areas relating to projections that this chapter will focus on are:

- Capital expenditure
- Profit forecasts
- Cash flow forecast or projections
Examples of situations where PFI may be prepared include the following:

- As an internal management tool, for example to assist in the evaluation of a possible capital investment
- As a prospectus distributed to potential investors with information about future expectations
- As an annual report to provide information to shareholders, regulatory bodies and other interested parties
- As a document for the information of lenders, for example, a cash flow forecast

In addition to SSAE 3400, prospectuses are discussed in SSAE 3420 and SSRS 4410.

In SSAE 3420 Assurance Engagements to Report on the Compilation of Proforma Financial Information Included in a Prospectus, the Chartered Accountant is not required to provide assurance on future events as with SSAE 3400. In both SSAE 3420 and SSAE 3400, the information is provided by management. This contrasts to SSRS 4410 Compilation Engagements which covers situations where the Chartered Accountant assists in the preparation and presentation of information for the prospectus and no opinion is given.

1.1 Principles of prospective financial information

The key principles of PFI are that it should be understandable, relevant, reliable and comparable. Due to the use of estimates and assumptions there are specific issues relating to these principles, as discussed in the table below.

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<th>Principle</th>
<th>Issue arising</th>
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<tr>
<td>Understandable</td>
<td>Disclosure is required of sources of uncertainty, assumptions made, determining factors that will affect whether the assumptions will be borne out, and alternative outcomes.</td>
</tr>
<tr>
<td>Relevant</td>
<td>No PFI-specific issues arise other than the need for the information to be relevant to the decision making of investors or other users of the information.</td>
</tr>
<tr>
<td>Reliable</td>
<td>The reliability of PFI cannot be confirmed by evidence of past transactions or events. Its reliability depends on it being supported by analysis of the entity’s business, strategies and plans.</td>
</tr>
<tr>
<td>Comparable</td>
<td>The PFI should be capable of comparison with eventual outcomes in the form of historical financial information. The accounting policies used in its preparation should also be disclosed.</td>
</tr>
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</table>

1.2 Types of prospective financial information

PFI can be of two types (or a combination of both):

**KEY TERMS**

**FORECAST** – PFI based on assumptions as to future events which management expects to take place and the actions management expects to take (best-estimate assumptions).

(SSAE 3400.4)

**PROJECTION** – PFI based on hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations, or a mixture of best-estimate and hypothetical assumptions. Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a ‘what-if’ scenario).

(SSAE 3400.5)
2 Accepting an engagement

2.1 General considerations

The SSAE gives the following guidance about accepting an engagement to examine PFI.

**SSAE 3400.11**
The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

**SSAE 3400.12**
The auditor and the client should agree on the terms of the engagement.

The SSAE also lists the following factors which the auditor should consider:

- The intended use of the information
- Whether the information will be for general or limited distribution
- The nature of the assumptions, that is, whether they are best estimate or hypothetical assumptions (hypothetical assumptions are based on events that may not take place, eg ‘if the entity does x, then y may follow’)
- The elements to be included in the information
- The period covered by the information

It also states that the auditor should have sufficient knowledge of the company to be able to evaluate the significant assumptions made.

An AE must also consider practical matters, such as the time available to them, the experience of the staff member compiling the information, any limitations on their work, and the degree of secrecy required beyond the normal duty of confidentiality.

**SECTION SUMMARY**
The auditor should withdraw from the engagement if the assumptions made to put together the PFI are unrealistic.
3 Procedures

SECTION INTRODUCTION
Procedures could include:
- Analytical procedures (against similar historical projects)
- Verification of projected expenditure to quotes or estimates

3.1 General procedures
General procedures will largely consist of analytical procedures. In carrying out their procedures, the general matters to which Chartered Accountants should direct their attention are:

- The nature and background of the company's business
- The accounting policies normally followed by the company
- The assumptions on which the forecast is based
- The procedures followed by the company in preparing the forecast

3.1.1 The nature and background of the company's business
The auditor will review the company's character and recent history, with reference to such matters as the nature of its activities and its main products, markets, customers, suppliers, divisions, locations, and trend of results.

3.1.2 The accounting policies normally followed by the company
The auditor will wish to establish the accounting policies normally followed by the company and ensure that they have been consistently applied in the preparation of forecasts.

3.1.3 The assumptions on which the forecast is based
The auditor will need to consider the methods used to develop and apply assumptions. The auditor will obtain sufficient appropriate evidence as to whether management's best-estimate assumptions are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information.

3.1.4 The procedures followed by the company in preparing the forecast
In carrying out their review of the accounting bases and calculations for forecasts, and the procedures followed by the company for preparing them, the main points which the auditor will wish to consider include the following:

(a) Whether the forecast under review is based on forecasts regularly prepared for the purpose of management, or whether it has been separately and specially prepared for the specific purpose.

(b) Where forecasts are regularly prepared for management purposes, the degree of accuracy and reliability previously achieved, and the frequency and thoroughness with which estimates are revised.

(c) Whether the forecast under review represents the management's best estimate of results which they reasonably believe can and will be achieved rather than targets which the management have set as desirable.

(d) The extent to which forecast results for expired periods are supported by reliable interim financial information.
(e) The details of the procedures followed to generate the forecast and the extent to which it is built up from detailed forecasts of activity and cash flow.

(f) The extent to which profits are derived from activities having a proven and consistent trend and those of a more irregular, volatile or unproven nature.

(g) How the forecast takes account of any material extraordinary items and prior year adjustments, their nature, and how they are presented.

(h) Whether adequate provision is made for foreseeable losses and contingencies and how the forecast takes account of factors which may cause it to be subject to a high degree of risk, or which may invalidate the assumptions.

(i) Whether working capital appears adequate for requirements (normally this would require the availability of properly prepared cash flow forecast or projections) and where short-term or long-term finance is to be relied on, whether the necessary arrangements have been made and confirmed.

(j) The arithmetical accuracy of the forecast and the supporting information and whether forecast statements of financial position and statements of cash flows have been prepared (as these help to highlight arithmetical inaccuracies and inconsistent assumptions).

SSAE 3400.17

When determining the nature, timing and extent of examination procedures, the auditor's considerations should include:

(a) The likelihood of material misstatement;

(b) The knowledge obtained during any previous engagement;

(c) Management's competence regarding the preparation of prospective financial information;

(d) The extent to which the prospective financial information is affected by the management's judgment;

(e) The adequacy and the reliability of the underlying data.

SSAE 3400.22

The SSAE goes on to say that the auditor should seek appropriate evidence on those areas which are particularly sensitive to variation and have a material effect on the information.

3.2 Specific matters

In addition to the general procedures discussed in Section 3.1 above, the list of procedures below may also be relevant when assessing prospective financial information.

**Profit forecasts**

- Verify projected income figures to suitable evidence. This may involve:
  - Review of current market prices for that product or service
- Verify projected expenditure figures to suitable evidence. There is likely to be more evidence available about expenditure in the form of:
  - Quotations or estimates obtained by the company
  - Current bills for things such as services which can be used to reliably estimate
  - Market rate prices, for example, for advertising
  - Interest rate assumptions can be compared to the bank's current rates
  - Costs such as depreciation should correspond with relevant capital expenditure projections
Capital expenditure
The auditor should check the capital expenditure for reasonableness.
- Projected costs should be verified to estimates and quotations where possible.
- The projections can be reviewed for reasonableness, including a comparison with prevailing market rates where such information is available (such as for property).

Cash flow forecast or projections
- The auditor should review cash flow forecast or projections to ensure the timings involved are reasonable.
- The auditor should check the cash flow forecast or projection for consistency with any profit forecasts (income/expenditure should be the same, just at different times).
- If there is no comparable profit forecast, the income and expenditure items should be verified.

Working capital
- Confirm sources of short-term and long-term finance to evidence from external finance providers.
- Compare the reasonableness of available finance to cash flow forecast or projections.
- Assess the reasonableness of projected working capital ratios such as trade receivables days and the assumptions made in calculating these.
- Compare working capital projections to historical trends to assess reasonableness.

SECTION SUMMARY
The auditor must assess the source and reliability of the evidence supporting management's best estimate assumptions. Such evidence may be from internal and external sources.

4 Expressing an opinion

SECTION INTRODUCTION
Due to the nature of prospective financial information an auditor can provide less assurance than in an audit of historical information.

4.1 Level of assurance
It is clear that as prospective financial information is subjective information, it is impossible for an auditor to give the same level of assurance regarding it as on historic financial information. It is therefore a limited assurance engagement.

The SSAE suggests that the auditor express an opinion including:
- A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information
- An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and the relevant reporting framework
- Appropriate caveats as to the achievability of the forecasts
The concept of limited assurance was introduced in Chapter 13. Limited assurance has a negative form of expression. The term ‘negative assurance’ is used to describe limited assurance with a negative form of expression.

4.2 Reports under SSAE 3400

SSAE 3400 sets out the content of a report on PFI. As you learnt in the previous chapter, all SSAE reports must be signed by a public accountant.

SSAE 3400.27
The report by an auditor on an examination of prospective financial information should contain the following:

(a) Title
(b) Addressee
(c) Identification of the prospective financial information
(d) A reference to the SSAE or practices applicable to the examination of prospective financial information
(e) A statement that management is responsible for the prospective financial information including the assumptions on which it is based
(f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information
(g) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information
(h) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework
(i) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information
(j) Date of the report which should be the date procedures have been completed
(k) Auditor’s address
(l) Signature

SSAE 3400.31
When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate.

SSAE 3400.32
When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information or withdraw from the engagement.

4.2.1 Comparison with audit-related services reports

The key point to note is that only limited assurance with a negative form of expression can be provided regarding the assumptions used as the basis for the prospective financial information. This level of assurance is also given on review assignments conducted in accordance with SSRE 2400 Engagements to Review Historical Financial Statements (see Chapter 13).
Question 14.1

A new client of your practice has recently been made redundant. The client is considering setting up a residential home for elderly people since there is an increasing need for this service with an ageing population (more people are living to an older age). The client plans to buy and convert a large house into a retirement home. Each resident will have a bedroom, there will be a communal sitting-room and all meals will be provided in a dining-room. It is not intended to provide long-term nursing care.

The large house is in a poor state of repair, and will require considerable structural alterations (building work), and repairs to make it suitable for a retirement home. The following will also be required:

- New furnishings (carpets, beds, wardrobes and so on for the residents’ rooms; carpets and furniture for the sitting-room and dining-room)
- Decoration of the whole house (painting the woodwork and covering the walls with wallpaper)
- Equipment (for the kitchen and for helping disabled residents)

The client proposes to work full-time in the business with a close relative. The residential home is expected to be available for residents six months after the purchase of the house. The client has already obtained some estimates of the conversion costs, and information on the income and expected running costs of the home.

The client has received about $300,000 as a redundancy payment. It is expected that about $3,000,000 will be received from the sale of the client’s own house (after repaying the outstanding loan on it). The owners of the house the client proposes to buy are asking $5,000,000 for it, and the client expects to spend $500,000 on conversion of the house (building work, furnishing, decorations and equipment).

The client has prepared a draft capital expenditure forecast, a profit forecast and a cash flow forecast or projection and has asked you to check these before submission to the bank, in order to obtain finance for the retirement home.

Required

Describe the procedures you would carry out on:

(a) The capital expenditure forecast
(b) The profit forecast
(c) The cash flow forecast or projection
Question 14.2

Serangoon Plumbing Supplies Pte Ltd (‘Serangoon’) is a wholly owned subsidiary company of Lucknow Builders Merchants Pte Ltd (‘Lucknow’) and has been trading at a loss for a number of years. The recent bleak economic climate has led the directors of Lucknow to decide to put Serangoon into liquidation and make all the employees redundant, including its three directors.

The three directors of Serangoon have decided to form a new company, Pluto Plumbing Supplies Pte Ltd (‘Pluto’), and use their redundancy pay and personal savings to purchase all the shares in the company.

The board of directors of Lucknow have agreed to sell the following assets and liabilities of Serangoon to the new company:

(a) All the non-current assets except for one warehouse (see below)
(b) Trading inventory
(c) Trade receivables and payables

The price for the non-current assets has been agreed and the value of the trading inventory, receivables and payables, will be confirmed at the date of transfer by an independent valuer.

The directors of Pluto propose to obtain additional finance in the form of a long-term loan from a merchant bank and working capital will be financed by a bank overdraft from their existing bankers.

The directors have asked you to review the profit forecast and cash flow forecast or projection for submission to the two banks. They have provided you with copies of the detailed financial statements of Serangoon for the past five years, and they point out the following changes which, in their opinion, will enable the new company to trade at a profit.

(a) The substantial management charge imposed by Lucknow will disappear. However, additional costs will have to be incurred for services which were provided by the parent company, such as maintaining the accounting records and servicing the company’s vehicles.
(b) Initially fewer staff will be employed.
(c) Only one of the company’s two premises is being taken over – the premises (warehouses) which are not being taken over will be sold by Lucknow on the open market.

The directors have provided you with the following brief details of Serangoon’s business. It currently has a revenue of about $1 million and is a wholesaler of plumbing equipment (copper pipes, pipe connections, water taps etc) which are sold mainly on credit to plumbers and builders. Trade discounts are given to larger customers. There are some cash sales to smaller customers, but these represent no more than 10% of total sales.

Required

Describe the work you would perform to:

(a) Verify that the value of items included in the profit forecast is reasonable
(b) Verify that the value of items included in the cash flow forecast or projection is reasonable

SECTION SUMMARY

The auditor provides a statement of limited assurance with a negative form of expression as to whether the assumptions used to prepare the PFI are reasonable.
Chapter Roundup

Prospective Financial Information

Principles
- Understandable
- Relevant
- Reliable
- Comparable

Types
Forecast or projection

Procedures
Pay attention to:
- Nature and background of the company's business
- Accounting policies
- Assumptions
- Procedures followed by the company

Opinion
Negative assurance
Report content given in SSAE 3400
Quick Quiz

1. Complete the definition.
   A …………………… means PFI prepared on the basis of ………………… as to …………………
   events which management expects to take place and …………………… management expects to take as
   of the …………………… the …………………… is ……………………. .

2. Complete the matters an auditor should consider when undertaking a PFI engagement.
   - The intended …………………… of the information
   - Whether the information will be general or limited ……………………
   - The nature of the ……………………
   - The …………………… to be included in the information
   - The …………………… to be covered by the information

3. Identify whether the following procedures are relevant to profit forecasts, capital expenditure forecasts or
   cash flow forecast or projections.
   - Ensure the timings are reasonable
   - Projected costs should be verified to estimates and quotations
   - Analytical review on income (based on comparable projects)
   - Review for reasonableness
   - Review for consistency with profit forecast

4. Complete the definition.
   …………………… …………………… is limited assurance with a negative form of ……………………. .

5. Auditors are responsible for the PFI they are giving an opinion on.
   True  □
   False □
Answers to Quick Quiz

1. Forecast, assumptions, future, actions, date, information, prepared.

2. Use, distribution, assumptions, elements, period.

3. • Ensure the timings are reasonable
   • Projected costs should be verified to estimates and quotations
   • Analytical review on income (based on comparable projects)
   • Review for reasonableness
   • Review for consistency with profit forecast

   Cash
   P/CapEx
   P
   P/CapEx/Cash
   CapEx/Cash

4. Negative assurance, expression.

5. False
Answers to Questions

14.1 Prospective financial information

All three of the forecasts to be reviewed should be prepared on a monthly basis and the following work would be required in order to consider their reasonableness.

(a) Capital expenditure forecast

(i) Read estate agent’s and solicitors’ detail correspondence and compare to the capital expenditure forecast to ensure that all expenditure (including sale price, surveyors’ fees, legal costs, taxes on purchase) is included

(ii) Confirm the estimated cost of new furnishings by agreeing them to supplier price lists or quotations

(iii) Verify any discounts assumed in the forecast are correct by agreeing them to supplier agreements or correspondence

(iv) Confirm projected building and decoration costs to the relevant suppliers’ quotation

(v) Confirm the projected cost of specialist equipment (and relevant bulk discounts) to suppliers’ price lists or websites

(vi) In the light of experience of other such ventures, consider whether the forecast includes all relevant costs

(b) Profit forecast

As a first step it will be necessary to recognise that the residential home will not be able to generate any income until the bulk of the capital expenditure has been incurred in order to make the home ‘habitable’. However, whilst no income can be anticipated, the business will have started to incur expenditure in the form of loan interest, property tax and insurance.

The only income from the new building will be rent receivable from residents. The rentals which the client is proposing to charge should be assessed for reasonableness in the light of rental charged to similar homes in the same area. In projecting income it would be necessary to anticipate that it is likely to take some time before the home is fully occupied and it would be prudent to allow for some periods where vacancies arise because of the ‘loss’ of some of the established residents.

The expenditure of the business is likely to include the following.

(i) **Wages and salaries.** Although the client and the close relative intend to work full-time in the business, they will undoubtedly need to employ additional staff to care for residents, cook, clean and tend to the garden. The numbers of staff and the rates of pay should be compared to similar local businesses of which the AE has knowledge.

(ii) **Property tax.** The estimate of the likely cost of these can be confirmed with IRAS.

(iii) **Food.** The estimate of the expenditure for food should be based on the projected levels of staff and residents, with some provision for wastage.

(iv) **Heat and light.** The estimates for heat, light and cooking facilities should be compared to similar clients' actual bills.

(v) **Insurance.** This cost should be verified to quotes from the insurance broker.

(vi) **Advertising.** The costs of newspaper and brochure advertising costs should be checked against quotes obtained by the client.

(vii) **Repairs and renewals.** Adequate provision should be made for replacement of linen, crockery and such like and maintenance of the property.
(viii) **Depreciation.** The depreciation charge should be recalculated with reference to the capital costs involved being charged to the capital expenditure forecast.

(ix) **Loan interest and bank charges.** These should be checked against the bank's current rates and the amount of the principal agreed to the cash flow forecast or projection.

(c) **Cash flow forecast or projection**

(i) Check that the timing of the capital expenditure on the cash flow forecast or projection is consistent with that shown on the capital expenditure forecast.

(ii) Compare the cash flow forecast or projection to the details within the profit forecast to ensure they tie up, for example:

- Income from residents would normally be receivable weekly/monthly in advance.
- The majority of expenditure for wages etc would be payable in the month in which it is incurred.
- Payments to the major utilities (gas, electricity, telephone) will normally be payable monthly, as will the bank charges.
- Property tax is normally paid monthly.
- Insurance premiums will normally be paid annually in advance.

(iii) Redo the additions on the cash flow forecast or projection and check that figures that appear on other forecasts are carried over correctly.

14.2 **More prospective financial information**

(a) **Verification of items in the profit forecast**

The main items appearing in the profit forecast and the required work in relation to them would be as follows:

(i) The budgeted sales income should be considered against that which has actually been achieved in recent years. If the new management is forecasting any increase in the level of sales, the justification for this must be carefully reviewed. Tests should be made to ensure that all expenditure directly related to income is properly accounted for. Confirmation should be sought that the projected income takes proper account of the trade discounts that it is assumed will have to be granted.

(ii) The major form of expenditure is likely to be the purchase of goods for resale. Enquiry should be made as to whether suppliers will continue to grant the new company the same level of trade discounts as the old company and also whether the volume of purchases is such that a similar mark-up will be attained. Management explanations should be sought for any material differences in the anticipated gross profit rate, such explanations being fully investigated as to their plausibility.

(iii) The wages and salaries payable by the new company should be checked by asking management how many people they intend to employ and at what rates. The reasonableness of the projected charge for wages and salaries should be assessed by comparison with the figure for wages and salaries most recently paid by the old company.

(iv) All other major items of expenditure included in the profit forecast (i.e., selling expenses, finance expenses, and administration expenses) should be considered by comparison with the figures of the old company in previous years, ensuring that a reasonable allowance is made for the effects of inflation.

(v) The charges for items previously covered by the management charge should be checked for their completeness and reasonableness.

(vi) An overall review of the projected profits should be undertaken to ensure that it appears to be a realistic forecast and not merely an idealistic target figure.
(b) **Verification of items in the cash flow forecast or projection**

As well as generally checking to ensure that the cash flow forecast or projection appears to be consistent with the profit forecast, specific checks should be made as follows.

(i) The timing of payments due to the parent company.

(ii) The period of credit granted to customers by the old company as it is unlikely that the new company will be in a position to insist on prompter payment by customers.

(iii) The period of credit taken from suppliers should be dealt with in a similar way, although enquiry should be made as to whether creditors are prepared to trade with the new company on the same terms as the old.

(iv) The timing of payment for overhead expenditure should be checked to see that it is reasonable and consistent with established practice.

(v) Although in the early months one would not expect there to be any major purchase or sale of non-current assets, the position here should be confirmed by discussion with management of their long-term plans.
This chapter covers three areas that should be considered by the auditor when conducting a financial statement audit: the internal audit function, outsourced functions and the use of service organisations. You will remember the fundamentals of the internal audit function from your earlier auditing studies. This chapter will recap the considerations of external auditors if they wish to rely on the work of the internal audit function. Since internal auditors investigate, evaluate and report on the same internal controls that external auditors test there are obvious advantages to relying on the work already done.

The second area covered in this chapter is outsourcing. Again this is an area where the external auditor may need to rely on the work performed by another party. Common examples of outsourced functions include payroll, information technology and data processing.

Lastly the chapter covers service organisations where the external auditor may provide assurance under SSAE 3402 Assurance Reports on Controls at a Service Organisation.

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<tr>
<td>Internal audit</td>
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<tr>
<td>Evaluate the potential impact of an internal audit function on the planning and performance of the statutory audit.</td>
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<tr>
<td>Explain how external and internal auditors may work together to provide stakeholders with combined assurance, including the need to plan all assignments.</td>
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<td>Discuss and conclude on the advantages and disadvantages of outsourcing finance and accounting functions.</td>
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<tr>
<td>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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ESSENTIAL READING

- SSA 610 (revised 2013) Using the Work of Internal Auditors
- SSA 402 Audit considerations relating to an entity using a service organisation
- SSAE (Singapore Standard on Assurance Engagements) 3402 Assurance Reports on Controls at a Service Organisation

1 Internal audit

SECTION INTRODUCTION

External auditors may make use of the work performed by internal audit when carrying out external audit procedures. The interaction between the internal and external auditor is a key aspect of combined assurance.

KEY TERM

An INTERNAL AUDIT FUNCTION is a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

1.1 Scope and objectives of the internal audit function

The scope and objectives of the internal audit function vary widely. Normally, however, internal auditors operate in one or more of the following broad areas.

- Evaluation of internal control
- Examination of financial and operating information
- Review of operating activities
- Review of compliance with laws and regulations
- Enterprise risk management
- Governance
1.2 Using the work of internal auditors

1.2.1 Objectives and responsibilities of the external auditors

SSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment requires the external auditors to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Amongst other things, these risk assessment procedures shall include inquiry of appropriate individuals within the internal audit function (if the function exists).

In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.

SSA 610 provides guidance to the external auditors when they have determined that the internal audit function is likely to be relevant to the audit. The objectives of the auditors are as follows:

- To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:
- If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

KEY TERM

DIRECT ASSISTANCE – The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Although the work of internal audit may be used for the purposes of the external audit, it is important to note that the external auditors have sole responsibility for the audit opinion expressed on the financial statements.
1.2.2 Evaluating the internal audit function

An effective internal audit function may reduce, modify or alter the timing of external audit procedures, but it can never eliminate them entirely. Even where the internal audit function is deemed ineffective, it may still be useful to be aware of the conclusions formed. The effectiveness of internal audit will have a great impact on how the external auditors assess the whole control system and the assessment of audit risk.

As part of the planning process the external auditors shall determine whether the work of the internal function can be used for the purposes of the audit by evaluating the following.

**Assessment of internal audit**

<table>
<thead>
<tr>
<th>Objectivity of internal auditors (SSA 610.15 &amp; A7)</th>
<th>Consider the extent to which the internal audit function's organisational status and relevant policies and procedures support its objectivity. This includes to whom it reports, any conflicting responsibilities, any constraints or restrictions, whether those charged with governance oversee employment decisions regarding internal auditors and whether the internal auditors are members of relevant professional bodies.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of competence of the internal audit function (SSA 610.15 &amp; A8)</td>
<td>Consider whether the internal audit function is adequately and appropriately resourced, whether there are established policies for hiring and training and assigning internal auditors to engagements, whether they have adequate technical training and proficiency, whether they have the required financial reporting knowledge and necessary skills and whether they are members of relevant professional bodies.</td>
</tr>
<tr>
<td>Systematic and disciplined approach including quality control (SSA 610.15 &amp; A11)</td>
<td>Consider the existence, adequacy and use of documented internal control procedures or guidance (such as risk assessments and work programmes) and whether the internal audit function has appropriate quality control policies and procedures.</td>
</tr>
</tbody>
</table>

1.2.3 Determining the nature and extent of the internal audit function that can be used

As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditors shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditors' overall audit strategy and audit plan. Examples of work of the internal audit function that can be used by the external auditors include the following.

- Testing of the design and/or operating effectiveness of controls
- Substantive procedures involving limited judgment
- Observations of inventory counts
- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements
- In some circumstances, audits or reviews of the financial information of subsidiary companies that are not significant components to the group

All significant judgments in the audit engagement must be made by the external auditors since they have sole responsibility for the auditors' opinion. To prevent inappropriate use of or reliance on the work of the internal audit function, the external auditors shall plan to perform more of the work directly:

- The more judgment is involved in planning and performing relevant audit procedures and evaluating the audit evidence gathered
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- The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant
- The less the internal audit function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors
- The lower the level of competence of the internal audit function

The external auditors shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditors being sufficiently involved in the audit, given the external auditors' sole responsibility for the audit opinion expressed.

1.2.4 Using the work of internal audit

The external auditors shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditors plan to use to determine its adequacy for purposes of the audit, including evaluating whether:

- The work of the function had been properly planned, performed, supervised, reviewed and documented
- Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions
- Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed

The nature and extent of the external auditors' audit procedures shall be responsive to the external auditors' evaluation of the following.

- The amount of judgment involved
- The assessed risk of material misstatement
- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors
- The level of competence of the function

The external auditors' procedures shall include reperformance of some of the work. Reperformance is likely to be focussed on those areas where more judgment has been exercised by the internal audit function. Other, less persuasive procedures include the following.

- Making inquiries of appropriate individuals within the internal audit function
- Observing procedures performed by the internal audit function
- Reviewing the internal audit function's work programme and working papers

1.2.5 Determining whether internal auditors can be used to provide direct assistance

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditors plans to use internal auditors to provide direct assistance on the audit, the external auditors shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance.

In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant.

- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates
- Association with the division or department in the entity to which the work relates
- Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority

The external auditors' evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

The external auditors shall not use an internal auditor to provide direct assistance if there are significant threats to the objectivity of the internal auditor; or the internal auditor lacks sufficient competence to perform the proposed work.

1.2.6 Determining the nature and extent of work that can be assigned to internal auditors providing direct assistance

The external auditors shall consider the following in determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances.

- The amount of judgment involved in planning and performing relevant audit procedures and evaluating the audit evidence gathered
- The assessed risk of material misstatement
- The external auditors' evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance

The external auditors shall not use internal auditors to provide direct assistance to perform procedures that:

- Involve making significant judgments in the audit
- Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited
- Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function
- Relate to decisions the external auditors make in accordance with SSA 610 regarding the internal audit function and the use of its work or direct assistance

For example, it would not be appropriate for the external auditors to provide direct assistance with the discussion of fraud risks or the determination of unpredictable audit procedures.

1.2.7 Using internal auditors to provide direct assistance

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditors shall obtain written agreement from an authorised representative of the entity that the internal auditors will be allowed to follow the external auditors' instructions, and that the entity will not intervene in the work the internal auditors perform for the external auditors. Additionally, the external auditors must obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditors and inform the external auditors of any threat to their objectivity.

The external auditors shall direct, supervise and review the work performed by internal auditors on the engagement. The nature, timing and extent of direction, supervision, and review shall recognise that the internal auditors are not independent of the entity and so the review will be of a different nature and more
extensive than if members of the engagement team had performed the work. The review procedures shall include the external auditors checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditors of the work performed by the internal auditors shall be sufficient in order for the external auditors to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

1.2.8 Documentation of work

If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

- The evaluation of whether the function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the function and whether the function applies a systematic and disciplined approach, including quality control
- The nature and extent of the work used and the basis for that decision
- The audit procedures performed by the external auditors to evaluate the adequacy of the work used

If the external auditors use the internal audit function to provide direct assistance, the external auditor shall include in the audit documentation:

- The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors
- Who reviewed the work performed and the date and extent of that review
- The written agreements obtained from an authorised representative of the entity and the internal auditors
- The working papers prepared by the internal auditors who provided direct assistance on the audit engagement

**Question 15.1**

**Revision: internal audit**

**Required**

(a) Describe the principal differences between internal and external auditors, considering the following factors.

(i) Eligibility
(ii) Security of appointment
(iii) Main objectives and limitations on the scope of their work

(b) Explain how external auditors would evaluate specific work carried out by internal auditors.

1.3 Internal audit and corporate governance

The 2018 Code of Corporate Governance states that: ‘The Board is responsible for the governance of risk and ensures that Management maintains a sound system of risk management and internal controls, to safeguard the interests of the company and its shareholders.’ (Principle 9)

The internal auditors' primary line of reporting is to the audit committee. Provision 10.4 of the Code also makes the following points:

- The audit committee should ensure that the internal audit function has appropriate standing within the company.
• The audit committee also decides on the appointment, termination and remuneration of the head of internal audit.
• The internal audit function should have unfettered access to all the company's documents, records, properties and personnel as part of its work.

1.4 Internal auditors and risk management
Directors need to ensure three steps are taken in their business.
• Identify risks
• Control risks
• Monitor risks

It is not internal audit's primary role to manage risk in a company. It is the responsibility of the directors, usually delegated to individual managers in various departments.

The risks are identified and assessed, and a policy approach is taken in respect of each of them. To recap, this policy is usually one of four:
• Accept risk (if it is low impact and likelihood)
• Reduce risk (by setting up a system of internal control)
• Avoid risk (by not entering a market, accepting contract etc)
• Transfer risk (by taking out insurance)

With their skills in business systems, internal auditors are ideally placed to monitor this process and add value to it. They can:
• Give advice on the best design of systems and monitor their operation
• Be involved in a process that continually improves internal control systems
• Provide assurance on systems set up in each department

The involvement of internal audit as a monitoring unit will help to ensure that the process of risk identification and management in a business is a continual process rather than a one-off exercise.

1.5 Internal audit and combined assurance
The concept of combined assurance was introduced in Chapter 13. It essentially involves the co-ordination of all assurance providers so that a comprehensive approach to oversight and risk management is taken rather than a piecemeal approach. A key part of this combined approach is the interaction between the internal and the external auditors. Effective communication and enhanced cooperation will result in an improvement in the overall quality of assurance and therefore risk management and reduce the potential for duplication.

SECTION SUMMARY
Reliance on the work of the internal audit function can reduce audit risk and affect the nature, timing and extent of the external auditors' work.
2 Outsourcing

SECTION INTRODUCTION

Outsourcing is the contracting out of certain functions. A business can outsource a small part of the function, or the entire function, or practically all its functions. The consequence for external auditors is that they may have to rely on evidence provided by the outsourced provider, which will result in specific audit procedures that need to be performed.

2.1 Why outsource?

KEY TERMS

OUTSOURCING is the process of purchasing key functions from an outside supplier. In other words, it is contracting-out certain functions, for example, finance and accounting, internal audit or information technology.

INSOURCING is when an organisation decides to retain a centralised department for the key function, but brings experts in from an external market on a short-term basis to account for 'peak' and 'trough' periods. It is a business decision that is often made to maintain control of certain critical processes or competencies.

There are three general reasons for outsourcing:

- Financial efficiency
- Change management
- Strategy

2.1.1 Financial efficiency

It is often argued that outsourcing reduces cost. This may not necessarily be the case, but companies often find that it is worth investigating. If outsourcing is never considered, it is often the case that the cost of maintaining the function in-house is never calculated, and therefore not considered either.

This fact links into the next point about financial efficiency. Outsourcing a function can lead to greater cost control over that function. This is as a result of the function now being subject to a contractual fee rather than a previously unidentified cost of maintaining the function in-house. This aspect of outsourcing might substantially improve budgeting and cost control.

Outsourcing may considerably reduce the number of employees for whom a company is responsible. The logistics of shedding staff may make outsourcing a difficult legal and human resource issue, but the cost savings in this area (salary, tax, pension, for example) could be substantial.

Outsourcing can have an effect on the shape of a company's financial statements, particularly if a function with a high capital investment (for example, information technology) is being outsourced. In some cases, it might be possible to sell the company's assets to the service provider, producing a cash injection, or reduced initial fees.

2.1.2 Change management

Outsourcing can be a way of managing change in a company. For example, if the company decides to change its software, outsourcing the software provision might mean that all staff training on the new system is incorporated into the service.

Outsourcing a function such as finance might facilitate the smooth running of a merger of two companies who have different accounting systems. This may also be true when a company is restructured.
2.1.3 Strategy

Outsourcing can also be part of a strategy to refocus on the core competencies of a company, or a thrust to improve technical services. It can be a way of entering a market in the most low risk way. For example, a previously low-tech company wanting to engage in e-commerce could outsource its website development and maintenance in the initial stages.

2.2 Advantages and disadvantages of outsourcing

We will look in detail at the advantages and disadvantages of outsourcing some specific functions in the following sections. For now, however, we shall consider some general advantages and disadvantages of outsourcing that apply to them all.

**Advantages of outsourcing**

| Cost. A key advantage of outsourcing is that it is often cheaper to contract a service out than it is to conduct it in-house. It may also significantly improve cost control. |
| Specialist service. Outsourcing results in specialists being used to provide the service when that would not have been the case if the function was performed in house. |
| Indemnity. The service organisation may provide indemnity in the event of problems arising. If problems arise in-house, there is no such recourse. |
| Cash flow. Obtaining the service through a contract may assist with cash flow, as the contract will represent a flat fee, whereas the cost of providing the service in-house might have led to fluctuating costs (for example, if temporary staff are required in a busy period). |

**Disadvantages of outsourcing**

| The single biggest disadvantage of outsourcing is the extent to which the company loses control over the function itself, although not over cost control. |
| The initial cost of outsourcing may be substantial, if an aspect of the decision is to close a current department of the company. The question of potential redundancies may dissuade companies from considering outsourcing. |
| The contract has to be managed to ensure that the service being provided is appropriate and in accordance with the contract. This may take a disproportionate amount of time, particularly in finalising the scope of services to be provided. |
| The contract might limit the liability of the contractor, leading to problems if the contract is not performed well. This might even result in disputes and court action being required. |
| Should these disadvantages be realised, the cost of outsourcing could outweigh the benefit, even though in theory outsourcing should reduce cost. |

2.3 Outsourcing finance and accounting functions

Various functions will be considered in the table below. Remember, however, the key advantages and disadvantages set out above are all likely to be true of the functions discussed more specifically below.

**Function**

<table>
<thead>
<tr>
<th>Accounting (bookkeeping)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
</tr>
<tr>
<td>As a specialist, the service organisation is likely to have greater expertise and technology resources.</td>
</tr>
<tr>
<td>The service organisation will carry out the day to day accounting required. This allows management to focus on other key areas of the company's business.</td>
</tr>
</tbody>
</table>
### Function

#### Asset management

**Advantages**
The service organisation is likely to have greater buying power than an individual company and may be able to access investments or markets that an individual company could not.

**Disadvantages**
Can be expensive and does not necessarily guarantee a greater return.

#### Data processing

**Advantages**
A third party may be able to process large volumes of work in a short time, saving on staff costs. Companies offering this service often locate in areas where salaries, rents, overheads etc are cheaper eg India, this can result in significant cost savings.

**Disadvantages**
There may be logistical difficulties in outsourcing data processing, due to the high level of paper involved (invoices, goods received notes etc). This information will have to be given to the service organisation.

A secondary, and more important, effect is that the company might not always have control of their key accounting documentation and records. It is a legal requirement that the directors maintain this information. While they may delegate the day to day operations, they are still responsible for maintaining the records.

#### Payroll (including calculation of Central Provident Fund deductions)

**Advantages**
As a specialist, the service organisation will have processes in place to make them aware of changes in legislation that may impact upon payroll. A small company may not have the resource to do this as well.

Increased segregation of duties. This reduces the susceptibility of the payroll to fraud.

**Disadvantages**
Confidential and sensitive employee data is given to a third party.

Loss of control (directors are still legally responsible for maintaining payroll documentation and records).

More difficult for auditors to access payroll records required as audit evidence. Access will need to be arranged in advance.

#### Information technology

**Advantages**
A key advantage of outsourcing all, or elements of, the IT function is that this will enable the company to keep pace with rapid technological advances.

It also allows the company to take advantage of the work of a specialist in a field that many people still find difficult but which they use regularly to carry out their business.

Outsourcing can provide a useful safety net of a technical helpline or indemnity in the event of computer disaster.

It is also possible that through outsourcing, the company will be able to obtain added value, such as new ways of doing business identified (for example, e-commerce).
### 2.4 Outsourcing internal audit

Internal audit is rarely a core competency of a company. However, it is a valuable service to management. The corporate codes of recent years that we discussed earlier in this Textbook have emphasised the importance of internal audit in assessing controls and monitoring risks.

There are problems associated with setting up an internal audit department, however. These are:

- Cost of recruiting staff
- Difficulty of recruiting staff of sufficient skill and qualification for the company’s preference or need
- The fact that management are not auditing specialists and therefore might struggle to direct the new department in their duties
- The time frame between setting up the department and seeing the results of having the department
- The fact that the work required may not be enough to justify engaging full-time staff, particularly in smaller entities
- The fact that a variety of skills and seniority levels are required, but only one member of full-time staff can be justified

#### 2.4.1 Advantages

The advantage of outsourcing internal audit is that outsourcing can overcome all these problems:

- Staff need not be recruited, as the service provider has good quality staff.
- The service provider has specialist skill and can assess what management require them to do. As they are external to the operation, this will not cause operational problems.
- Outsourcing can provide an immediate internal audit function without the long-drawn out process of interviewing and hiring.
- The service contract can be for the appropriate time scale (a two week project, a month, etc).
- Because the time scale is flexible, a team of staff can be provided if required.
- The service provider could also provide less than a team, but, for example, could provide one member of staff on a full-time basis for a short period, as a secondment.

A key advantage of outsourcing internal audit is that outsourcing can be used on a short-term basis to:

- Provide immediate services
- Lay the basis of a permanent function, by setting policies and functions
- Prepare the directors for the implications of having an internal audit function
- Assist the directors in recruiting the permanent function

Outsourced internal audit services are provided by many AEs. This can range from a team of staff for a short-term project, or a single staff member on a long-term project.
2.4.2 Disadvantages

However, the fact that internal audit services are typically provided by external auditors can raise problems as well:

- The company might wish to use the same AE for internal and external audit services, but this may lead to independence issues and other complications for the external auditors.
- The cost of outsourcing the internal audit function might be high enough to make the directors choose not to have an internal audit function at all.

SECTION SUMMARY

Auditors need to be aware of relevant functions that have been outsourced and adjust their planned audit procedures accordingly.

3 Impact of outsourcing on an audit

SECTION INTRODUCTION

When a company outsources a function to a service organisation there are special audit considerations.

3.1 Use of service organisations

KEY TERMS

SERVICE ORGANISATION – A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities’ information systems relevant to financial reporting.

USER ENTITY – An entity that uses a service organisation and whose financial statements are being audited.

USER AUDITOR – An auditor who audits and reports on the financial statements of a user entity.

SERVICE AUDITOR – An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

A TYPE 1 REPORT is a report on the description and design of controls at a service organisation. It comprises (i) a description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date, and (ii) a report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
A **TYPE 2 REPORT** is a report on the description, design and operating effectiveness of controls at a service organisation. It comprises (i) a description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period, and (ii) a report by the service auditor with the objective of conveying reasonable assurance that includes (a) the service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls, and (b) a description of the service auditor's tests of the controls and the results thereof.

(SSA 402.8)

The key difference between the two types of reports is that Type 1 reports provide an opinion confirming the description and design of controls at a service organisation whereas Type 2 reports provide this plus an opinion on the operating effectiveness of those controls.

**SSA 402.7**

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement, and

(b) To design and perform audit procedures responsive to those risks.

### 3.2 Obtaining an understanding

A service organisation may establish and execute policies and procedures that affect a client organisation's accounting and internal control systems. These policies and procedures are physically and operationally separate from the client organisation.

(a) When the services provided by the service organisation are limited to recording and processing client transactions and the client retains authorisation and maintenance of accountability, the client may be able to implement effective policies and procedures within its organisation.

(b) When the service organisation executes the client's transactions and maintains accountability, the client may deem it necessary to rely on policies and procedures at the service organisation.

The auditors need to understand how a user entity uses the services of the service organisation, including:

- The nature and significance of the service provided including the effect on the controls at the user entity
- The nature and materiality of the transactions processed or accounts/financial reporting processes affected
- The degree of interaction between the user entity and the service organisation
- The nature of the relationship between the two, including the contractual terms
- If the service organisation maintains accounting records for the user entity, whether the arrangements affect the auditors' responsibility to report concerning accounting records

Sources of information include:

- User manuals
- System overviews
- Technical manuals
- The contract/service level
15: Internal audit, outsourcing and service organisations

- Reports by the service organisations, internal auditors or regulatory authorities
- Reports by the service organisation auditor

The user auditor must evaluate the controls at the user entity that relate to the service organisation and determine whether this gives the auditors sufficient understanding to provide a basis for assessing risks of material misstatement in the user entity financial statements.

If the auditors conclude that this is insufficient, he must carry out one of the following four activities:

- Obtain type 1 or type 2 report from the service organisation, if available
- Contact the service organisation to get specific information (with permission)
- Visit the service organisation and perform procedures to obtain the information (with permission)
- Use another auditor to perform procedures at the service organisation (with permission)

It is likely that the auditors will be able to obtain a type 1 or 2 report, and this will be the most straightforward option. If this action is taken, the auditors need to be sure that:

- The service organisation's auditor is competent and objective
- The standards under which the report was issued are adequate for the user entity's auditors' purposes
- The report is for an appropriate date (that is, it covers the period the user entity is reporting on)
- The evidence it is based on is sufficient and appropriate for the user entity's auditors' understanding of the internal controls
- If complementary user entity controls are relevant to the user entity, that the auditors have obtained an understanding of these

3.3 Responding to assessed risks

The auditors need to assess whether sufficient appropriate audit evidence is available from records at the user entity. If so, they should carry out appropriate procedures at the user entity. If not, he should carry out further audit procedures.

When the user auditors expect controls at the service organisation to be operating effectively, they must obtain evidence that this is the case, by one of the following three methods:

- Obtaining a type 2 report, if available
- Performing test of controls at the service organisation
- Using another auditor to perform tests of controls at the service organisation

Again, obtaining a type 2 report is the most likely option, in which case the entity auditor has to:

- Check that the report is made up to an appropriate date
- Ensure that he has tested complimentary controls at the user entity if necessary
- Check the adequacy of the time period covered by the tests of controls and the time elapsed since those tests of controls were performed
- Ensure the tests of controls performed for the purposes of the report are relevant and provide sufficient appropriate audit evidence for the user entity auditors' purposes

The auditors must also make enquiries of management if it is aware or suspects any fraud, non-compliance with laws and regulations or uncorrected misstatements at the service organisation that could affect the financial statements of the user entity and evaluate the impact of any matters on his procedures and report.
3.4 Reporting

The key issue to remember is that if the user auditors cannot obtain sufficient appropriate evidence about the impact of the service organisation on the user entity, the auditors must modify the auditors’ report as the scope of the audit has been limited.

Question 15.2

Required

(a) Explain the meaning of the word ‘outsourcing’ and distinguish it from ‘insourcing’.

(b) Discuss the risks and benefits of outsourcing the payroll function of a small business with 100 employees which currently employs a management accountant and an accounts clerk.

(c) You are planning the audit of a company that has just outsourced its credit control function. Describe the planning issues that arise as a result of this action.

SECTION SUMMARY

The auditors must assess the effect on internal control of the use of a service organisation by the entity and design and perform procedures responsive to those risks.

4 Service organisations

SECTION INTRODUCTION

Where a service is outsourced the service auditor may be required to provide a report on controls to the entity using the service or their auditors.

4.1 Introduction

SSAE 3402 Assurance Reports on Controls at a Service Organisation complements SSA 402 in that the reports prepared in accordance with this SSAE are capable of providing appropriate evidence under SSA 402.

SSAE 3402 deals with assurance engagements carried out by Chartered Accountants to provide a report for user entities and their auditors on the controls at a service organisation. It only applies when the service organisation is responsible for, or otherwise able to make assertions about, the suitable design of controls. It does not apply where the assurance engagement is to:

(a) Report on whether controls at the service organisation operated as described, or

(b) To report only on controls at a service organisation other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting.
4.2 Objectives
SSAE 3402 states that the objectives of the service auditor are:

**SSAE 3402.8**
(a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
   (i) The service organisation's description of its system fairly presents the system as designed and implemented throughout the specified period or as at a specified date.
   (ii) The controls related to the control objectives stated in the service organisation's description of its system were suitably designed throughout the specified period.
   (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organisation's description of its system were achieved throughout the period.
(b) To report on the matters in (a) above in accordance with the service auditor's findings.

4.3 Requirements
SSAE 3402 requires the service auditor to carry out the following procedures:
- Consider acceptance and continuance issues.
- Assess the suitability of the criteria used by the service organisation.
- Consider materiality with respect to the fair presentation of the description, the suitability of the design of controls, and in the case of a type 2 report, the operating effectiveness of controls.
- Obtain an understanding of the service organisation's system.
- Obtain evidence regarding:
  - The service organisation's description of its system
  - Whether controls implemented to achieve the control objectives are suitably designed
  - The operating effectiveness of controls (when providing a type 2 report)
- Determine whether, and to what extent, to use the work of the internal auditors (where there is an internal audit function).

4.4 Written representations
The service auditor must request the service organisation to provide the following written representations in the form of a representation letter addressed to the service auditor:
(a) Reaffirmation of the assertions accompanying the description of the system
(b) That it has provided the service auditor with all relevant information and access
(c) That it has disclosed to the service auditor any of the following of which it is aware:
   (i) Non-compliance with laws and regulations, fraud or uncorrected deviations
   (ii) Design deficiencies in controls
   (iii) Instances where controls have not operated as described
   (iv) Subsequent events

4.5 Content of the service auditor's assurance report
The service auditor's assurance report shall include the following basic elements:
(a) A title that clearly indicates that the report is an independent service auditor's assurance report
(b) An addressee
PART E OTHER ASSIGNMENTS

(c) Identification of:
   (i) The service organisation's description of its system, and the service organisation's assertion
   (ii) Those parts of the service organisation's description of its system that are not covered by
        the service auditor's opinion (if any)

(d) Identification of the criteria, and the party specifying the control objectives

(e) A statement that the report is intended only for user entities and their auditors

(f) A statement that the service organisation is responsible for:
   (i) Preparing the description of its system, and the accompanying assertion
   (ii) Providing the services covered by the service organisation's description of its system
   (iii) Stating the control objectives
   (iv) Designing and implementing controls to achieve the control objectives stated in the service
        organisation's description of its system

(g) A statement that it is the service auditor's responsibility to express an opinion on the service
    organisation's description, on the design of controls related to the control objectives, and in the
    case of a type 2 report on the operating effectiveness of those controls

(h) A statement that the engagement was performed in accordance with SSAE 3402

(i) A summary of the service auditor's procedures

(j) A statement of the limitations of controls

(k) The service auditor's opinion expressed in a positive form

(l) Date

(m) Name of the service auditor

4.6 Auditor's opinion

For a type 1 report the service auditor will express his opinion as to whether the description fairly presents
the service organisation's system and that the controls related to the control objectives stated in that
description were suitably designed.

In addition to the above for a type 2 report the auditor will also express an opinion as to whether the
controls tested operated effectively throughout the specified period.

4.6.1 Modified opinions

Where the auditor cannot agree with the details of the report or is unable to obtain sufficient appropriate
evidence a modified report must be issued.

SECTION SUMMARY

The service auditor expresses an opinion on the service organisation's description, on
the design of controls related to the control objectives stated in that description,
based on the service auditor's procedures.
Chapter Roundup

**Internal audit function**

- Reports to Chairman of Audit Committee
  - IIA

**Using for the external audit**

- Direct assistance
- Using their work
- Supervise and review work
- Is it adequate?

**Performance procedures including reperformance**

**Outsourcing**

**Why?**

- Financial efficiency
- Change management
- Strategy

**What?**

- Bookkeeping
- Data processing
- Payroll
- IT
- Tax
- Internal audit

**Audit impact**

- Assess effect on internal control
- Design and perform procedures responsive to those risks
  - SSA 402

- May need to use service auditor's assurance report
  - SSAE 3402
  - Type 1/Type 2
Quick Quiz

1. Name the three areas which the external auditors must consider in relation to whether the work of internal audit can be used for the purposes of the external audit.

   (1) ........................................
   (2) ........................................
   (3) ........................................

2. Name five elements of the accounting and finance function which could be outsourced.

   (1) ........................................
   (2) ........................................
   (3) ........................................
   (4) ........................................
   (5) ........................................

3. Complete the table, putting the advantages of outsourcing under the right headings and naming the specific function, if relevant.

<table>
<thead>
<tr>
<th>General advantages</th>
<th>Function-specific advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Cost</td>
<td>-</td>
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<td>- Technological advance</td>
<td>-</td>
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<tr>
<td>- Liability/indemnity</td>
<td>-</td>
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<td>- Cash flow</td>
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<tr>
<td>- Specialist service</td>
<td>-</td>
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<tr>
<td>- Immediacy</td>
<td>-</td>
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<tr>
<td>- Flexibility (particularly with regard to timescale)</td>
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</tbody>
</table>

4. The user auditor may refer to the responsibility of the service organisation when giving their opinion in financial statements.

   True [ ]
   False [ ]
Answers to Quick Quiz

1 (1) The objectivity of the internal auditors (includes their organisational status and whether the entity being audited has policies and procedures in place to support this objectivity)

(2) Level of competence of the internal auditors

(3) Whether the internal auditors apply a systematic and disciplined approach

2 Any from:
- Pension
- Tax
- Payroll
- Asset management
- Bookkeeping
- Internal audit

3

<table>
<thead>
<tr>
<th>General advantages</th>
<th>Function-specific advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>Technological advance (IT)</td>
</tr>
<tr>
<td>Liability/indemnity</td>
<td>Liability/indemnity (IT/due diligence)</td>
</tr>
<tr>
<td>Cash flow</td>
<td>Immediacy (IA)</td>
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<tr>
<td>Specialist service</td>
<td>Flexibility (IA)</td>
</tr>
<tr>
<td>Flexibility</td>
<td></td>
</tr>
</tbody>
</table>

4 False
- Responsibility for accounting records still lies with directors
- Responsibility for auditing them still lies with user auditor
Answers to Questions

15.1 Revision: internal audit

(a) (i) Eligibility

Eligibility to act as external auditor is usually defined by the law and regulations of the jurisdiction in question. For example, in Singapore a person is ineligible to act as external auditor if they are an officer or employee of the company, a partner or employee of such a person or a partnership in which such a person is a partner. An internal auditor is an employee of the company.

External auditors are also required to belong to a recognised supervisory body, and this means they must hold an appropriate qualification, follow technical standards and maintain competence and independence.

By contrast anyone can act as an internal auditor even if they do not have a formal accounting qualification. It is up to the company's management who they appoint.

(ii) Security

In Singapore, the external auditors of public interest companies are appointed to hold office until the conclusion of the next general meeting and need permission from ACRA if resigning before the end of their term. They can be dismissed by an ordinary resolution of shareholders with special notice in a general meeting.

External auditors cannot be dismissed by individual directors or by a vote of the board. The only influence directors can have on the removal of external auditors is through their votes as shareholders. The rules on security of tenure are there because of the need for external auditors to protect the interests of shareholders by reporting on directors' stewardship of the business.

By contrast, as internal auditors are employees of the company, they can be dismissed by the directors or lower levels of management, subject only to their normal employment rights.

(iii) Objectives and limitations on the scope of the audit work

The primary objective of external auditors is laid down by statute, to report on whether the company's accounts show a true and fair view of the state of the company's affairs at the period-end, and of its profit or loss for the period. External auditors are also required to report if certain other criteria have not been met, for example the company fails to keep proper accounting records or fails to make proper disclosure of transactions with directors.

Internal auditors' objectives are whatever the company's management decide they should be. Some of the objectives may be similar to those of external audit, for example to confirm the quality of accounting systems. Other objectives might be in areas which have little or no significance to the external auditor, for example recommending improvements in operational efficiency.

Statutory rules mean that management cannot limit the scope of external auditors' work. External auditors have the right of access to all of a company's books and records, and can demand all the information and explanations they deem necessary. As the objectives of internal audit's work are decided by management, management can also decide to place limitations on the scope of that work.

(b) Procedures on specific work carried out by the internal auditors would include an evaluation of whether:

(i) The work of the function is properly planned, performed, supervised, reviewed and documented

(ii) Sufficient appropriate audit evidence is obtained to enable the function to draw reasonable conclusions

(iii) The conclusions reached are appropriate in the circumstances

(iv) Any reports prepared by internal audit are consistent with the results of the work performed
(v) Any exceptions or unusual matters disclosed by internal audit are properly resolved.

(vi) Amendments to the external audit programme are required as a result of matters identified by internal audit work.

(vii) There is a need to reperform the work of internal audit to confirm its adequacy.

15.2 Outsourcing

(a) Outsourcing is the practice of purchasing a specific function from an outside service provider. In other words, it is the practice of contracting-out functions of the business to an expert. Insourcing, by contrast, is the practice of maintaining a specialist function in-house, but buying in external expertise on a short-term basis to balance peaks and troughs in demand for that expertise.

(b) Payroll is a complicated accounting area, particularly due to the issues of taxation arising. It is also susceptible to fraud in the absence of strong controls. In a small company, such as the one described, there is little scope for segregation of duties in relation to payroll. It is likely that payroll would be managed by the Chartered Accountant, as the clerk is likely to have a full-time job in relation to sales and purchases, and the Chartered Accountant has greater expertise. However, it is possible that a Chartered Accountant in such a position, even in a small business, might not have time to manage payroll in addition to other accounting duties. In order for there to be adequate authorisation and segregation in relation to payroll, another senior member of personnel should be involved in authorising the payroll.

In this situation, it might be cost-effective to outsource the payroll function to an expert. This might also reduce the control problems inherent in the small department. However, there are some disadvantages related to outsourcing the function. The key issue is one of confidentiality, as payroll records contain sensitive data about personnel (for example, their bank details). Personnel might object to this information being given to an outside provider. The company would also have to institute controls over the transfer of data (such as weekly hours worked) to the service provider.

(c) The user auditor should determine whether the outsourced function is relevant to the audit. In the case of the credit control function, this is clearly relevant to receivables reported in the statement of financial position and to sales and bad debts.

The user auditor must ensure that he understands the terms of the contract between the client and the service provider. As part of planning the audit, therefore, they must obtain a copy of the contract and become familiar with its terms.

The user auditor must ascertain whether they will have access to the records that they will require as part of their audit evidence. As part of planning they must make arrangements to enable this access.

As part of the risk assessment at the planning stage, the user auditor must consider whether the outsourcing arrangements affect the risk of material misstatement in the financial statements. In doing so they will consider factors such as the contract (referred to above), the reputation of the service provider and the effectiveness of past controls when the function was maintained in-house and present controls over the outsourcing arrangements.
PART F REPORTING
As a Candidate at this stage of your studies, you should be familiar with the external audit opinion. If this is not the case, before you read any of this chapter, you must go back to your notes from your accountancy degree or Foundation Programme or SAC–NP Advanced Diploma in Accountancy and revise the basic features of the report, the various modifications that can be made, the concept of a true and fair view and the statutory requirements in relation to the audit opinion.

At this level, Candidates are expected not only to know what the audit opinion is and how it is presented, they are required to draw audit opinions and also assess the appropriateness of an audit opinion formed by another person.

In this chapter we shall also consider the form of the auditor's report, the criticism that it receives and whether it enables an auditor to properly express a true and fair view.

Reporting to those charged with governance is also a key issue. Effective two-way communication is essential for the audit to be carried out effectively. The auditor will communicate general matters which will apply to each audit, for example auditor's responsibilities and matters specific to individual audits, for example, significant findings from the audit and deficiencies in internal control.

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<td>Analyse the form and content of the Professional Accountant's report for an assurance engagement as compared with an auditor's report and the restricted use of reports.</td>
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<td><strong>Communication</strong></td>
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<tr>
<td>Describe the auditor's responsibility to communicate with those charged with governance and understand the importance of effective two-way communication of specific matters that are required to be communicated to those charged with governance under local and international auditing standards.</td>
<td>2</td>
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1 Critically appraising the standard unmodified auditor's report

SECTION INTRODUCTION

The audit opinion is given in the auditor's report, which communicates information about the audit to users of the financial statements.

1.1 The act of communication

External auditors carry out audit procedures to gather and evaluate evidence with the intention of forming an audit opinion. This audit opinion becomes the external communication of this process and it is against this communication that the company and the auditors themselves are critically assessed. However, since this communication has to stand alone without the understanding and evidence that supported and created it, it is open to different interpretations by users and hence issues may arise.

This communication problem can be summarised under the broad headings:

- Understandability
- Responsibility
- Availability
1.2 Understandability

Although the essence of the auditors' role is simple, in practice it is surrounded by auditing standards and guidance as it is a technical art. It also involves specialised language, or ‘jargon’ that non-auditors may not understand.

This can be seen in a definition of what audit is. ‘An audit is an exercise designed to show whether financial statements are free from material misstatement and give a true and fair view.’ The highlighted words reveal the problem. Communicating the audit opinion in a way that people can understand is a challenge.

1.3 Responsibility

Connected with the problem of what the audit is and what the audit opinion means is the issue of what the auditor is responsible for. As far as the law is concerned, auditors have a restricted number of duties. Professional standards and other bodies place other duties on auditors.

Users of financial statements, and the public, may not have a very clear perception of what the auditors are responsible for and what the audit opinion relates to, or in what context the opinion is rendered.

The issue of auditors' liability ties in here. Auditor's reports are addressed to shareholders, to whom auditors have their primary and legal responsibility. However, audited financial statements are used by significantly more people. Should this fact be addressed in the auditor's report? This issue is also considered in Chapter 3.

1.4 Availability

It is a fact that a significant number of people use audited financial statements. Auditor's reports are publicly available. This fact alone may add to any perception that exists that auditors address their report to more than just shareholders.

The problem of availability is exacerbated by the fact that many companies publish their financial statements on their website. Directors and senior management need to ensure that any financial information provided has the same integrity as that published in paper form as millions of people around the world have access to the auditor's report.

However, this issue may add significant misunderstandings.

- Language barriers may cause additional understandability problems.
- The auditor's report may be subject to malicious tampering by hackers or personnel.
- Different countries will be subject to different auditing and accounting standards.

If an auditor's report is published electronically, auditors lose control of the physical positioning of the report, that is, what it is published with. This might significantly impact on understandability and also perceived responsibility.
1.5 The standard report

The standard auditor's report for listed companies under SSA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements* is set out below. A different standard report applies for private companies. This has not yet been updated to refer to SFRS(I).

INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements are properly drawn up in accordance with the provisions of the Companies Act, Chapter 50 (the Act) and Financial Reporting Standards in Singapore (FRSs) so as to give a true and fair view of the financial position of the Company as at 31 December 20X1 and of the financial performance, changes in equity and cash flows of the Company for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Singapore Standards on Auditing (SSAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Accounting and Corporate Regulatory Authority (ACRA) Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Singapore, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ACRA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SSA 701.]

Responsibilities of Management and Directors for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the provisions of the Act and FRSs, and for devising and maintaining a system of internal accounting controls sufficient to provide a reasonable assurance that assets are safeguarded against loss from unauthorised use or disposition; and transactions are properly authorised and that they are recorded as necessary to permit the preparation of true and fair financial statements and to maintain accountability of assets.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

The directors' responsibilities include overseeing the Company's financial reporting process.
Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with SSAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the directors, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.
Report on Other Legal and Regulatory Requirements

In our opinion, the accounting and other records required by the Act to be kept by the Company have been properly kept in accordance with the provisions of the Act.

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as “other reporting responsibilities”) shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the SSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the SSAs where such a difference exists.]

The engagement partner on the audit resulting in this independent auditor's report is [name].

_________________________

(AE)

Public Accountants and Chartered Accountants Singapore

_________________________

(Date)

The revised standard auditor's report tries to communicate the audit process as clearly as it can, and is designed to eliminate common misconceptions:

(i) The report is clearly addressed to shareholders, in the first line. This shows that it is not intended for anyone else's use.

(ii) The auditor's opinion is given at the start of the report. This is a change from the form of auditor's reports under the original SSA 700, which placed the auditor's opinion at the end. Hence prominence is achieved by placing the opinion at the beginning of the report.

(iii) There is an explanation of the basis for the auditor's opinion.

(iv) Key audit matters are discussed in detail, giving users a better understanding of what the auditor has considered and the audit approach adopted on this individual audit.

(v) The responsibilities of management and the auditor are clearly stated. There is now a detailed description of what the auditor does.

However, some parties still argue that the revised auditor's report is a difficult document to understand. It still includes technical terms which require further explanation.

Further examples of auditor's reports are given in AGS 1 Sample Independent Auditor's Reports.

1.5.1 Advantages of a standard report

The key advantages of having a standard report is that it is easier for users to understand an auditor's report that has elements in common with all other auditor's reports. It also means that auditor's reports can be more easily compared.

When a standard report is used, there is less chance of isolated misunderstanding caused by the way one AE chooses to express itself or in relation to the explanation of a particular issue.

SSA 700 (Revised) aims to strike a balance between comparability and relevance. It is largely standardised (comparability), but the auditor must tailor specific elements of it to the individual audit (relevance). The auditor does this in the discussion of key audit matters, in any emphasis of matter/other matter paragraphs they include, and of course in the opinion expressed.
1.5.2 Comparison with other assurance reports

There are many similarities between the auditor's report and other reports for assurance engagements. For example if a report in accordance with SSA 700 is compared with a reports produced in accordance with SSAE 3000 both can be seen to include the following:

- A title
- An addressee
- A statement that the work was performed in accordance with relevant standards
- A summary of the work performed
- The Chartered Accountant's/auditors conclusion
- The report date
- Identification of the Chartered Accountant/auditor

The key difference is with respect to the opinion itself. With an audit, the opinion will be expressed in a positive form and the matters which are reported on are set down in law. For other assurance engagements the opinion may be expressed in negative terms and the matters on which the opinion is expressed will depend on the nature of the engagement.

1.5.3 Restrictions on use of the auditor's report

Auditor's reports are addressed to the members or shareholders of the company, however, there are many different users of financial statements and they use them for many differing reasons. The auditors cannot be expected to know all of the users of the financial statements and their reasons for using them so they cannot be assumed to enter into a relationship with all of the users. This can cause the auditors difficulty if they are sued for negligence by a third party who placed reliance on the audited financial statements. Being sued for negligence by a third party was covered in Chapter 3, Section 2.3 of this Textbook. Since Chartered Accountants often trade as partnerships, each partner will be jointly and severally liable to claims made against individual partners.

SECTION SUMMARY

A standard format is used to promote understandability because the auditor's report is widely available to both accustomed users and those who are not familiar with audits and related jargon. The availability of auditor's reports has been increased by the trend to publish financial statements on companies' websites. Auditors should consider the risks relating to this.

2 Forming and critiquing an audit opinion

SECTION INTRODUCTION

Auditors are required by law and professional standards to express an opinion as to the truth and fairness of the financial statements.

2.1 Forming an audit opinion

When the auditors have gathered all the evidence required, the audit engagement partner will form the audit opinion as to truth and fairness of the financial statements as a whole.
The following standards apply for the various audit opinions that can be given:

- SSA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
- SSA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
- SSA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

In order for the auditors to be able to give an unmodified opinion, they must be satisfied that there are no material misstatements in the financial statements and that they are able to obtain sufficient appropriate audit evidence. When forming their opinion, there are some key matters that the auditors must consider. These can be illustrated in the form of three questions:

**Question 1**
Have all the procedures necessary to meet auditing standards and to obtain all the information and explanations necessary for the audit been carried out?

**Question 2**
Have the financial statements been prepared in accordance with the applicable accounting requirements?

**Question 3**
Do the financial statements give a true and fair view?

**IMPORTANT**

**True:** Information is factual and conforms with reality. In addition the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

**Fair:** Information is free from discrimination and bias and in compliance with expected standards and rules. The financial statements should reflect the commercial substance of the company's underlying transactions.

The process of forming an audit opinion in an exam question can be summarised in a step format, as follows:

1. **STEP 1**
   Read through all the information given in the question carefully.

2. **STEP 2**
   Analyse the requirement.

3. **STEP 3**
   Read through the information given in the question again in the light of the requirement, making notes of any key factors.

4. **STEP 4**
   Ascertain whether all the evidence reasonably expected to be available has been obtained and evaluated.
If not, identify whether the effect of not gaining evidence is such that the financial statements could as a whole be misleading (disclaimer of opinion) or a material part could be misleading ('except for' opinion).

Ascertain whether the financial statements have been prepared in accordance with SFRS(I).

If not, determine whether departure was required to give a true and fair view and if so, whether it has been properly disclosed.

Decide whether any unnecessary departure is material to the financial statements ('except for' opinion) or is pervasive to them (adverse opinion).

Conclude whether the financial statements as a whole give a true and fair view.

Even if the answers to Steps 4 and 6 are yes, you must still carry out Step 9 and make an overall assessment of the truth and fairness of the financial statements in order to conclude that an unmodified opinion is appropriate.

2.2 Emphasis of Matter and Other Matter paragraphs

SSA 706 (Revised) Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report addresses additional communication in the auditor's report where the audit opinion remains unqualified. Hence we are dealing here with modified auditor's reports but with unqualified audit opinions.

KEY TERMS

**Emphasis of Matter Paragraph** – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

**Other Matter Paragraph** – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

(SSA 706.7)
2.2.1 Emphasis of Matter

The Emphasis of Matter paragraph can be used where the auditors consider it necessary (e.g., with regards to an uncertain outcome to litigation, early application of an accounting standard that has a pervasive effect on the financial statements in advance of its effective date or a major catastrophe that has had, or continues to have, a devastating effect on the entity's financial position). In the following circumstances, however, it must be used:

(a) When the auditors have determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.

(b) To alert users that the financial statements are prepared in accordance with a special purpose framework.

(c) When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., re-issuance of report due to subsequent events).

Note that an Emphasis of Matter paragraph is not used when the issue has been covered as a key audit matter (see Section 3). The auditor must choose whether the matter is simply a Key Audit Matter, or whether it needs an Emphasis of Matter paragraph.

When the auditors include an Emphasis of Matter paragraph in the auditors' report, the auditors shall:

- Include it immediately after the Basis for Opinion paragraph in the auditors' report
- Use the heading ‘Emphasis of Matter’
- Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- Indicate that the auditors' opinion is not modified in respect of the matter emphasised.

If there is a Key Audit Matters section in the report, then it is up to the auditor's judgment whether to place the Emphasis of Matter paragraph before this (i.e., straight after the Basis of Opinion) or after it.

The following is an example of an Emphasis of Matter paragraph, taken from Appendix 3 to SSA 706.

**Emphasis of Matter**

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

2.2.2 Other Matter

The Other Matter paragraph can also be used when deemed necessary by the auditors (e.g., when the auditors are unable to withdraw from the engagement and yet are unable to obtain sufficient appropriate audit evidence, when the auditors have been requested to report on other matters or to provide more clarifications in line with the legal jurisdiction of the country). As with the Emphasis of Matter paragraph, there are specific circumstances where the Other Matter paragraph must be used:

(a) Where prior period financial statements were audited by predecessor auditors

(b) Where prior period financial statements were not audited (Note: This does not relieve the auditors of the requirement of obtaining sufficient appropriate audit evidence on opening balances.)

(c) When reporting on prior period financial statements in connection with the current period's audit, if the auditors' opinion on such prior period financial statements differs from the opinion the auditors previously expressed

An Other Matter paragraph must not refer to something that has been included as a Key Audit Matter (see Section 3).

The following is an example of an Other Matter paragraph, taken from the appendix to SSA 710.
Other Matter

The financial statements of the Company for the year ended 31 December 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on 31 March 20X1.

The Other Matter paragraph is included after the Basis for Opinion paragraph and any Emphasis of Matter paragraph and after any Key Audit Matters section (or elsewhere in the auditors' report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section).

In SSA 560 Subsequent Events, a statement is required in either an Emphasis of Matter or Other Matter paragraph where facts become known to the auditor after the date of the auditor's report but before the date the financial statements are issued.

(a) Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditors are permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either:

(i) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or

(ii) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

(b) Where a reference is required referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

2.3 Modified opinions

Modified opinions are covered by SSA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report, which identifies three types of possible modification:

- A qualified opinion (material misstatement or an inability to obtain sufficient appropriate audit evidence)
- An adverse opinion
- A disclaimer of opinion

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

<table>
<thead>
<tr>
<th>Nature of matter giving rise to the modification</th>
<th>Auditor's judgment about the pervasiveness of the effects or possible effects on the financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements are materially misstated</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence</td>
<td>Qualified opinion</td>
</tr>
</tbody>
</table>
Alternatively, the decision tree below can be used to decide between the various types of audit opinion.

```
Financial statements give a true and fair view

Material item(s) in the financial statements does not give a true and fair view

A true and fair view is not given because material misstatements are pervasive to the financial statements

The auditor cannot tell whether a true and fair view is given in respect of one or a few material item(s) due to being unable to obtain sufficient appropriate audit evidence

Auditor cannot tell whether a true and fair view is given at all due to being unable to obtain sufficient appropriate audit evidence over a few or many material items
```

The concept of ‘pervasiveness’ is crucial here in deciding which opinion to express.

**KEY TERM**

**Pervasive** is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor’s judgment:

- Are not confined to specific elements, accounts or items of the financial statements
- If so confined, represent or could represent a substantial proportion of the financial statements
- In relation to disclosures, are fundamental to users’ understanding of the financial statements

(SSA 705.5)
The following reports are given when there is an inability to obtain sufficient appropriate audit evidence.

### Qualified opinion

We have audited the financial statements of ABC Company (the Company) and its subsidiaries (the Group), which comprise the consolidated statement of financial position of the Group and the statement of financial position of the Company as at 31 December 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows of the Group for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements of the Group and the statement of financial position of the Company are properly drawn up in accordance with the provisions of the Companies Act, Chapter 50 (the Act) and Singapore Financial Reporting Standards (International) (SFRS(I)s) so as to give a true and fair view of the consolidated financial position of the Group and the financial position of the Company as at 31 December 20X1 and of the consolidated financial performance, consolidated changes in equity and consolidated cash flows of the Group for the year ended on that date.

#### Basis for Qualified Opinion

The Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at $xxx on the consolidated statement of financial position as at 31 December 20X1, and the Company's share of XYZ's net income of $xxx is included in the Group's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of the Company's investment in XYZ as at 31 December 20X1 and the Company's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with Singapore Standards on Auditing (SSAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the Accounting and Corporate Regulatory Authority (ACRA) Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Singapore, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ACRA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.
Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after 31 December 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X0 and 20X1, which are stated in the statements of financial position at $xxx and $xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of $xxx as at 31 December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

The following reports are given when the financial statements are materially misstated.

Qualified opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements are properly drawn up in accordance with the provisions of the Companies Act, Chapter 50 (the Act) and Singapore Financial Reporting Standards (International) (SFRS(I)s) so as to give a true and fair view of the financial position of the Company as at 31 December 20X1 and of the financial performance, changes in equity and cash flows of the Company for the year ended on that date.

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at $xxx. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from FRS 2, *Inventories*. The Company's records indicate that, had management stated the inventories at the lower of cost and net realisable value, an amount of $xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by $xxx, and income tax, net income and shareholders' equity would have been reduced by $xxx, $xxx and $xxx, respectively.

We conducted our audit in accordance with Singapore Standards on Auditing (SSAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Accounting and Corporate Regulatory Authority (ACRA) Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Singapore, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ACRA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.
Adverse opinion

We have audited the financial statements of ABC Company (the Company) and its subsidiaries (the Group), which comprise the consolidated statement of financial position of the Group and the statement of financial position of the Company as at 31 December 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows of the Group for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements of the Group and the statement of financial position of the Company do not give a true and fair view of the consolidated financial position of the Group and the financial position of the Company as at 31 December 20X1 and of the consolidated financial performance, consolidated changes in equity and consolidated cash flows of the Group for the year then ended in accordance with the provisions of the Companies Act, Chapter 50 (the Act) and Singapore Financial Reporting Standards (International) (SFRS(I)s).

Basis for Adverse Opinion

As explained in Note X, no provision has been made for losses expected to arise on certain significant long-term contracts currently in progress, as management considers that such losses should be off-set against amounts recoverable on other long-term contracts. Provision for foreseeable losses on individual contracts is required by FRS 11, Construction Contracts. Had such losses been provided for, the effect would have been to reduce the profit before tax and the contract work in progress by $xxx, income taxes by $xxx and retained earnings by $xxx. Additionally, net profit for the year would have been reduced by $xxx.

We conducted our audit in accordance with Singapore Standards on Auditing (SSAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the Accounting and Corporate Regulatory Authority (ACRA) Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Singapore, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ACRA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Note: The auditor's reports in SSA 705 Modifications to the Opinion in the Independent Auditor's Report have not been updated for SFRS(I) at the time this Textbook went to print. Thus, the illustrative auditor's reports in SSA 705 still refer to FRS 2, Inventories and FRS 11 Construction Contracts, as opposed to the relevant SFRS(I)s which you will be examined on.
2.4 Going concern

Various situations can arise in relation to going concern, and we saw in Chapter 12 the effects of these situations on the auditor's report. There are two main potential situations: either the going concern basis of accounting is appropriate but there is a material uncertainty, or the going concern basis of accounting is inappropriate.

The following table shows the effects on the auditor's report of each of these situations giving rise to a modification.

<table>
<thead>
<tr>
<th>Disclosure/treatment</th>
<th>GC basis of accounting appropriate, but with Material Uncertainty</th>
<th>GC basis of accounting inappropriate</th>
</tr>
</thead>
<tbody>
<tr>
<td>adequate</td>
<td>• Unmodified opinion</td>
<td>• Unmodified opinion (where alternative basis of preparation used appropriately)</td>
</tr>
<tr>
<td></td>
<td>• Section headed ‘Material Uncertainty Related to Going Concern’</td>
<td>• Consider EoM to draw attention to alternative basis of preparation</td>
</tr>
<tr>
<td>inadequate</td>
<td>• Qualified or adverse opinion</td>
<td>• Adverse opinion</td>
</tr>
</tbody>
</table>

Here is an example of an auditor's report where there is a material uncertainty, with adequate disclosure. The report is standard/unmodified, except for this new paragraph, placed straight after the ‘Basis for Opinion’:

Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of $ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by $ YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

This replaces the use of an Emphasis of Matter paragraph, which used to be used in this situation.

Also the inclusion of this paragraph means that going concern is not a ‘Key Audit Matter’ (covered in the next section).

Question 16.1

You are an audit senior. You are nearing the end of the audit of Funghi Ltd for the year ended 30 June 20X8. Funghi Ltd owns a small chain of high-street clothing stores and also has a manufacturing division where it makes its own label brand 'Little Miss'. Own label clothing represents 50% of the inventory and sales of Funghi Ltd. The financial statements show a profit before tax of $7 million (20X7: $3 million) and a statement of financial position total of $23 million (20X7: $15 million). The following points have arisen on the audit:

(a) Funghi Ltd owns a number of its retail premises, which it revalues annually. This year several of its shops rose sharply in value due to inflated property prices in their locality. Funghi Ltd also capitalises refits of its shops. Two shops were refitted in the year. The total increase in assets due to refits and revaluations is $10 million. Funghi Ltd does not revalue its factory premises, which are held in the statement of financial position at $175,000.
(b) Funghi Ltd values its inventory at the lower of cost or net realisable value. Cost is determined by deducting a suitable estimated profit margin from selling price. Inventory in the statement of financial position at 30 June 20X8 was $1,265,000.

(c) Funghi Ltd has a refunds policy which states that a customer who is not satisfied with their purchase may return their goods within 28 days of purchase and obtain an exchange or a cash refund. Experience has shown that exchanges and refunds are common, as Funghi Ltd's shops do not provide fitting rooms, space being at a premium. Funghi Ltd does not make any provision in the financial statements for refunds.

Required

Comment on the matters you will consider in relation to the implications of the above points on the auditor's report of Funghi Ltd.

2.5 Form and content of modified reports

SSA 705 is very specific about the format of modified reports.

2.5.1 Opinion paragraph

The paragraph should be entitled 'Qualified Opinion', 'Adverse Opinion', or 'Disclaimer of Opinion' as appropriate. This paragraph should match the relevant example given above, and does not include a description of the reasons for the opinion being expressed, as this is included in the paragraph below it.

2.5.2 Basis for Modification paragraph

This paragraph must be included whenever the opinion is modified, and must bear the title ‘Basis for Qualified Opinion' (or Adverse Opinion/Disclaimer of Opinion).

If there is a material misstatement, then the paragraph must:

- Quantify the financial effects of the misstatement. If impracticable, this should be stated;
- Explain why any narrative disclosures are misstated;
- Describe any omitted information or disclosures (unless prohibited by law).

If there is an inability to obtain sufficient appropriate audit evidence, then the paragraph must give the reasons for the inability.

Finally, when a modified opinion is expressed, this will affect the 'auditor's responsibility' section of the report, which must now end with eg 'We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified [or adverse] audit opinion' (for qualified/adverse opinions). Where the opinion is a Disclaimer of Opinion, the 'auditor's responsibility' is completely different.

2.6 Critically appraising an audit opinion

Critiquing an audit opinion is an extension of forming an audit opinion. It is necessary to form an audit opinion yourself in order to ascertain whether someone else's conclusions on the same facts are fair and reasonable.

2.6.1 When will it be necessary to critically appraise an audit opinion?

The exam will be based on real-life scenarios and it is important for you to consider the actual context in which audit opinions will be appraised. Consider the following situations:

- Engagement partner reviewing the audit work and conclusions drawn
- Second partner required to review an audit file
Probably the most common example is the engagement partner conducting a file review before drawing an opinion, which is given on the auditor’s report that the engagement partner takes responsibility for. The audit team has carried out the work, and in doing so has drawn audit conclusions about each aspect of the audit work. The engagement partner must appraise these conclusions and determine whether they are correct or not.

Where a second partner review has been required, for instance, if the client is listed, one of the things the second partner is required to do is to review the audit opinion suggested and assess whether it is reasonable.

2.6.2 How should an auditor critically appraise an audit opinion?

Auditors should form their own opinions on the basis of the facts and then evaluate the original audit opinion in the light of their own opinion. As this is a matter of judgment, it is possible that two different, yet reasonable conclusions could be drawn. For instance, auditors might disagree on whether a matter was material or not. If this was the case, further judgments and risk assessments would have to be made.

In exam questions, then, you should bear in mind the step process required to form an audit opinion in the first place. If you work through each step, you may be able to see that the person who formed the original opinion has missed out steps or failed to notice something important.

In the final analysis, this is a skill that you must practise to be able to do well. Try the following question.

Question 16.2 Critically appraising an audit opinion

You are an audit partner. Your AE carries out the audit of Mayflower Ltd, a public company. Because the company is a listed entity, you have been asked to perform a second partner review of the audit file for the year ended 30 June 20X8 before the audit opinion is finalised. Reported profit before tax is $1.65 million and the statement of financial position total is $7.6 million.

You have read the following notes from the audit file:

‘Earnings per share
As required by SFRS(I) 1-33 Earnings per share, the company has disclosed both basic and diluted earnings per share. The diluted earnings per share has been incorrectly calculated because the share options held by a director were not included in the calculations. Disclosed diluted earnings per share are 22.9c. Had the share options held by the director been included, this figure would have been 22.4c. This difference is immaterial.

Financial performance statement
The directors have currently not amended certain financial performance ratios in this statement to reflect the changes made to the financial statements as a result of the auditors’ work. The difference between the reported ratios and the correct ratios is minimal.

Opinion
We recommend that an unmodified auditor’s report be issued.’

A corporate governance statement referring to the Singapore Code of Corporate Governance is to be issued as part of the annual report, but there is no evidence on file that this has been reviewed by the audit team. You are aware that the company does not have an audit committee.

You are also aware that the director exercised their share options last week.

Required
Comment on the suitability of the proposed audit opinion and other matters arising in the light of your review. Your comments should include an indication of what form the auditor’s report should take.
SECTION SUMMARY
Auditors express an opinion on financial statements based on the work they have done, the evidence obtained and conclusions drawn in relation to that evidence.

3 Key audit matters (KAMs)

SECTION INTRODUCTION
Listed company auditor's reports include a description of the key audit matters.

SSA 701 Communicating Key Audit Matters in the Independent Auditor's Report sets out the auditor's responsibility to communicate KAMs.

KEY TERM
KEY AUDIT MATTERS are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

(SSA 701.8)

Reporting on KAMs aims to improve transparency by helping users to understand the most significant issues the auditor faced. This should enhance the communicative value of the auditor's report.

KAMs are part of every listed company auditor's report, and can be included in other auditor's reports if needed. KAMs do not constitute a modification of the report or of the opinion. They are a part of the standard report which must be tailored to each company's circumstances. KAMs are not a substitute for disclosures, for Emphasis of Matter or Other Matter paragraphs, nor for modified opinions. KAMs must always relate to matters already included within the financial statements.

The auditor's objectives are as follows.

SSA 701.7
The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

KAMs are communicated after the opinion. This is because the reported KAMs do not include matters which have resulted in a modified opinion – any explanations in relation to these issues would already have been included in the ‘Basis for’ modified opinion paragraph.

The auditor must do four main things:

- Determine the matters which should be described as KAMs.
- Communicate the KAMs in the auditor's report.
- Communicate the KAMs to those charged with governance.
- Keep appropriate audit documentation.
3.1 Determining KAMs

KAMs should be selected from the matters communicated to those charged with governance, and they should represent the issues which have required the most audit attention during the audit. In working out which matters to report as KAMs, the auditor takes into account:

- Areas of higher risk of material misstatement, or ‘significant risks’ identified in line with SSA 315 (Revised) (eg at the planning stage)
- Significant auditor judgments in relation to areas where significant management judgments are involved
- The effect of significant events or transactions

The key part of the definition of KAMs above is that these are the most significant matters, and are more significant than the other matters communicated to those charged with governance. In other words, the auditor must edit out the less significant issues, and only include the really important ones in the auditor's report. This involves using the auditor's professional judgment.

It should be obvious that KAMs are specifically audit matters, not just difficult areas of financial reporting. You could think of these as the areas that have been the most prominent during the audit or those on which most time and effort were spent.

The decision-making framework looks like this:

Source: IAASB The New Auditor’s Report, slide presentation, March 2015 (amended)

One approach might therefore be to begin with the audit matters communicated to those charged with governance, and to pick the key matters from those.

SSA 701 notes that these 'matters of most significance' may be the ones that there has been most discussion with management about. Other things to consider when determining KAMs include:

- The importance of the matter to intended users' understanding, including materiality
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved
- The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any
- The nature and extent of audit effort needed to address the matter (including the need for specialised knowledge and for consultations outside the audit engagement team)
- The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, obtaining evidence or forming conclusions, including more subjective judgments
- The severity of any control deficiencies
- Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may have an effect on other accounting estimates
How many KAMs should the auditor report? This is a matter of judgment and depends on the circumstances, but the auditor should not just report everything. They are key matters, and by definition not everything is 'most significant'.

3.1.1 Choosing not to include a KAM
The auditor may choose not to communicate a matter identified as a KAM, but only under specific circumstances:

The description of each KAM says two main things:

**SSA 701.14**
The auditor shall describe each key audit matter in the auditor's report unless:

(a) Law or regulation precludes public disclosure about the matter; or

(b) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

One example of this is where the auditor suspects money laundering since communications might prejudice an investigation. Including suspicions of money laundering as a KAM would be tipping off.

3.2 Communicating KAMs
KAMs are communicated in a separate subsection of the auditor's report. There is a general introduction first, and then each KAM is presented in detail. The general introduction states that:

- These are the 'matters of most significance'; and
- No separate opinion is provided on them because they are covered by the audit opinion.

The description of each KAM then says two main things:

**SSA 701.13**
The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

(a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and

(b) How the matter was addressed in the audit.

The example below contains a separate paragraph for each of these, and includes a reference to where the disclosures are for goodwill.

Here is an example of how KAMs could appear, taken from the IAASB's guidance publication *Auditor reporting – illustrative key audit matters*:

**Key Audit Matters**
Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.
Goodwill

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of $XX as at December 31, 20X1 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

The Company's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Revenue Recognition

The amount of revenue and profit recognized in the year on the sale of [name of product] and aftermarket services is dependent on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of [name of product]. As the commercial arrangements can be complex, significant judgment is applied in selecting the accounting basis in each case. In our view, revenue recognition is significant to our audit as the Group might inappropriately account for sales of [name of product] and long-term service agreements as a single arrangement for accounting purposes and this would usually lead to revenue and profit being recognized too early because the margin in the long-term service agreement is usually higher than the margin in the [name of product] sale agreement.

Our audit procedures to address the risk of material misstatement relating to revenue recognition, which was considered to be a significant risk, included:

- Testing of controls, assisted by our own IT specialists, including, among others, those over: input of individual advertising campaigns' terms and pricing; comparison of those terms and pricing data against the related overarching contracts with advertising agencies; and linkage to viewer data; and
- Detailed analysis of revenue and the timing of its recognition based on expectations derived from our industry knowledge and external market data, following up variances from our expectations.

3.2.1 KAMs should not provide new information

The KAMs are matters that are already disclosed in the entity's financial statements. They may refer to financial reporting issues, but they describe the matter in the context of the audit.

KAMs should not therefore provide new information about the entity, ie information that is not already in the financial statements. If something is not disclosed but the auditor thinks it should be, then the auditor should ask management to disclose it.

3.2.2 No KAMs?

It is possible that there might not be any KAMs to communicate. SSA 701 does allow for this possibility, but only in extremely rare circumstances, eg for a listed entity which has very limited operations (eg if it has not traded during the period).

In this case the auditor's report still has a section on KAMs, but states that there were none to communicate.
3.2.3 Audit Practice Bulletin no 2 of 2016

In August 2016, ACRA published Audit Practice Bulletin (APB) No 2 of 2016 *The Enhanced Auditor Reporting Standards: Communicating Key Audit Matters and Addressing Going Concern in “Close-Call” Situations*. The APB notes that the determination of KAMs requires significant professional judgement and so provides extra guidance on how to identify KAMs. It also details ACRA’s expectations with regards to the documentation requirements of SSA 701.

3.3 Relationship with the auditor's opinion

The basic relationship is this:

```
Financial statements as a whole
```

```
Key audit matters (KAMs)  Auditor's opinion
```

The KAMs are the key matters for the audit of the financial statements as a whole. They are not separate auditor's opinions for each little part of the financial statements, but merely further information on the process that led up to the opinion on the financial statements as a whole. Likewise, the auditor's opinion refers to the financial statements as a whole: as a whole they might give a true and fair view, or as a whole they might be true and fair but 'except for' one area (and so on).

If the auditor is going to express a modified opinion, then logically the matter giving rise to the modification is a key audit matter. However, the description of the matter will be given in the 'basis for modified opinion' paragraph, so it is not included as a KAM in the report. The auditor should include a reference to the basis for modified opinion paragraph instead.

SSA 701 also makes special mention of going concern problems. Where there is a material uncertainty in relation to going concern, the matter should not be described as a KAM, but should be discussed in the ‘Material uncertainty in relation to going concern’ paragraph instead.

3.4 Relationship with Emphasis of Matter and Other Matter paragraphs

Key Audit Matters do not overlap with Other Matter paragraphs because KAMs must refer to issues present in the financial statements, whereas Other Matter paragraphs do not by definition.

There is some degree of overlap with Emphasis of Matter paragraphs. The difference is that KAMs do not modify the report, and are included as standard in every listed company auditor's report. An Emphasis of Matter, on the other hand, does modify the report – although neither modifies the opinion. You could think of the issues giving rise to an Emphasis of Matter as being like KAMs but just more extreme: the Emphasis of Matter is for a ‘matter of such importance that it is fundamental for users’ understanding’, whereas KAMs are merely ‘most significant matters’, ie less than fundamental. Where a matter has been included in an Emphasis of Matter paragraph, it must not be included as a KAM as well.

3.5 Communication with those charged with governance, and documentation

The auditor must communicate the KAMs to those charged with governance.

The audit documentation must include the 'significant audit matters' from which the KAMs were selected, together with the auditor's reasons for selecting the KAMs.

If the auditor determines there are no KAMs, this must also be communicated to those charged with governance. If no KAMs are communicated, then the reasons why must be documented. Likewise if a
matter determined to be a KAM is not communicated (e.g. to avoid ‘tipping off’ in relation to money laundering), this must be documented.

SECTION SUMMARY

All listed company auditor’s reports must include a key audit matters (KAMs) section. This section must describe why each KAM was determined and how each KAM was addressed in the audit. KAMs do not constitute a modification to the auditor’s opinion.

4 Communication with those charged with governance

SECTION INTRODUCTION

The audit must promote effective two-way communication.

4.1 Report to those charged with governance

SSA 260 (Revised) Communication with Those Charged with Governance gives guidance in this area.

SSA 260.9

The objectives of the auditor are:

(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit

(b) To obtain from those charged with governance information relevant to the audit

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process, and

(d) To promote effective two-way communication between the auditor and those charged with governance

KEY TERM

THOSE CHARGED WITH GOVERNANCE are the persons or organisations with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

The auditors may communicate with the whole board, the supervisory board or the audit committee depending on the governance structure of the organisation. To avoid misunderstandings, the engagement letter should explain that auditors will only communicate matters that come to their attention as a result of the performance of the audit. It should state that the auditors are not required to design procedures for the purpose of identifying matters of governance interest, however, if the auditors have agreed any specific matters of governance interest to be communicated, it will set these out.
The auditors will also explain:

- The form which any communications on governance matters will take (must be in writing)
- The relevant persons with whom such communications will be made
- The expected content of communications
- The expected timing or frequency of the communications (which should be on a timely basis)

4.1.1 Requirements

SSA 260.11
The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

Where the auditors communicate with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor should also consider the need to communicate with the governing body.

4.1.2 Matters to be communicated
Matters would include the following.

<table>
<thead>
<tr>
<th>Matters to be communicated</th>
<th>Including that:</th>
</tr>
</thead>
</table>
| The auditor's responsibilities in relation to the financial statements | • The auditor is responsible for forming and expressing an opinion on the financial statements  
• The audit does not relieve management or those charged with governance of their responsibilities |
| Planned scope and timing of the audit | Including: |
| | • How the audit proposes to address the significant and higher risks of material misstatement from fraud or error  
• The auditor's approach to internal control  
• Application of materiality  
• Whether an auditor's expert will be used  
• Preliminary views of areas that may be key audit matters (where this is a required section in the auditor's report)  
• The extent to which the auditor will use the work of internal audit  
• Matters those charged with governance consider warrant particular attention  
• For group audits, the group audit approach  
• The expectation of co-operation from management |
### Matters to be communicated

**Significant findings from the audit**

- Selection of, or changes in, significant accounting policies
- The potential effect on the financial statements of any significant risks and exposures, for example pending litigation, that are required to be disclosed in the financial statements
- Significant difficulties, if any, encountered during the audit (e.g., delays in provision of required information, brief time in which to complete audit, unavailability of expected information)
- Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control, including identified fraud risks
- Written representations the auditor is requesting
- Circumstances that affect the form and content of the auditor’s report (including key audit matters)
- Other significant matters including material misstatements or inconsistencies in other information that have been corrected
- Uncorrected adjustments

**Auditor independence**

In the case of listed entities, matters include:

- A statement that relevant ethical requirements regarding independence have been complied with
- All relationships (including total fees for audit and non-audit services) which may reasonably be thought to bear on independence
- The related safeguards that have been applied to eliminate/reduce identified threats to independence

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### 4.1.3 Communication process

The communication process will vary with the circumstances including:

- The size and governance structure of the entity
- How those charged with governance operate
- The auditor's view of the significance of the matters to be communicated

For example, reports of relatively minor matters to a small client may be best handled orally via a meeting or telephone conversation.

Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it would not be appropriate to discuss questions of management's competence or integrity with management.

### 4.1.4 Timing

The auditor shall communicate with those charged with governance on a timely basis.

### 4.1.5 Adequacy of the communication process

The auditor is required to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purposes of the audit. If not adequate and the situation cannot be resolved, the auditor may take action as follows:

- Modifying the auditor's opinion on the basis of an inability to obtain sufficient appropriate audit evidence
- Obtaining legal advice
- Communicating with third parties (e.g., shareholders in a general meeting)
- Withdrawing from the engagement where permitted in the relevant jurisdiction
4.1.6 Documentation
Where matters are communicated orally the auditor is required to document them and to note when and to whom they were communicated.

4.2 Reporting deficiencies in internal control

SSA 265 Communicating Deficiencies in Internal Control to those Charged with Governance and Management deals with this area.

SSA 265.5
The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

KEY TERMS
A DEFICIENCY IN INTERNAL CONTROL exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or a control necessary to prevent or detect and correct misstatements in the financial statements on a timely basis is missing.

A SIGNIFICANT DEFICIENCY IN INTERNAL CONTROL is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

The auditor determines whether any deficiencies in internal control have been identified during the audit, and if so, whether individually or in combination, they are significant deficiencies.

SSA 265.A6
Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions with related parties.
Controls over significant transactions outside the entity's normal course of business.

- Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

- The interaction of the deficiency with other deficiencies in internal control.

### SSA 265.A7

Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.

- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).

- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

- Evidence of management's inability to oversee the preparation of the financial statements.

### SSA 265.9

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The communication should include a description of the deficiencies and an explanation of their potential effects. The communication should also make clear that the audit was for the purpose of identifying misstatements in financial statements, not identifying deficiencies in controls, and that the deficiencies identified have been identified as part of audit work, and are not exhaustive.

Auditors shall also issue a report on control deficiencies to management.
The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

### 4.2.1 Key qualities of a report

**Recap of key qualities of a report to those charged with governance**

- It should not include language that conflicts with the opinion expressed in the auditor's report.
- It should state that the accounting and internal control systems were considered only to the extent necessary to determine the auditing procedures to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurance on the accounting and internal control systems.
- It will state that it discusses only deficiencies in internal control which have come to the auditors' attention as a result of the audit and that other deficiencies in internal control may exist.
- It should also include a statement that the communication is provided for use only by management (or another specific named party).
- The auditors will usually ascertain the actions taken, including the reasons for those suggestions rejected.
- The auditors may encourage management to respond to the auditors' comments in which case any response can be included in the report.
- It should be issued on a timely basis.

### 4.2.2 Form of report

The form of the report will depend on the type of organisation concerned. It may be appropriate to divide the report into sections, which cover significant and general points for senior management first, and then proceed to more specific, divisional points in subsequent sections. The report covering findings from the audit may typically be in the form of a covering letter (see below) and a schedule of points raised.
Example: Reports to management covering letter

Private & Confidential

The Directors

XYZ Ltd

1 High Street

Anytown

24 June 20XX

Dear Sirs

XYZ Ltd

Following our recent audit of your company, we are writing to advise you of various matters which came to our attention.

We set out on the attached schedule the areas of significant deficiency which we noted, together with our recommendations. These recommendations have already been discussed with... and their comments have been included.

As the purpose of the audit is to form an opinion on the company's financial statements, you will appreciate that our examination cannot necessarily be expected to disclose all shortcomings of the system and for this reason, the matters raised may not be the only ones which exist.

We should appreciate your comments as to how you propose to deal with the matters raised in this letter. If you require any further information or advice, please contact us.

We have prepared this letter for your use only. It should not be disclosed to a third party and we can assume no responsibility to any person to whom it is disclosed without our written consent.

We would like to take this opportunity to thank you and your staff for your help and co-operation during the course of our audit.

Yours faithfully,

ABC & Co

4.2.3 Specific recommendations

The detailed recommendations included in the appendix would be structured as per the following example.

Preparation of payroll and maintenance of personnel records

Deficiencies

Under your present system, just two members of staff are entirely and equally responsible for the maintenance of personnel records and preparation of the payroll. Furthermore, the only independent check of any nature on the payroll is that the chief accountant confirms that the amount of the wages cheque presented to him for signature agrees with the total of the net wages column in the payroll. This latter check does not involve any consideration of the reasonableness of the amount of the total net wages cheque or the monies being shown as due to individual employees.
Implications
The fact that two people have so much responsibility over the payroll system and their duties are not clearly defined make it possible that clerical errors could go undetected and in the worst case, fraud could take place in this area (e.g., by inserting the names of 'ghost employees' into the personnel records and hence on to the payroll).

Recommendations
(i) A person other than the two wages clerks could be made responsible for maintaining the personnel records and for periodically (but on a surprise basis) checking them against the details on the payroll.
(ii) The two wages clerks could be allocated specific duties in relation to the preparation of the payroll, with each clerk independently reviewing the work of the other.
(iii) When the payroll is presented in support of the cheque for signature to the chief accountant, he could be responsible for assessing the reasonableness of the overall charge for wages that week.

SECTION SUMMARY
Auditors must report relevant audit matters to those charged with governance and will also sometimes produce a report to management detailing control deficiencies observed during the audit. The primary purpose of the report to management is to inform management of deficiencies in the system of internal controls, but the letter can also be used for other purposes.

5 Actions when an auditor's report is modified

SECTION INTRODUCTION
If the auditor's report is modified the auditor must consider legal and professional issues.

5.1 Communicate with those charged with governance

If the auditor expects that the audit opinion will be modified, then they must communicate the circumstances surrounding the modification with those charged with governance along with the wording of the modification. This is in order:

- To give notice with those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s)
- To confirm the auditor's understanding with those charged with governance of the facts of any matters giving rise to modifications, and to confirm matters on which the auditor and those charged with governance disagree
- To give those charged with governance an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s)

SSA 706 contains a similar requirement in relation to Emphasis of Matter and Other Matter paragraphs.
In addition, it is a specific requirement of SSA 260 that ‘circumstances that affect the form and content of the auditor's report’ are communicated with those charged with governance.

5.2 External consultation

If a modified opinion is expected to be expressed, then the auditor may need to consider consulting externally on the impact of this, eg with legal counsel under legal privilege, or anonymously with ISCA. Such situations are not common in practice.

5.3 Management integrity

The first thing to consider where the auditor's report is to be modified is whether the matter in question suggests that management may not have the requisite integrity. This is particularly relevant where the scope of the audit has been limited by management, eg if management refuses to allow auditors access to all necessary books and records.

If the auditor does consider management's integrity to be in doubt, then any representations (including written representations) provided by management during the course of the audit need to be re-considered in this light.

It may also be necessary to perform an engagement quality control review on the audit, as a lack of management integrity would mean that the audit carries a higher level of risk than may have been envisaged at the planning stage of the audit.

5.4 Withdrawal from engagement

If the matter in relation to which the auditor's report is modified is sufficiently serious, then it may be necessary to seek to withdraw from the audit engagement. If the auditor does seek to withdraw then it will be necessary to obtain advice from legal counsel.

SSA 210 Agreeing the Terms of Audit Engagements states that if there has been a limitation on the scope of a prior audit which leads the auditor to believe that the audit opinion expressed this year will likely be a disclaimer of opinion, then the auditor must not accept the engagement (unless required to do so by law).

SECTION SUMMARY

When the auditor's report is expected to be modified, the auditor must communicate with those charged with governance, and must consider the effect of the modification on future audit engagements.

6 Special purpose auditor's reports

SECTION INTRODUCTION

Auditing guidance is given in SSAs 800, 805 and 810 for when there are special considerations required in relation to audit reporting.
6.1 Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

6.1.1 Overview

SSA 800 (Revised) Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks aims to address special considerations that are relevant to complete sets of financial statements prepared in accordance with another basis of accounting.

The aim of the SSA is simply to identify additional audit requirements relating to these areas.

6.1.2 General considerations

(a) Before undertaking a special purpose audit engagement, the auditor should ensure there is agreement with the client as to the exact nature of the engagement and the form and content of the report to be issued.

(b) To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to indicate in the report the purpose for which it is prepared and any restrictions on its distribution and use. (Note the distribution and use of reports is not allowed for statutory audit.)

6.1.3 Special purpose frameworks

In the context of the SSA, special purpose frameworks refer to a financial reporting framework designed to meet the financial information needs of specific users.

The financial reporting framework may be a fair presentation framework or a compliance framework. Specific examples include:

- Tax basis of accounting for a set of financial statements that accompany an entity's tax return
- Cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors
- The financial reporting provisions established by a regulator to meet that regulator's requirements
- The financial reporting provisions of a contract, such as a bond, indenture, a loan agreement, or a project grant

SSA 800 (Revised) Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks states that the auditor shall form an opinion and report on the special purpose financial statements, applying the requirements of SSA 700 (Revised). This SSA requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

The auditor's report in these circumstances shall include an Emphasis of Matter paragraph alerting users that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. This helps to avoid misunderstandings where the special purpose financial statements might be used for purposes other than those intended.

6.1.4 Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

SSA 805 (Revised) Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement relates to individual elements of financial statements such as the liability for accrued benefits of a pension plan or a schedule of employee bonuses.

Many financial statement items are interrelated. Therefore, when reporting on a component the auditor will not always be able to consider it in isolation and will need to examine other financial information.
This will need to be considered when assessing the scope of the engagement and determining whether the audit of a single statement or single element is practicable.

The auditor's report shall indicate the applicable financial reporting framework adopted or the basis of accounting used and shall state whether the component is prepared in accordance with this.

### Reporting considerations

| Engagements that involve reporting on a single financial statement or a specific element in conjunction with auditing the entity's complete set of financial statements | • The auditor shall express a separate opinion for each engagement.  
• The auditor shall ensure that management presents the single financial statement or specific element of a financial statement in such a way that it is clearly differentiated from the complete set of financial statements. |
| --- | --- |
| The auditor's report on the entity's complete set of financial statements includes one or more of the following:  
• A modified opinion  
• An Emphasis of Matter or Other Matter paragraph  
• A Material Uncertainty Related to Going Concern section  
• Key Audit Matters  
• A statement that describes an uncorrected material misstatement of other information | • The auditor shall consider the implications for the audit of the single financial statement or specific element of a financial statement and for the auditor's report. |
| The auditor has expressed an adverse opinion or disclaimed an opinion on the entity's complete set of financial statements | • The auditor must not include an unmodified opinion on a single financial statement or specific element that forms part of those financial statements in the same report (as this would contradict the adverse opinion or disclaimer on the complete set of financial statements).  
• The auditor must not express an unmodified opinion on a single financial statement of a complete set financial statements even if the report on the single financial statement is not published with the auditor's report containing the adverse opinion or disclaimer.  
• If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element of those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:  
  – Not prohibited by law  
  – The opinion is published separately  
  – The element does not constitute a major portion of the entity's complete set of financial statements |
### 6.1.5 Engagements to Report on Summary Financial Statements

SSA 810 (Revised) Engagements to Report on Summary Financial Statements deals with this issue. The key point which it makes is that the auditor shall not accept an engagement to express an opinion on the summarised financial statements unless they have expressed an audit opinion on the financial statements from which they have been derived.

#### Reporting considerations

<table>
<thead>
<tr>
<th>SSA 810.5</th>
<th>SSA 810.9</th>
<th>SSA 810.19</th>
<th>SSA 810.20</th>
<th>SSA 810.21</th>
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</thead>
<tbody>
<tr>
<td><strong>Form of opinion</strong></td>
<td><strong>Unless law specifies otherwise, the wording should be:</strong></td>
<td><strong>When the auditor's report on the audited financial statements includes:</strong></td>
<td><strong>When the auditor's report on the audited financial statements contains an adverse opinion, or a disclaimer</strong></td>
<td><strong>Modified opinion on the summary financial statements</strong></td>
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<td>• The accompanying summary financial statements are consistent in all material respects with the audited financial statements, in accordance with the applied criteria; or</td>
<td>• A qualified opinion</td>
<td>• A statement that describes an uncorrected material misstatement of other information</td>
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<td></td>
<td>• The auditor must:</td>
<td>• An Emphasis of Matter (EoM) or Other Matter (OM) paragraph</td>
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<td></td>
<td>• A Material Uncertainty Related to Going Concern section</td>
<td>• A Material Uncertainty Related to Going Concern section</td>
<td>• Describe:</td>
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<td>• Key Audit Matters (KAMs)</td>
<td>• Key Audit Matters (KAMs)</td>
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<td>• A statement that describes an uncorrected material misstatement of other information</td>
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When the auditor's report on the audited financial statements includes:

- A qualified opinion
- An Emphasis of Matter (EoM) or Other Matter (OM) paragraph
- A Material Uncertainty Related to Going Concern section
- Key Audit Matters (KAMs)
- A statement that describes an uncorrected material misstatement of other information

If the auditor is satisfied that an unmodified opinion, as above, is appropriate for the summary financial statements, the report must:

- State that the auditor's report on the audited financial statements includes a qualified opinion, an EoM or OM paragraph, a Material Uncertainty Related to Going Concern section, KAMs or a statement that describes an uncorrected material misstatement of other information; and
- Describe:
  - The basis for the qualified opinion; or
  - The matter referred to in the EoM, OM, or Material Uncertainty Related to Going Concern section; or
  - The uncorrected material misstatement of other information
- Explain the effect on the summary financial statements if any.

When the auditor's report on the audited financial statements contains an adverse opinion, or a disclaimer

The auditor must:

- State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;
- Describe the basis for the adverse opinion or disclaimer; and
- State that it is inappropriate to express an opinion on the summary financial statements.

Modified opinion on the summary financial statements

If the summary financial statements are not consistent in all material respects with the audited financial statements (or not a fair summary of the audited financial statements) and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.
SECTION SUMMARY

Where the audit is of financial statements prepared in accordance with a special purpose framework or where the audit is a single financial statement or specific element, account or item the auditor's report must specify the applicable reporting framework. For engagements to report on summary financial statements the auditor must not express an opinion on the summary financial statements unless they have expressed an opinion on the financial statements from which the summary is derived.
Chapter Roundup

Auditor's report

SSA 700

- Title
- Addressee
- Auditor's Opinion
- Basis for Opinion
- Going Concern
- Key Audit Matters (SSA 701)
- Other Information
- Management and auditor's responsibilities
- Other reporting responsibilities
- Name of the engagement partner (if listed)
- Signature
- Address
- Date

SSA 705

Opinion is modified

SSA 706

Opinion is unmodified

Special purpose audit reports

SSA 800
SSA 805
SSA 810

Emphasis of matter
Other matter

Qualified
Adverse
Disclaimer

Either a:
- Material misstatement
- Inability to obtain sufficient appropriate audit evidence which is material but not pervasive

Material misstatement that is material and pervasive
An inability to obtain sufficient appropriate audit evidence that is material and pervasive

SSA 260

Auditor's responsibilities
- Scope/timing
- Significant findings
- Auditor independence

SSA 265

Deficiencies in internal control

Significant
Not significant

Communicating to those charged with governance
Quick Quiz

1. Name the various opinions auditors may give in their auditor's report.
   
   (1) ........................................
   
   (2) ........................................
   
   (3) ........................................

2. Complete the definitions.
   
   (a) …………………………. information is free from ………………………… and …………………………. and is in compliance with the expected standards and rules.
   
   (b) …………………………. is an expression of the relative …………………………. or importance of a particular matter in the …………………………. as a whole.
   
   (c) …………………………. information is …………………………. and conforms with ……………………….., not ……………….. …………….. information conforms with required standards and law.

3. List the main contents of the SSA 700 standard unmodified report.

4. Name four matters which might be covered in a letter to those charged with governance.
   
   (1) ........................................
   
   (2) ........................................
   
   (3) ........................................
   
   (4) ........................................

5. Which of the following could be reported as key audit matters?
   
   - Material uncertainties over going concern;
   
   - Explanations of the auditor's view on other information included in the annual report, and which is consistent with the financial statements;
   
   - Explanations of judgments made by the auditor in material areas;
   
   - Explanations of judgments made by the auditor on matters that are of such importance that they are fundamental to users' understanding of the financial statements.
Answers to Quick Quiz

1. (1) Unmodified
   (2) Modified due to material misstatement
   (3) Modified due to the inability to obtain sufficient appropriate audit evidence

2. (a) Fair, discrimination, bias
   (b) Materiality, significance, financial statements
   (c) True, factual, reality, false, true

3. Title, addressee, auditor's opinion, basis for opinion, going concern (where required), key audit matters, other information, responsibilities for the financial statements, auditor's responsibilities for the audit of the financial statements, other reporting responsibilities, name of the engagement partner, signature, address, date

4. Any four from the following:
   - Auditor's responsibilities in relation to the financial statements
   - The general approach or overall scope of the audit
   - Selection of, or changes in, significant accounting policies
   - The potential effect on the financial statements of any significant risks and exposures, for example, pending litigation, that are required to be disclosed in the financial statements
   - Significant difficulties encountered during the audit
   - Other significant matters such as significant deficiencies in internal control, questions regarding management integrity, and fraud involving management
   - Other matters mentioned in terms of engagement
   - Circumstances that affect the form and content of the auditor's report (including key audit matters)

5. Explanations of judgments made by the auditor in material areas are KAMs. All of the other answers are incorrect. Why? Let's see:
   - Material uncertainties over going concern would be explained in a separate section of the report.
   - Explanations of the auditor's view on other information included in the annual report is not a key audit matter as it does not relate to the financial statements.
   - Explanations of judgments made by the auditor on matters that are fundamental to users' understanding may be key audit matters, but since they may require an emphasis of matter paragraph they would not be reported in the key audit matters section of the auditor's report.
16.1 Forming an audit opinion

(a) Non-current assets

There are two issues here. The first is whether Funghi Ltd's policy of revaluations is correct and the second is whether Funghi Ltd should capitalise refit costs.

The most important issue to consider is materiality as only material items will affect the audit opinion. The revaluations and refit total is material to the statement of financial position. It is possible that any revaluation of the factory premises would also be material.

(i) Revaluation policy

Per SFRS(I) 1-16, non-current assets may be held at cost or valuation. Where a company applies a revaluation policy, SFRS(I) 1-16 requires that all revaluations are made with sufficient regularity that the carrying amount does not vary materially from that which would be determined if fair value were used. Funghi Ltd revalues annually, so meets the requirement.

Funghi Ltd revalues property and SFRS(I) 1-16 requires that all items in the same class of assets be revalued, so the question arises as to whether it should also revalue the factory. This might have a material effect on the statement of financial position.

SFRS(I) 1-16 states that a 'class' of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. Although the SFRS(I) implies that buildings comprise one class, in this case the nature and use of the two kinds of building are quite distinct. Therefore creating two classes (retail premises and manufacturing premises) would appear to be reasonable.

(ii) Refits

Assets should be held at cost or valuation as discussed above. However, in some cases, SFRS(I) 1-16 allows the cost of refits to be added to the original cost of the asset. This is when it is probable that future economic benefits in excess of the originally assessed standard of performance of the existing asset will flow to the entity. A retail shop will be subject to refitting and this refitting may enhance its value. However, it is possible in a shop that such refitting might be better classified as expenditure on fixtures and fittings. Funghi Ltd's policy should be consistent and comparable, so if they have followed a policy of capitalising refits into the cost of the shop in the past, this seems reasonable.

Conclusion

The issues relating to non-current assets are material and could affect the auditor's report. However, having considered the issues, it appears that there are no material misstatements in the financial statements. As there appears to have been no inability to obtain sufficient appropriate audit evidence in relation to non-current assets, the audit opinion would be unmodified in relation to these issues.

(b) Inventory

SFRS(I) 1-2 requires that inventory be valued at the lower of cost or net realisable value. SFRS(I) 1-2 defines cost as all costs of purchase, conversion and other costs incurred in bringing the inventory to its present location and condition.

The SFRS(I) outlines a number of methods of arriving at an approximation of cost in the absence of a satisfactory costing system. One such method is the use of a selling price less an estimated profit margin. This is a costing method commonly used in retail entities. However, this is reasonable only if it can be shown that the method gives a reasonable approximation of cost.
Given that 50% of Funghi Ltd’s inventory is manufactured in-house, it appears to be unlikely that they cannot ascertain the cost of the inventory in a better way than the selling price method. The chain of shops is small, and there should be sufficient controls over inventory transfer to enable the company to establish the cost of inventory using a FIFO system.

While the auditors might suggest to the directors that they look into the costing systems and make improvements in future years, it is unlikely that they would modify the auditor’s report in the current year over this matter, assuming that the directors have shown that the accounting policy gives a reasonable approximation of cost.

This is because if a reasonable approximation of cost is given, the difference is not going to be material to the financial statements. Also, if Funghi Ltd has had the policy for a long period, the policy is at least consistent throughout the year. If the auditors had made recommendations that the system was reviewed in future years and the directors refused to make any amendments to the system in future, the auditors might want to consider taking further action in future years.

Conclusion

If there are no other audit matters arising in relation to inventory, the auditor’s report will be unmodified in this respect.

(c) Provisions

Funghi Ltd offers refunds and exchanges to unhappy customers and experience shows that this offer is commonly taken up. If a sale is refunded, it is as if the sale never took place. It is therefore not prudent for Funghi Ltd to recognise profits on such sales. If items are exchanged, the profit element would still exist, so only the inventory element would be potentially misstated.

As the refund period is 28 days, the issue is isolated to sales made in the last month of the year. In the absence of specific figures, this approximates to 1/12 of annual revenue and profit, and is therefore potentially material. Using these approximations, this would mean that if more than a quarter of June’s sales were refunded, this could be material to revenue, and potentially to profit.

Given that the financial statements are unlikely to be finalised before the end of July, the refunds figure for June should be available to both the directors and to the auditors. They should both be able to assess whether the potential provision required is material to the financial statements, and how much the provision should be, if one is required.

Conclusion

The auditor’s report would only be modified in respect of this matter if the auditors felt that a material provision was required and the directors refused to include one in the financial statements. In this case, the auditors would issue an ‘except for’ opinion, on the grounds of material misstatement in the financial statements.

Overall conclusion

It appears likely that the auditors will issue an unmodified report for the year ended 30 June 20X8.

16.2 Critically appraising an audit opinion

Earnings per share

The problem in the EPS calculation relates to share options held by a director. As they are held by a director, it is unlikely that they are immaterial, as matters relating to directors are generally considered to be material by their nature. The fact that EPS is a key shareholder ratio which is therefore likely to be material in nature to the shareholders should also be considered.
As the incorrect EPS calculation is therefore material to the financial statements, the auditor's report should be modified in this respect, unless the directors agree to amend the EPS figure. This would be an 'except for' modification on the grounds of material misstatement.

**Share options**

The share options have not been included in the EPS calculations. The auditors must ensure that the share options have been correctly disclosed in information relating to the director both in the financial statements and the other information, and that these disclosures are consistent with each other. If proper disclosures have not been made, the auditor will have to express a modified opinion due to lack of disclosure in this area.

**Exercise of share options**

The fact that the director has exercised his share options after the year-end does not require disclosure in the financial statements. However, it is likely that he has exercised them as part of a new share issue by the company and if so, the share issue would be a non-adjusting event after the reporting period that would require disclosure in the financial statements. We should check if this is the case and, if so, whether it has been disclosed. Non-disclosure would be further grounds for modification.

**Financial performance statement**

In line with SSA 720, the financial performance statement is ‘other information’ in the annual report. The auditor is required to read this other information to identify material inconsistencies with the financial statements. The whole of the other information must therefore be read. Since Mayflower Ltd is a listed company, the auditor's report must contain an Other Information section.

An inconsistency has been discovered between the ratio figures, and it is the figures in the other information that are misstated. The figures in the financial statements are not misstated. The auditor should request that management revises the other information for any material misstatements.

It should be noted that the SSA refers to ‘material misstatements’. The ratios will be of interest to shareholders, being investor information and this fact may make them material by their nature. However, as the difference is negligible in terms of value, on balance, the difference is probably not material. Therefore, the Other Information section will state that the auditor has nothing to report.

**Corporate governance statement**

As having an audit committee is a mandatory requirement of the 2018 Singapore Code of Corporate Governance and the company does not have one, the corporate governance statement should explain why the company does not comply with the Code in this respect.

We would not modify our auditor's opinion over the corporate governance statement. The statement that the company has complied with the Singapore Code of Corporate Governance would be a material misstatement of other information in the annual report under SSA 720. We should first discuss the matter with management and those charged with governance and ask them to include the necessary explanations. If the corporate governance statement is not amended, then we should communicate that the Other Information section of the auditor's report will conclude there is an uncorrected misstatement in the other information and describe this to those charged with governance.

**Overall conclusion**

None of the matters discussed above, either singly or seen together are pervasive to the financial statements. The auditor's opinion should be modified on the material matter of the incorrect EPS calculation. We should ensure that all the other disclosures are in order and also review the corporate governance statement. If the corporate governance statement does not adequately address the issue of the company not having an audit committee, then we will need to amend the Other Information section in the auditor's report.
PART G CURRENT ISSUES AND DEVELOPMENTS
Companies may be subject to environmental legislation in the countries where they are incorporated, or in countries where their operations are based. Even when there is no legislation, companies may be under pressure to demonstrate a commitment to corporate responsibility for social and environmental issues. Auditors should consider the impact of environmental legislation on the audit as non-compliance may be a significant business risk. The danger of non-compliance may be in the form of fines and penalties, bad publicity and therefore loss of customer support, etc. In extreme cases these may be significant enough to impact going concern. Finally, there may be an opportunity for the auditor to provide other assurance services related to compliance with environmental legislation.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social and environmental auditing</td>
<td>2</td>
</tr>
<tr>
<td>Explain the auditor's main considerations in respect of social and environmental</td>
<td></td>
</tr>
<tr>
<td>matters and how they impact on entities and their financial statements (eg</td>
<td></td>
</tr>
<tr>
<td>impairment of assets, provisions and contingent liabilities).</td>
<td></td>
</tr>
<tr>
<td>Describe substantive procedures to detect potential misstatements in respect of</td>
<td></td>
</tr>
<tr>
<td>socio-environmental matters.</td>
<td></td>
</tr>
</tbody>
</table>

ESSENTIAL READING

- SSAE 3410 Assurance Engagements on Greenhouse Gas Statements
- Code of Governance for Charites and Institutions of a Public Character

1 Importance for the company

SECTION INTRODUCTION

A company's stakeholders include not only its shareholders, customers and suppliers, but also its employees, society and the environment.

Social and environmental audits have become increasingly important over the last decade or so, principally as a result of increasing recognition that what companies do can affect their whole social and natural environment, in addition to just their shareholders.

CASE STUDY

Coal industry

Consider the coal industry. Coal is burnt to generate electricity and is mined from coalfields worldwide, including Australia, Europe, the US, China and India. A coal mining company's financial statements will include the costs of employee wages, plant and machinery used, licences and future dismantling costs.

But the costs of the coal industry to the social and natural environment may be much more widespread than this. The environmental impact of the coal industry as a whole includes the following factors, not part of financial statements:

- Land use. Mining radically changes the landscape, eg by eliminating vegetation, changing soil profiles and stopping current land uses.
- Waste management. Burning coal (eg to make electricity) creates ash, much of which must be stored in the ground, which both uses up land and creates a potential hazard to communities.
- Wildlife. Mining damages wildlife principally by changing or destroying habitats, which can result in the depletion or total extinction of species from affected areas.
• Air pollution. Coal is the largest contributor to the man-made increase of carbon dioxide (CO2) in the atmosphere, which is associated with climate change. It is important to note, however, that the coal industry is usually seen as bringing economic benefits to society, through providing energy to consumers and employment to workers.

It is increasingly the case that investors want to know about a company's social and environmental impact, and a social or environmental audit enables them to do this. Since the 1980s there have been 'ethical' investment funds. A fund is where investors pool their assets together to be collectively invested in shares. An 'ethical investment fund' is where the choice of shares purchased by the fund is influenced by social, ethical or environmental criteria. For example, some ethical investment funds state they do not invest in companies involved in weapons manufacture and others might invest in companies who have taken positive steps to using renewable energy sources.

WEBSITE

Equity Fund provides good coverage of the long-term changes.
http://www.insurance.hsbc.com.sg/1/PA_ES_Content_Mgmt/content/SGHl/personal/investment/ilp/funds/images/fs_tgf.pdf

In general terms there is a widespread belief that environmental issues in particular are a source of risk to a company, eg through unforeseen liabilities, or reputational damage.

1.1 Stakeholders

A company can be seen from the perspectives of various stakeholders. Traditionally auditors are concerned with one set, the shareholders, to whom they report on the financial statements. The diagram below shows various other stakeholders that a company might have.

In this chapter we are concerned with the needs of three of the above categories: employees, the environment and society. These then have knock-on effects on the shareholders, directors and the company itself. The diagram links the first three together because in this context they are inextricably linked.

<table>
<thead>
<tr>
<th>Company stakeholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environment</td>
</tr>
</tbody>
</table>
| The environment is directly impacted by many of our corporate activities today. This may be PRIMARY The impact of processes
| SECONDARY The impact of products
| The primary impact is regulated by environmental legislation, which has been prolific in recent years. The secondary impact is governed partly by legislation and partly by consumer opinion. |
Company stakeholders

Society
Society, from the point of view of the company, is made up of consumers or potential consumers. As recognised above, consumers increasingly have opinions about 'green', environmentally-friendly products and will direct their purchasing accordingly. Society will also, through lobby groups, often speak out on behalf of the environment as it cannot speak out itself.

Employees
Employees have a relationship with the company in their own right, in terms of their livelihood and also their personal safety when they are at work. However, from the company's perspective, they are also a small portion of society at large, as they may purchase the products of the company or influence others to do so.

In some ways it is easier to see why the company is important to these stakeholders than why they are important to the company.

Company stakeholders

Environment
The company can cause harm to natural resources in various ways, including:
- Exhausting natural resources such as coal and gas
- Emitting harmful toxins which destroy the atmosphere

Society
Is concerned with the harm to the natural resources as they and their children have to live on the planet and may suffer direct or indirect effects of pollution or waste.

Employees
Have all the concerns that society do and, more immediately, depend on the company for their livelihood and safety when at work.

For a company, however, there is one simple need. Companies desire above all else to keep providing returns for their shareholders. Employees are needed to keep making the product, as are natural resources, and consumers' (that is, society's) goodwill is required to keep selling it.

Obviously, loss of employees and consumers is going to make it impossible for companies to stay in business. Therefore it is important for companies to have policies in order to appease these stakeholders and to communicate the policies to them.

Companies are also constrained by extensive legislation regulating their behaviour towards the environment. Many countries have produced environmental legislation in recent years.

1.2 Implications for management: risk management

Management is responsible for internal controls which must comprise a sound system to manage risks to the company. Management may seek to discharge this responsibility by using some kind of risk audit. This is not a mandatory requirement, although some form of ongoing risk assessment and audit may be compulsory in some industry sectors (eg banking, financial services). Risk audit can be done internally or externally.

Social and environmental audit is a type of risk audit which management may decide to undertake, either as part of its overall risk management process, or in order to address the concerns of stakeholders. Risk management was covered in Chapter 13, Section 3.

Question 17.1

Environmental and social risks

Required
(a) Describe the key environmental and social risks that a company might face.
(b) Explain why they might result in the failure of the company.
1.3 Management controls

**KEY TERM**

An **ENVIRONMENTAL MANAGEMENT SYSTEM (EMS)** is a system for managing an organisation's overall risk associated with its environment, encompassing the organisational elements, the planning and the resources involved in developing, implementing and maintaining the organisation's policy in this area.

The specific controls that management put into place in line with their duties under the corporate governance codes will vary according to the needs of the company.

They are likely to involve specific measures designed to ensure that environmental legislation is complied with, for example they may relate to protective clothing, disposal of waste etc. The human resources department is likely to design policies to ensure that employment legislation is complied with.

The directors may also seek to incorporate social and environmental values into the corporate culture of the company, so that all employees are aware of the risks arising in these areas, and are focused on avoiding them. This can be achieved by implementing a corporate code, or by setting targets of social and environmental performance.

**CASE STUDY**

**BP oil spill**

BP used to be the UK's biggest company, with a stock market value of about £122 billion (S$256 billion). However, on 20 April 2010, an explosion occurred on the *Deepwater Horizon* drilling rig. Eleven people died, many others were injured and oil began to flood into the Gulf of Mexico. The oil flowed unabated for three months until 15 July 2010, making this the biggest oil spill in history with approximately 800,000 cubic metres of crude oil being released into the ocean.

BP's stock market valuation fell by about £49 billion (S$103 billion), dividends were suspended and its CEO stepped down. The accident continues to affect BP, which set up a disaster fund that it paid for by selling a number of oil fields, thus affecting BP's profitability.

**WEBSITE**

You can read more about the accident and BP's response to this accident on their corporate website.


**SECTION SUMMARY**

Social and environmental issues may present a risk to the company and, by implication, the shareholders' investment, which directors are required to manage as part of their corporate governance responsibilities.
2 Measuring social and environmental performance

SECTION INTRODUCTION

Key stakeholders must be identified and performance indicators generated and appraised.

2.1 The problem of measurement – What? And for whom?

A key part of risk management is monitoring and evaluating results. Social and environmental performance is not as easy a thing to measure as financial performance. Financial performance can be measured fairly easily, e.g. by performing analytical procedures on the financial statements. But these methods will not work with social and environmental performance, because quantitative information on the AE’s social and environmental impact is not usually available.

The first step in deciding what to measure is to identify who the key stakeholders are. With financial performance the main stakeholders are clear: the users of the financial statements, as defined by accounting standards. When it comes to social and environment performance, the company will need to think about its own specific stakeholders. Once these have been identified, the company must identify their needs and the performance measures that best relate to those needs.

2.1.1 Identifying and engaging stakeholders

Stakeholders can be grouped according to various criteria, e.g. internal/external, corporate/operational. You should be familiar with these from your undergraduate studies. Examples of stakeholders include:

- Internal: employees
- External: financial institutions, pressure groups, local communities, regulatory bodies, customers

A good way to do this in practice might be to map out the company’s value chain, and to think of stakeholders at each point on the value chain.

The next step is to engage stakeholders, which means finding out their views on how they are affected by the company. This must be an active process, as it is possible that stakeholders will know more about the impact of the company than management do. The aim of this process is to prioritise the main issues that concern stakeholders, with a view to measuring the company’s impact in these areas.

2.1.2 Generating performance measures

The next step is to translate the main stakeholder issues into performance measures. This could take the form of Key Performance Indicators (KPIs).

A simple example of this could be:

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Issue</th>
<th>KPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local community</td>
<td>Noise</td>
<td>Number of noise complaints each year</td>
</tr>
<tr>
<td>Employee groups</td>
<td>Work-related injuries</td>
<td>Number of injuries sustained at work each year</td>
</tr>
<tr>
<td>Environmental groups</td>
<td>Pollution</td>
<td>Quantity of CO₂ emitted each year</td>
</tr>
</tbody>
</table>

In practice it is often difficult to generate appropriate KPIs. One key reason for this is that social and environmental effects may be impossible to quantify. For example, the issue for employees may be job satisfaction, but this can be difficult to measure. It is possible to gather statistical information on this, but whether or not this information is useful or reliable is open to question.
A further difficulty is that systems for gathering information on these KPIs may not be established well enough to allow accurate and consistent measurement.

2.2 Targets and indicators

One way to measure social performance is to set targets and sustainability indicators and then appraise whether the targets have been met and the indicators exist.

These targets will vary from company to company, depending on what the issues are. To illustrate the point, a case study based on Shell is given below.

CASE STUDY

Shell is a large multinational group of companies that deals in oil, gas and chemicals. There are various issues which make social and environmental issues important to this company:

- It deals in the earth's natural resources.
- Its business is heavily environmentally legislated.
- It employs a significant number of people.
- Some employees work in risky environments.
- It operates in areas of the world where human rights issues are not given sufficient priority.

Targets

In response to the social and environmental issues raised above, Shell has set targets of social and environmental performance which it evaluates and reports on to shareholders on an annual basis.

The following are examples of targets which the company has set:

**Environmental**
- Reduce emissions of carbon dioxide from refinery activity
- Continue to develop cleaner fuels
- Reduce emissions of nitrogen oxides from burning fuel in operations
- Reduce spills of crude oil and chemicals

**Social**
- Zero employee fatalities in work-related incidents
- Not exploit children in any country where child labour exists, by
  - Not employing children under the legal age of employment
  - Dealing with other companies who employ children illegally
- Pursue equal opportunities for men and women in all countries where this is legally possible

**Sustainability principles**

The company has also set general sustainability principles which all staff should apply in daily business:

- Respect and safeguard people
- Engage and work with stakeholders
- Minimise impact on the environment
- Use resources efficiently
- Maximise benefits to the community

**Reporting**

The company reports on all these issues to its shareholders and, wherever possible, the facts included within this report are checked by independent verifiers.
The case study shows a number of targets and sustainability indicators. Some can be measured in mathematical terms, including:

- Emissions
- Spills
- Elimination of work-related fatalities
- Employment of children

For example, Shell produces the following environmental data on emissions.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Greenhouse gas emissions (GHG)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct total GHGs (million tonnes CO₂ equivalent)</td>
<td>73</td>
<td>70</td>
<td>72</td>
<td>76</td>
<td>73</td>
<td>72</td>
<td>74</td>
<td>76</td>
<td>69</td>
</tr>
<tr>
<td>Carbon dioxide (CO₂) (million tonnes)</td>
<td>70</td>
<td>67</td>
<td>68</td>
<td>73</td>
<td>71</td>
<td>69</td>
<td>71</td>
<td>72</td>
<td>66</td>
</tr>
<tr>
<td>Methane (CH₄) (thousand tonnes)</td>
<td>123</td>
<td>138</td>
<td>132</td>
<td>126</td>
<td>120</td>
<td>93</td>
<td>133</td>
<td>128</td>
<td>127</td>
</tr>
<tr>
<td>Nitrous oxide (N₂O) (thousand tonnes)</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Hydrofluorocarbons (HFCs) (tonnes)</td>
<td>23</td>
<td>21</td>
<td>18</td>
<td>16</td>
<td>17</td>
<td>23</td>
<td>22</td>
<td>23</td>
<td>25</td>
</tr>
</tbody>
</table>


However, some of the targets are not specific enough to be able to measure in that way. For example, it is more difficult to identify where the company is in relation to achieving a target of developing cleaner fuels until the cleaner fuel appears. Such a development target cannot have a prescribed timescale.

Equally, it is difficult to measure the effect of the general principles which the company has included within the culture of the company.

**CASE STUDY**

The Minerals and Metals Group (MMG) has a dedicated series of strategic objectives related to the group’s Sustainability and Community commitments. A key area for the group is safety and health, in relation to which a key performance indicator is the ‘Total recordable injury frequency rate’, which measures the rate of injuries sustained at work. The group’s sustainability report contained a narrative account of the events during the year, along with figures which showed a fall from 1.90 injuries per million hours worked at the start of the year to 1.17 at the end of the year.

_Sourced: MMG Sustainability Report 2017_

### 2.3 Social audits

The process of checking whether a company has achieved set targets may fall within the scope of a social audit that a company carries out.

Social audits involve:

- Establishing whether the company has a rationale for engaging in socially responsible activity
- Identifying that all current environmental programmes are congruent with the mission of the company
• Assessing objectives and priorities related to these programmes
• Evaluating company involvement in such programmes past, present and future

Whether or not a social audit is used depends on the degree to which social responsibility is part of the corporate philosophy. A cultural awareness must be achieved within an organisation in order to implement environmental policy, which requires board and staff support.

In the US, social audits on environmental issues have increased since the Exxon Valdez catastrophe in 1989, when millions of gallons of crude oil were released into Alaskan waters.

The Valdez principles were drafted by the Coalition for Environmentally Responsible Economics to focus attention on environmental concerns and corporate responsibility:

• Eliminate pollutants and hazardous waste.
• Conserve non-renewable resources.
• Market environmentally safe products and services.
• Prepare for accidents and restore damaged environments.
• Provide protection for employees who report environmental hazards.
• Appoint an environmentalist to the board of directors, name an executive for environmental affairs, and develop an environmental audit of global operations, which is to be made publicly available.

2.4 Environmental audits

**KEY TERM**

**ENVIRONMENTAL AUDITS** seek to assess how well the organisation performs in safeguarding the environment in which it operates, and whether the company complies with its environmental policies.

Environmental auditing is exactly what is says: auditing a company to assess its impact on the environment.

The audit will cover a range of areas and will involve the performance of different types of testing. The scope of the audit must be determined and this will depend on each individual organisation. There are, however, some aspects of the approach to environmental auditing which are worth mentioning.

(a) An Environmental Impact Assessment (EIA) is a detailed study to determine the effect a potential project will have on the environment. The EIA process can be incorporated into any environmental auditing strategy. An EIA is not mandatory for any project in Singapore.

(b) Environmental surveys are a good way of starting the audit process, by looking at the organisation as a whole in environmental terms. This helps to identify areas for further development, problems, potential hazards and so forth.

(c) Environmental SWOT analysis. A 'strengths, weaknesses, opportunities, threats' analysis is useful as the environmental audit strategy is being developed. This can only be done later in the process, when the organisation has been examined in much more detail.

(d) Environmental Quality Management (EQM). This is seen as part of TQM (Total Quality Management) and it should be built in to an environmental management system.

(e) Eco-labels. The Singapore Green Labelling Scheme is a scheme administered by the Singapore Environment Council. Products meeting specified eco-standards are allowed to print the green label on their packaging. The objective of the scheme is to encourage manufacturers to consider the environment.

(f) Supplier audits, to ensure that goods and services bought by an organisation meet the standards applied by that organisation.
In general, an environmental audit encompasses three processes.

(a) Agreeing metrics: determining in what areas targets should be set, and at what level they should be set. This might be influenced by, for instance, the need to meet legal requirements (so that the metrics would be set in areas that are relevant to those requirements). Examples of metrics include:
   - Emissions (pollution, greenhouse gases, waste)
   - Consumption (water, gas, electricity, non-renewable feedstocks)

(b) Performance measurement: the measurement of actual performance in terms of the agreed metrics.

(c) Reporting compliance: reporting on the implications of the results for compliance with the targets specified in (a).

In order to do this, the environmental auditor will carry out the following steps:

- Obtain a copy of the company's environmental policy
- Assess whether the policy is likely to achieve objectives:
  - Meet legal requirements
  - Meet country specific standards
  - Satisfy key customers/suppliers' criteria
- Test implementation and adherence to the policy by:
  - Discussion
  - Observation
  - 'Walk-through tests' where possible

SECTION SUMMARY

Measuring social and environmental performance can be a difficult area. Auditors can provide assurance services in this area, giving opinions as to whether directors' assertions about performance are reasonable.

3 Implications for the statutory audit

SECTION INTRODUCTION

Social and environmental issues may have an impact on the financial statements and therefore must be considered by the auditor.

3.1 Why important?

We now turn from the importance of social and environmental issues to the company and look at why they are important to the auditor in the context of the statutory audit.

These issues are important to the company and its stakeholders, and have the potential to have a significant impact on the company's financial statements. For example, the Fukushima nuclear disaster of
2011, which was a substantial environmental disaster, will have huge financial impacts, such as the costs of decommissioning the plant and the costs of decontamination and compensation to affected parties. Social and environmental issues may be relevant in a group context, where components have social or environmental risks associated with them that could impact the group financial statements.

The auditor must therefore keep up to date with relevant environmental regulations and issues which could impact financial statements. An ongoing issue is the recent legislation establishing liability for transboundary haze pollution.

WEBSITE

The Transboundary Haze Pollution Act can be accessed at the following address:


You should try and think about environmental issues that have been in the news and consider how they might impact companies generally and the financial statements of companies in particular. For example, the following link leads to an article discussing bans on sand being exported from Cambodia to Singapore, despite its importance in helping to underpin essential urban development.

https://www.bbc.co.uk/news/business-40590695

The impact of social and environmental issues on an audit can be divided into three specific areas:

- Planning the audit
- Undertaking substantive procedures
- Audit reviews

Another important point to note is the duties of the auditor arising under SSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements. We shall also consider this below.

3.2 Planning the audit

Social and environmental issues can affect the audit in two main ways:

- Knowledge of the company
- Inherent risk assessment

You should be aware of the principles involved in these two issues, so there is no need to go into a lot of further detail at this stage.

As part of their knowledge of the company, the auditor should have an awareness of any environmental regulations the company is subject to, and any key social issues arising in the course of business.

The auditor may be able to obtain knowledge of this aspect of the company by reading the company's procedures or reviewing any quality control documentation it has relating to standards. The auditor may be able to review the results of any environmental audits undertaken by the company.

This will then form part of the assessment of inherent risk.
Environmental legislation in Singapore is issued by the National Environment Agency (NEA), which is a statutory board associated with the Ministry of the Environment and Water Resources (MEWR). Details of environment legislation can be found on the NEA’s website.


Examples of environmental legislation issued by the NEA which audit clients need to adhere to include, but are not limited to, the following.

- Energy Conservation Act
- Environmental Protection and Management Act
- Environmental Public Health Act
- Hazardous Waste (Control of Export, Import and Transit) Act
- Radiation Protection Act

### 3.3 Substantive procedures

Social and environmental issues, particularly environmental issues, may impact on the financial statements in a number of ways.

#### Examples of the impact of social and environmental matters on financial statements

- Provisions (for example, for site restoration, fines/compensation payments)
- Contingent liabilities (for example, in relation to pending legal action)
- Asset values (issues may impact on impairment or purchased goodwill/products)
- Capital/revenue expenditure (costs of clean-up or meeting legal standards)
- Going concern issues (considered later in this chapter, under reviews)

### ALERT

When approaching a question about auditing specific items in financial statements, or issuing an audit opinion in respect of them, you should bear in mind whether there is an environmental/social issue which will impact on valuation or disclosure. Use your common sense, however do not make up such issues where no obvious indicators are given in the question.

The auditor will have to bear in mind the effects of social or environmental issues on the financial statements when designing audit procedures. We will now look at some potential audit procedures that would be relevant in three of the key areas above.

### 3.3.1 Substantive procedures: asset valuation

The audit risk that arises with regard to valuation is that assets might be impaired. SFRS(I) 1-36 *Impairment of Assets* requires an impairment review to be undertaken with regard to non-current assets if certain indicators of impairment exist. We have discussed the audit of impairments in Chapter 9, but shall consider the points specific to environmental and social issues here.
17: Social and environmental auditing

PART G CURRENT ISSUES AND DEVELOPMENTS | 17: Social and environmental auditing

Knowledge brought forward from Financial Reporting

SFRS(I) 1-36 gives a list of indicators in which an impairment review is required. The indicator relevant here is a significant change in the technological market, legal or economic environment of the business in which the assets are employed.

Auditors should be aware of the regulatory environment of the client as part of their knowledge of the company (as discussed above), but the following general procedures could be undertaken as part of the non-current asset testing to establish whether an impairment review is required:

- Review the board minutes for indications that the environmental regulatory environment has changed.
- Review relevant trade magazines or newspapers to assess whether any significant adverse change has taken place.
- Discuss the issue with management, particularly those nominated to have responsibility for environmental issues, if such a position exists.

If a significant adverse change has taken place, the directors may or may not have conducted an impairment review. If the directors have not, the auditors should discuss the matter with them. If the directors refuse to conduct an impairment review, the auditors should consider the result of that on their auditor's report.

If an impairment review has been undertaken, and the valuation of the asset has been adjusted accordingly, the auditor should independently assess the impairment review to determine its reasonableness.

3.3.2 Substantive procedures: provisions

Guidance on accounting for provisions is given in SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets. The audit of provisions has been discussed previously in Chapter 10. We shall consider the points specific to environmental and social issues here.

Knowledge brought forward from Financial Reporting

SFRS(I) 1-37 defines a provision as a liability of uncertain timing or amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A provision should be recognised when:

- An entity has a present obligation (legal or constructive) as a result of a past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the obligation
The SFRS(I) provides some helpful examples of environmental issues that result in provisions being required. If a company has an environment policy such that the parties would expect the company to clean up contamination, or if the company has broken current environmental legislation then a provision for environmental damage must be made.

The auditor needs to be aware of any circumstances that might give rise to a provision being required, and then apply the recognition criteria to it.

The general substantive procedures for establishing if a provision is required are the same as they were for identifying whether an impairment review was required.

If the directors have included provisions in the financial statements relating to environmental issues, the audit procedures will be the same as were discussed earlier. Specifically, the auditor may be able to review correspondence from any regulatory watchdog, or obtain a copy of the relevant legislation to review its requirements.

3.3.3 Substantive procedures: contingent liabilities

Accounting for contingent liabilities is also governed by SFRS(I) 1-37.

**LINK**

Knowledge brought forward from *Financial Reporting*

SFRS(I) 1-37 defines a contingent liability as either:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control, or

(b) A present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability.

Social and environmental issues may also impact accounting for contingent liabilities. In fact, a contingent liability is likely to arise through items being identified in a provision review, when the items highlighted do not meet the recognition criteria for a provision in accordance with SFRS(I) 1-37.

Given their relationship with provisions, the general audit procedures to establish if contingent liabilities exist are the same as the ones for provisions.

If the directors have made disclosures relating to contingent liabilities in respect of environmental and social issues, the procedures to test them were set out earlier. Specific evidence would be on similar lines as for provisions in respect of social and environmental issues: correspondence with a regulator or relevant legislation.

3.3.4 Substantive procedures: Capital/revenue expenditure

If social and environmental costs meet the criteria given by SFRS(I) 1-38 *Intangible Assets*, they can be capitalised on the statement of financial position.
LINK
Knowledge brought forward from Financial Reporting

SFRS(I) 1-38 states that:

An intangible asset shall be recognised if, and only if:

(a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) The cost of the asset can be measured reliably

Costs specifically relating to social and environmental issues may include the cost of meeting new environmental legislation or the cost of cleaning up land to make it useable. The auditors will need to use their judgment in deciding what forms a future economic benefit and whether it is probable when deciding whether the capitalisation criteria have been met. The key audit tests will be as follows.

Check accounting records to confirm:

– Project is clearly defined (separate cost centre or general ledger codes)
– Related expenditure can be separately identified, and certified to invoices, timesheets

• Review budgeted revenues and costs by examining results to date, production forecasts, advance orders and discussion with directors.
• Review calculations of future cash flows to ensure resources exist to complete the project.
• Review previously deferred expenditure to ensure SFRS(I) 1-38 criteria are still justified.
• Check amortisation:
  – Commences with production
  – Charged on a systematic basis

3.4 Going concern

Environmental and social issues can impact on the ability of the company to continue as a going concern.

The auditor will need to be aware of such issues when undertaking the going concern review. The procedures involved in going concern reviews were discussed in Chapter 12.

3.5 Auditor responsibility in the event of non-compliance with laws and regulations

The auditor's responsibility with regard to laws and regulations is set out in SSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements. This was discussed in Chapter 1, so you should refer back to this to remind yourself of the actions the auditor should take in the event of discovering non-compliance.

Environmental obligations would be core in some businesses (for example, our oil and chemical company given in the case study above), in others they would not. SSA 250 talks of 'other laws and regulations' where compliance may be fundamental to the operating aspects of the company, to an entity's ability to continue its business or to avoid material penalties.

Clearly, in the case of a company which stands to lose its operating licence to carry on business in the event of non-compliance, environmental legislation is fundamental to the company.

In the case of social legislation, this will be a matter of judgment for the auditor. It might involve matters of employment legislation, health and safety regulation, human rights law and such matters which may
not seem fundamental to the objectives of the company, but permeate the company due to the needs of employees.

Auditors are not expected to be specialists in environmental law. However, as part of their professional duty, they must ensure that they have enough knowledge to undertake the assignment, or that they engage the use of an auditor’s expert if necessary.

### 3.6 Social and environmental issues as other information

Social and environmental issues may be reported as other information which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor’s report.

You have already studied the auditor’s responsibility for other information in Chapter 12 which examines SSA 720 (Revised) *The Auditor’s Responsibilities Relating to Other Information*.

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#### SECTION SUMMARY

Social and environmental issues can affect the statutory audit at the planning stage (risk), while undertaking substantive procedures (impairment/provisions) and during audit reviews (going concern).

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### 4 Implications for assurance services

#### SECTION INTRODUCTION

Many different assurance services could be offered within the broad context of social and environmental issues.

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#### 4.1 Types of service

Auditors can provide a variety of services in respect of environmental and social issues. Most of these services are familiar to us, so there is no need to revisit these in detail. Remember that most of the services we have discussed could be applied in an environmental and social context:

- Internal audit services (reviewing controls)
- Review of internal controls and procedures as part of statutory audit
- Management letter concerning controls as a by-product of statutory audit
- Assurance services (see below)

Management increasingly reports to members on social and environmental issues, and there is a growing public perception that this is an important area. This means that it is an issue that can give rise to assurance services.

#### IMPORTANT

An assurance engagement is one where a Chartered Accountant expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
Assurance engagements give rise to assurance reports, which we outlined in Chapter 13. We shall consider the issue of specific verification reports in relation to social and environmental issues here.

If the directors issue an environmental and social report, it may contain figures and statements that are verifiable. Using the example of Shell (above), the directors could make the following assertions:

- Carbon dioxide emissions were X million tonnes in 2001, which represents a 2% decrease from 2000.
- We have implemented a strategy aimed at ensuring that in five years' time, no one we deal with will have an involvement in child labour.

These assertions can be reviewed and assurance given about them. For instance, in the first case, the level of emission could be traced to records of emission from the refineries, and the percentage calculation could be checked.

In the second instance, the Chartered Accountant could obtain details of the strategy and ascertain how fully it has been implemented by making enquiries of the staff who should be implementing the strategy. They could also appraise the strategy and give an opinion of the chances of it achieving the objective within the given time frame.

**4.2 Contents of an assurance report on environmental issues**

There is no guidance in issue as to the contents of such a report. The box below shows some items that should be included as a minimum.

- Scope and objectives of the review
- Work performed
- Limitations to the work performed
- Opinions
- Basis on which those opinions have been reached
- Limitations to the opinion given

**4.3 SSAE 3410 Assurance Engagements on Greenhouse Gas Statements**

ISCA issued Singapore Standard on Assurance Engagements (SSAE) 3410 Assurance Engagements on Greenhouse Gas Statements in May 2013. The standard was developed in response to a growing demand for assurance over carbon trading schemes and other global emissions reporting initiatives. Many companies now prepare a Greenhouse Gas (GHG) Statement as part of a regulatory disclosure regime (for example, as required in Australia), as part of an emissions trading scheme or to inform investors or others on a voluntary basis.

**KEY TERM**

A **GHG Statement** is a statement setting out constituent elements and quantifying an entity’s GHG emissions for a period (sometimes known as an emissions inventory) and, where applicable, comparative information and explanatory notes including a summary of significant quantification and reporting policies. An entity’s GHG statement may also include a categorized listing of removals or emissions deductions. Where the engagement does not cover the entire GHG statement, the term ‘GHG statement’ is to be read as that portion that is covered by the engagement. The GHG statement is the ‘subject matter information’ of the engagement.

(SSAE 3410.14)
Engagements carried out in accordance with SSAE 3410 must also comply with SSAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information.

GHGs include carbon dioxide, methane, nitrous oxide and fluorinated gases. SSAE 3410 does not apply to engagements providing assurance over the following:

- Statements of emissions other than GHG emissions
- Other GHG-related information, such as product lifecycle ‘footprints’, hypothetical ‘baseline’ information, and key performance indicators based on emissions data
- Instruments, processes or mechanisms, such as offset projects, used by other entities as emissions deductions

SSAE 3410 allows an engagement to provide assurance over a GHG Statement to be either a reasonable or limited assurance engagement. Since a limited assurance engagement provides a lower level of assurance than a reasonable assurance engagement, the procedures which the standard requires for a limited assurance engagement are less extensive. In either case, a risk-based approach is necessary where the Chartered Accountant carries out the following:

- Planning and determining materiality
- Gaining an understanding of the entity and its environment, including the entity’s internal control
- Identifying and assessing the risk of material misstatement in the GHG Statement
- Performing procedures to respond to the assessed risk
- Production of an assurance report

Examples of assurance reports for both a reasonable and limited assurance engagement are provided in Appendix 2 of SSAE 3410. The conclusion of the assurance report will vary depending on the level of assurance being provided.

<table>
<thead>
<tr>
<th>Limited assurance</th>
<th>Reasonable assurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>The practitioner shall evaluate whether anything has come to the practitioner's attention that causes the practitioner to believe that the GHG statement is not prepared, in all material respects, in accordance with the applicable criteria.</td>
<td>The practitioner shall evaluate whether the GHG statement is prepared, in all material respects, in accordance with the applicable criteria.</td>
</tr>
</tbody>
</table>

Question 17.2

Your audit client, Naturascope Ltd, is a health food and homeopathic remedies retailer, with a strong marketing emphasis on the ‘natural’ elements of the products and the fact that they do not contain artificial preservatives.

The directors have decided that it would benefit the company's public image to produce a social and environmental report as part of their annual report. There are three key assertions which they wish to make as part of this report:

- Goods/ingredients of products for sale in Naturascope have not been tested on animals.
- None of Naturascope's overseas suppliers use child labour (regardless of local laws).
- All Naturascope's packaging uses recycled materials.

The directors have asked the audit engagement partner whether the AE would be able to produce a verification report in relation to the social and environmental report.
Required

(a) Identify and explain the matters the audit engagement partner should consider in relation to whether the AE can accept the engagement to report on the social and environmental report.

(b) Comment on the matters to consider and the evidence to seek in relation to the three assertions.

SECTION SUMMARY

Many different assurance services could be offered within the broad context of social and environmental issues.

5 Audit of charities

SECTION INTRODUCTION

There are various types of organisations which do not exist for the purpose of maximising shareholder wealth, which may require an audit, key of which for your purposes is a charity.

The key objective of most companies is to manage the shareholders' investments well. In a large majority of cases, ‘manage the shareholders' investment’ means ‘create a profit’, as this will create returns to the shareholders in the terms of dividends or growth in the capital value of the share. However, some companies and other entities do not operate for the purpose of making profit but have other objectives. A key example is charities.

Some charities may be companies (often companies limited by guarantee) and so are required to prepare financial statements and have them audited under companies' legislation.

Where a statutory audit is required, the auditors will be required to produce the statutory audit opinion concerning the truth and fairness of financial statements.

Where a statutory audit is not required, it is possible that the charity might have one anyway for the benefit of interested stakeholders, such as the public or people who give to a charity.

It is also possible that such entities will have special, additional requirements of an audit. These may be required by the Commissioner of Charities, or by the governing instrument of the organisation. For example, a charity's governing instrument may require an audit of whether the charity is operating in accordance with its charitable purpose.

An audit of a not-for-profit organisation may vary from a 'for-profit audit' due to:

- Its objectives and the impact on operations and reporting
- The purpose an audit is required

5.1 Charities and Institutions of a Public Character (IPCs)

Charities are regulated under the Charities Act. This sets out what a charity is and outlines how they are regulated. The charities' regulator is the Commissioner of Charities.
The Charities Act recognises the following charitable purposes:

- Relief of poverty
- Advancement of education
- Other purposes beneficial to the community, which include commonly recognised ones such as:
  - Promotion of health
  - Advancement of citizenship or community development
  - Advancement of arts, heritage or science
  - Advancement of environmental protection or improvement
  - The relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage
  - Advancement of animal welfare
  - Advancement of sport, where the sport promotes health through physical skill and exertion

Charities are required to prepare financial statements in accordance with SFRS(I) or the Charities Accounting Statement (CAS). Once the governing body have selected which accounting statement to follow they are strongly encouraged not to change the basis of preparation in the future.

The Charities (Accounts and Annual Report) Regulations 2011 require the following:

- An income and expenditure account which shows income and expenditure for the year for the charity
- A statement of financial position that shows the assets, liabilities and funds of the charity at the end of the financial year.
- An explanation of the accounting policies used to prepare the financial statements
- Details of transactions relating to, and the state of, the various funds of the charity
- Notes:
  - On how the funds reflected in the statement of financial position must or may be utilised because of restrictions imposed by donors
  - On the relationships between, and analyses of, the information contained in the income and expenditure account and statement of financial position
  - Which explain, expand on or provide the circumstances relating to, or other useful information on, the information contained in the income and expenditure account and statement of financial position
5.2 Audit requirement

The audit requirements for charities are as follows:

- The financial statements of all IPCs must be audited.
- The financial statements of charities which are companies limited by guarantee must be audited if companies' legislation requires them to have an audit.
- Other charities must have their financial statements examined as follows:
  - Charities with income of $250,000 or less have their financial statements examined by an independent person (known as an independent examiner).
  - Charities with income of between $250,000 and $500,000 have their financial statements examined by an independent person (independent examiner) who is a member of ISCA, or who possesses the necessary qualifications to be a member of ISCA.
  - Charities with income above $500,000 have an external audit by a Chartered Accountant.

A charity's governing document may contain specific provisions about audit requirements. In such cases the charity must follow the higher standard of scrutiny required by either the statutory framework or governing document.

The independent examination is a less onerous form of scrutiny than an audit and correspondingly gives a lower level of assurance. The examiner is not required to give an opinion as to whether the financial statements give a true and fair view. Instead they must report whether or not any matter has come to their attention indicating that:

- Proper accounting records have not been kept
- The financial statements do not comply with such records
- The financial statements fail to comply with relevant regulations

In addition, if such matters have become apparent, the report should include details of:

- Material expenditure or actions contrary to the trusts of the charity
- Failure to provide information or explanations to which the examiner is entitled
- Evidence that the financial statements prepared on an accruals basis are materially inconsistent with the governing body's annual report

In order to produce this report, the examiner should:

- Carry out procedures to be satisfied the charity qualifies for this independent verification
- Agree a timetable for the verification
- Obtain an understanding of the charity and its environment
- Record the examination procedures carried out and any matters important to support the statements made in the report
- Compare the financial statements of the charity with the charity's accounting records in sufficient detail to be able to decide the financial statements are in accordance with the records
• Review the accounting records
• Carry out analytical procedures to identify unusual items in the financial statements
• Carry out detailed procedures if judged necessary
• Consider whether accounting policies are reasonable
• Enquire about subsequent events
• Consider if the governing body's report is consistent with the financial statements
• Review the evidence obtained

5.2.1 Planning

When planning the audit of a charity, the auditors should particularly consider the following:

• The scope of the audit
• Recent recommendations of the Commissioners of Charities or the other regulatory bodies
• The acceptability of accounting policies adopted
• Changes in circumstances in the sector in which the charity operates
• Past experience of the effectiveness of the charity's accounting system
• Key audit areas
• The amount of detail included in the financial statements on which the auditors are required to report

In order to identify the key audit areas, the auditors will have to consider audit risk. This should be considered in a similar way to other audits, arising from the auditors' understanding of the particular entity.

However, there are certain risks applicable to charities that might not necessarily be applicable to other companies. The auditors should consider the following:

<table>
<thead>
<tr>
<th>Problem</th>
<th>Key factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent risk</td>
<td>• The complexity and extent of regulation</td>
</tr>
<tr>
<td></td>
<td>• The significance of donations and cash receipts</td>
</tr>
<tr>
<td></td>
<td>• Difficulties of the charity in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies</td>
</tr>
<tr>
<td></td>
<td>• Lack of predictable income or precisely identifiable relationship between expenditure and income</td>
</tr>
<tr>
<td></td>
<td>• Uncertainty of future income</td>
</tr>
<tr>
<td></td>
<td>• Restrictions imposed by the objectives and powers given by charities' governing documents</td>
</tr>
<tr>
<td></td>
<td>• The importance of restricted funds (funds which the company is only allowed to put to a specific purpose)</td>
</tr>
<tr>
<td></td>
<td>• The extent and nature of trading activities must be compatible with the entity's charitable status</td>
</tr>
<tr>
<td></td>
<td>• The complexity of tax rules relating to charities</td>
</tr>
<tr>
<td></td>
<td>• The sensitivity of certain key statistics, such as the proportion of resources used in administration</td>
</tr>
<tr>
<td></td>
<td>• The need to maintain adequate resources for future expenditure while avoiding building up reserves which could appear excessive</td>
</tr>
</tbody>
</table>
Problem | Key factors
---|---
Control risk | • The amount of time committed by governing body to the charity's affairs
• The skills and qualifications of individual members of the governing body
• The frequency and regularity of governing body meetings
• The form and content of governing body meetings
• The independence of members of the governing body from each other
• The division of duties between members of the governing body
• The degree of involvement in, or supervision of, the charity's transactions on the part of individual members of the governing body

Control environment | • A recognised plan of the charity's structure showing clearly the areas of responsibility and lines of authority and reporting
• Segregation of duties
• Supervision by the governing body of activities of staff where segregation of duties is not practical
• Competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform
• Involvement of the governing body in the recruitment, appointment and supervision of senior executives
• Access of the governing body to independent professional advice where necessary
• Budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis
• Communication of results of such reviews to the governing body on a regular basis

5.2.2 Internal control

Small charities in particular may generally suffer from internal control weaknesses common to small enterprises, such as lack of segregation of duties and use of unqualified staff. Shortcomings may arise from the staff's lack of training and also, if they are volunteers, from their attitude, in that they may not understand the need to follow formal procedures, as they may feel they are acting in good faith.

The auditors will have to consider particularly carefully whether they will be able to obtain adequate assurance that the accounting records do reflect all the transactions of the enterprise and bear in mind whether there are any related statutory reporting requirements.

The following sorts of internal control might be typical of a number of charities.

<table>
<thead>
<tr>
<th>Cash donations</th>
<th>Example of controls</th>
</tr>
</thead>
</table>
| Collecting boxes and tins | • Numerical control over boxes and tins
• Satisfactory sealing of boxes and tins so that any opening prior to recording cash is apparent
• Regular collection and recording of proceeds from collecting boxes
• Dual control over counting and recording of proceeds |
### Cash donations

<table>
<thead>
<tr>
<th>Source</th>
<th>Examples of controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Postal receipts</td>
<td>- Unopened mail kept securely</td>
</tr>
<tr>
<td></td>
<td>- Dual control over the opening of mail</td>
</tr>
<tr>
<td></td>
<td>- Immediate recording of donations on opening of mail or receipt</td>
</tr>
<tr>
<td></td>
<td>- Agreement of bank paying-in slips to record of receipts by an independent person</td>
</tr>
</tbody>
</table>

### Other donations

<table>
<thead>
<tr>
<th>Source</th>
<th>Examples of controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift aid</td>
<td>- Regular checks and follow-up procedures to ensure due amounts are received</td>
</tr>
<tr>
<td></td>
<td>- Regular checks to ensure all tax repayments have been obtained</td>
</tr>
<tr>
<td>Legacies</td>
<td>- Comprehensive correspondence files maintained in respect of each legacy</td>
</tr>
<tr>
<td></td>
<td>- Regular reports and follow-up procedures undertaken in respect of outstanding legacies</td>
</tr>
<tr>
<td>Donations in kind</td>
<td>- In the case of charity (thrift) shops, separation of recording, storage and sale of inventory</td>
</tr>
<tr>
<td>Tax deductible donations (in an IPC)</td>
<td>- Detailed records of tax deductible donations to the charity (in accordance with the Charities (Institutions of a Public Character) Regulations)</td>
</tr>
</tbody>
</table>

### Other income

<table>
<thead>
<tr>
<th>Source</th>
<th>Examples of controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund-raising activities</td>
<td>- Records maintained for each fund-raising event</td>
</tr>
<tr>
<td></td>
<td>- Other appropriate controls maintained over receipts</td>
</tr>
<tr>
<td></td>
<td>- Controls maintained over expenses as for administrative expenses</td>
</tr>
<tr>
<td>Central and local government grants and loans</td>
<td>- Regular checks that all sources of income or funds are fully utilised and appropriate claims made</td>
</tr>
<tr>
<td></td>
<td>- Ensuring income or funds are correctly applied</td>
</tr>
</tbody>
</table>

### Use of resources

<table>
<thead>
<tr>
<th>Resource</th>
<th>Examples of controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restricted funds</td>
<td>- Separate records maintained of relevant revenue, expenditure and assets</td>
</tr>
<tr>
<td></td>
<td>- Terms controlling application of fund</td>
</tr>
<tr>
<td></td>
<td>- Oversight of application of fund monies by independent personnel or governing body</td>
</tr>
<tr>
<td>Grants to beneficiaries</td>
<td>- Records maintained, as appropriate, of requests for material grants received and their treatment</td>
</tr>
<tr>
<td></td>
<td>- Appropriate checks made on applications and applicants for grants, and that amounts paid are in accordance with the charity's aims</td>
</tr>
<tr>
<td>Resource</td>
<td>Examples of controls</td>
</tr>
<tr>
<td>----------</td>
<td>----------------------</td>
</tr>
<tr>
<td></td>
<td>• Records maintained of all grant decisions, checking that proper authority exists, that adequate documentation is presented to decision-making meetings, and that any conflicts of interest are recorded</td>
</tr>
<tr>
<td></td>
<td>• Control to ensure grants made are properly spent by the recipient for the specified purpose, for example requirements for returns with supporting documentation or auditors’ reports concerning expenditure, or monitoring visits</td>
</tr>
</tbody>
</table>

Conversely, large charities might have very strong controls and the auditors may find that they are able to rely on them to a great extent.

Remember, however, that while relying on controls might be acceptable in order to determine whether the financial statements give a true and fair view, it might not be acceptable to meet any special additional auditing requirements that the charity has.

### 5.2.3 Substantive procedures

When designing substantive procedures for charities the auditors should give special attention to the possibility of:

- Understatement or incompleteness of the recording of all income including gifts in kind, cash donations, and legacies
- Overstatement of cash grants or expenses
- Misanalysis or misuse in the application of funds (such as restricted funds which the charity might only be able to use for specific purposes)
- Misstatement or omission of assets including donated properties and investments
- The existence of restricted or uncontrollable funds in foreign or independent branches

Completeness of income can be a particularly problematic area. Areas auditors may check:

- Loss of income through fraud
- Recognition of income from professional fundraisers
- Recognition of income from branches, associates or subsidiary companies
- Income from informal fundraising groups
- Income from grants

### 5.2.4 Overall review

The auditors must consider carefully whether the accounting policies adopted are appropriate to the activities, governing instrument and objectives of the charity, and are consistently applied, and whether the financial statements adequately disclose these policies and fairly present the financial position and performance for the accounting period.

In particular, the auditors should consider the basis of disclosing income from fundraising activities (for example net or gross), accounting for income and expenses ( accruals or cash), the capitalising of expenditure on non-current assets, apportioning administrative expenditure, and recognising income from donations and legacies.

Charities without significant endowments or accumulated funds will often be dependent upon future income from voluntary sources. In these circumstances auditors may question whether a going concern basis of accounting is appropriate.
5.2.5 Reporting

On not-for-profit audits where a statutory auditor's report is required, the auditors should issue the standard auditor's report we consider in Chapter 16. They should also consider whether any additional statutory requirements fall on the auditor's report.

Where an association or charity is having an audit for the benefit of its members or governing body, the standard auditor's report may not be required or appropriate. The auditor should bear in mind the objectives of the audit and make suitable references in the auditor's report. However, the SSA 700 format will still be relevant. The auditor should ensure that they make the following matters clear:

- The addressees of the report
- What the report relates to
- The scope of the engagement
- The respective responsibilities of auditors and management/governing body/directors
- The work done
- The opinion formed

The points made above are general points. Remember that not all clubs and charities will be the same and you need to apply your general auditing understanding and approach to the specific entity you are examining.

Note that further guidance on the audit of charities is given in AGS 5 Audit of Entities in Specific Industries, Professions or Vocations.

SECTION SUMMARY

- The audit risks associated with a charity may well be different from other entities.
- Cash may be significant in small not-for-profit charities and controls may be limited. Income may well be a risk area, particularly where money is donated or raised informally.
- Obtaining audit evidence may be a problem, particularly where small charities have informal arrangements and there might be limitations on the scope of the audit.
- The nature of the report will depend on statutory and entity requirements, but it should conform to SSA 700 criteria.
Chapter Roundup

PART G CURRENT ISSUES AND DEVELOPMENTS

Social and environmental auditing

- Reasons for:
  - Stakeholder expectations
  - Enhance company reputation

- What?
- For whom?

Audit implications

Planning
- Knowledge of the company
- Inherent risk assessment

Substantive procedures
- Provisions
- Contingent liabilities
- Asset values
- Capital/revenue expenditure
- Development costs

Review
- Going concern

Audit report should conform with SSA 700

FRS

OAS

Charities

Financial Statements

Measurement
Quick Quiz

1. Draw a mindmap showing the major stakeholders in a company.

2. Management has a duty to monitor risks arising from social and environmental issues as part of their corporate governance.
   - True [ ]
   - False [ ]

3. Name three areas of a statutory audit where social and environmental issues are relevant.
   (1) ........................................
   (2) ........................................
   (3) ........................................

4. Give an example of why social and environmental issues might affect all of the following financial statement areas:
   - Provisions
   - Contingent liabilities
   - Asset values
   - Capital/revenue expenditure
   - Development costs
   - Going concern

5. List six items which should be covered in an assurance report relating to environmental issues.
   (1) ................................. (4) .................................
   (2) ................................. (5) .................................
   (3) ................................. (6) .................................

6. Identify three inherent risks associated with the audit of charities.
   (1) ..............................................................
   (2) ..............................................................
   (3) ..............................................................
Answers to Quick Quiz

1

2  True

3  (1) Planning (risks)
(2) Substantive testing (accounting issues arising)
(3) Reviews (going concern)

4  • Provisions (site restoration or fines/compensation payments)
• Contingent liabilities (pending legal action)
• Asset values (impairment due to new environmental legislation)
• Capital/revenue expenditure (cost of clean-up or meeting legal standards)
• Development costs (new, environmentally friendly products)
• Going concern (operational existence threatened by new/proposed environmental laws)

5  (1) Objectives
(2) Opinions
(3) Basis of opinions
(4) Work performed
(5) Limitations on work
(6) Limitations on opinion

6  (1) Risk associated with the amount of regulation a charity is subject to
(2) Risks associated with the fact that many charities have significant cash transactions
(3) Going concern risk associated with uncertainty of future income

There are many inherent risks associated with charities, see the table in Section 5.2.1 of this chapter for others.
17.1 Environmental and social risks

(a) The mindmap below shows the risks that the company faces.

(b) Any of these issues could be at a level serious enough to cause significant business interruption or even company failure, for the reasons given below.

(i) Bad publicity. This could lead to customers choosing other products, boycotts or loss of market share significant enough to prevent the company from continuing in operation.

(ii) Legislation. The company could be found not to be complying with legislation (through whistleblowing by employees or auditors, or investigation by a regulatory body). This could have the following effects:
   - Fines/compensation. These could be significant enough to prevent the continuance of the company.
   - Disqualification of directors. If the staff involved are key members of the organisation, this could threaten the ability of the company to continue.
   - Bad publicity. See points made above.

17.2 Social and environmental audit

(a) Acceptance considerations

There are four key things that the audit engagement partner should consider:

(i) Impact of the new engagement on the audit

The audit engagement partner needs to ensure that the objectivity of the audit is not adversely affected by accepting any other engagements from an audit client. This is of primary importance.

Factors that the audit engagement partner will consider include the impact that any fees from the engagement will have on total fees from the client and what staff will be involved in carrying out the new engagement (i.e., will they be audit staff, or could the engagement be carried out by a different department?).

In favour of the engagement, the audit engagement partner would consider that such an engagement should increase the AE's knowledge of the client and its suppliers and systems, and might enhance the AE's understanding of the inherent audit risk relating to the client.

(ii) Competence of the AE to carry out the assignment

The audit engagement partner needs to consider whether the AE has the necessary competence to carry out the engagement in a quality manner, so as to minimise the risk of being sued for negligence.
This will depend on the nature of the engagement and assurance required (see below) and on whether the auditor feels it would be cost-effective to use the work of an auditor's expert, if required.

(iii) Potential liability of the AE for the report

As the engagement is not an audit engagement, partners should consider to whom they would be accepting liability in relation to this engagement, and whether the risk that that entails is worth it, in relation to the potential fees and other benefits of doing the work (such as keeping an audit client happy, and not exposing an audit client to the work of an alternative AE).

Unless otherwise stated, liability is unlikely to be restricted to the shareholders for an engagement such as this; indeed, it is likely to extend to all the users of the annual report. This could include:

- Financial institutions, for example, banks
- Future investors making ethical investing decisions
- Customers and future customers making ethical buying decisions

The partner should also consider whether it might be possible to limit the liability for the engagement, and disclaim liability to certain parties.

(iv) Nature of the engagement/criteria/assurance being given

Before partners accept any such engagement on behalf of the AE, they should clarify with the directors the exact nature of the engagement, the degree of assurance required and the criteria by which the directors expect the AE to assess the assertions.

As the engagement is not an audit engagement, the audit rules of ‘truth and fairness’, and ‘materiality’ do not necessarily apply. The partner should determine whether the directors want the AE to verify that the assertions are ‘absolutely correct’ or ‘correct in x% of cases’ and also, what quality of evidence would be sufficient to support the conclusions drawn – for example, confirmations from suppliers, or legal statements, or whether the auditors would have to visit suppliers and make personal verifications.

This engagement might be less complex for the AE if they could conduct it as an ‘agreed-upon procedures’ engagement, rather than an assurance engagement.

(b) Assertions

(i) Animal testing

The assertion is complex because it does not merely state that products sold have not been tested on animals, but that ingredients in the products have not been tested on animals.

This may mean a series of links have to be checked, because Naturascope's supplier who is the manufacturer of one of their products may not have tested that product on animals, but may source ingredients from several other suppliers, who may in turn source ingredients from several other suppliers, etc.

The AE may also find that it is a subjective issue, and that the assertion 'not tested on animals' is not as clear cut as one would like to suppose. Potential sources of evidence include: assertions from suppliers, site visits at suppliers' premises, a review of any licences or other legal documents in relation to testing held by suppliers.

(ii) Child labour

This assertion is less complex than the previous assertion because it is restricted to Naturascope's direct overseas suppliers.

It does, however, contain complexities of its own, particularly in relation to the definition of 'child labour'. It is not certain, for example, whether labour means 'any work', 'a certain type of work', or even, 'work over a set period of time'. Further, the definition of a child is not given, when other countries do not have the same legal systems and practical requirements of schooling, marriage, voting etc.
There may also be a practical difficulty of verifying how old employees actually are in certain countries, where birth records may not be maintained.

Possible sources of evidence include: assertions by the supplier and inspection by auditors.

(iii) **Recycled materials**

This may be the simplest assertion to verify, given that it is the least specific. All the packaging must have an element of recycled materials. This might mean that the assertion is restricted to one or a few suppliers. The definition of packaging may be wide, for example, if all goods are boxed and then shrink-wrapped, it is possible that those two elements together are termed ‘packaging’ and so only the cardboard element need contain recycled materials.

The sources of evidence are the same as previously – assertions from suppliers, inspections by the auditors or review of suppliers' suppliers to see what their methods and intentions are.
The use of information technology is fundamental in business. This chapter covers two areas that the auditor must consider:

- The business risks (and therefore related audit risks) relevant to information technology
- The practical aspects of auditing in an information technology environment

There are many efficiencies to be gained by using information technology tools during the audit, as well as considerations when relying on computer systems and the information they produce.
## Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Information technology (IT)</strong></td>
<td></td>
</tr>
<tr>
<td>Describe recent trends in IT and their current and potential impact on auditors (e.g., the audit implications of ‘cyber incidents’ and other risks).</td>
<td>2</td>
</tr>
<tr>
<td>Explain how IT may be used to assist auditors and discuss the issues that may be encountered in automating the audit process.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the circumstances in which enhancements to data capture and information processing systems may add value to a client's activities.</td>
<td>2</td>
</tr>
<tr>
<td>Discuss how business reporting on the internet and growing use of XBRL impacts on the duties of the auditor and how assurance may best be given to stakeholders using such information.</td>
<td>2</td>
</tr>
</tbody>
</table>

## 1 Developments in use of IT in business

### SECTION INTRODUCTION

IT impacts on business in a number of ways:

1. Processing of accounting transactions such as receivables accounting, wages and salaries, and payables accounting. This can be regarded as automation of existing processes.
2. The provision of management information. For example, the analysis of customers' buying patterns.
3. E-commerce and e-business. The purchase and sales of goods and services over the internet.
4. Fundamental shifts in business models. For example, the transformation taking place in the music and book publishing industries.

Increasing reliance on IT brings with it both benefits and risks.

### 1.1 Processing accounting transactions

Automating the processing of routine accounting transactions was one of the first uses of IT in business. Once wages and salaries calculations, invoice production, and the like were automated, businesses potentially enjoyed:

- Cost savings (fewer accounting staff were needed)
- Greater speed of processing and therefore faster results and more timely information
- Greater accuracy and consistency

It is the computerised processing of accounting transactions that has most impact on audits as financial statements are now heavily dependent on the completeness and accuracy of processing. Furthermore, back-up and safeguarding of the computer-held accounting data is of the highest importance as huge amounts of data can be easily lost or stolen. The reliability of the system is also important because, in some businesses, computer malfunctions can mean that business operations have to stop and this could lead to claims from customers (for example, late deliveries), loss of goodwill, or even place the going concern basis of accounting in jeopardy.

In addition to merely processing accounting information, the IT system can have internal control procedures built in. For example, a sales system can be programmed to reject orders that would take customers over their credit limits. A purchases system can be programmed to prevent staff from placing orders that have values over their authority limits.
If internal controls rely on computer procedures then these will have to be tested as part of a systems-based audit approach and auditors will have to devise ways in which they can test that the controls are operating properly.

1.2 The provision of management information

Once accounting transactions have been computerised then it becomes relatively quick, easy and cheap to examine the data and to produce useful management information. The management information can be used for internal control purposes and for wider management purposes. For example:

- Aged receivables reports help managers to identify and follow up on slow payers.
- Slow moving inventory reports help managers to control inventory.
- Invoices due reports can help managers to decide which supplier invoices need to be paid soon.
- Sales analyses identify key customers and key products.

Management information and control reports form a vital part of internal control systems and auditors might rely on the computer-produced reports for part of their audit work, such as assessing the allowance needed for irrecoverable debts.

Question 18.1

What management information might become easily available if hourly paid workers' wages were calculated by computerised wages and salaries system?

1.3 E-commerce and e-business

E-commerce and e-business have become increasingly important in recent years. Amazon.com and Expedia.com are well-known examples of companies which rely on e-commerce. Additionally, many smaller local companies buy and sell goods over the internet. Initially, there were security fears about money or credit card information going astray, but to a large extent early fears about security have proven to be unfounded though risk identification and risk reduction are crucial. A number of recent high-profile security breaches in relation to e-commerce systems have underlined that this is an area that can carry significant operational risks and to which auditors must give specific consideration.

Specific business risks include:

- Loss of transaction integrity or confidential customer information
- Pervasive e-commerce security risks, such as virus infiltration
- Improper accounting policies, such as revenue recognition or tax liabilities
- Non-compliance with tax, legal and regulatory requirements (e.g., local laws in relation to protection of customers' data)
- Over-reliance on e-commerce
- Systems and infrastructure failures
- Damage to reputation if the website fails or security is breached
It should also be noted that e-commerce often creates greater price transparency. Often both customers and competitors can see an organisation's prices and this means price competition is likely to be greater and that price changes will be more common.

**CASE STUDY**

In June 2012, the Royal Bank of Scotland updated software which processed bank payments. The update was corrupted and for over a week the bank was unable to process customers’ payments (such as wages and payments to suppliers) and customers were unable to use ATM machines for cash withdrawals or to access their accounts. Compensating their many million customers for the computer failure reportedly cost the bank around £100 million (approximately $210 million). Similar problems were experienced in 2018 when another UK bank (TSB) attempted to update its online banking systems with equally unsuccessful results.

2018 also saw a number of high profile personal data breaches – social media site Facebook, UK airline BA, taxi operator Uber and even Singapore health database Singhealth all suffered at the hands of expert cyber criminals intent on illegally accessing private data.

Audit procedures regarding the integrity of the information in the accounting system relating to e-commerce transactions would need to be concerned with evaluating the reliability of the system for capturing and processing transactions. Therefore in contrast to audit procedures for traditional business activities which focus separately on control processes relating to each stage of transaction processing, audit procedures for sophisticated e-commerce often focus on automated controls such as accessing a customer’s bank to ensure that funds are available and successfully transferred.

**Example: Risk in an e-commerce environment**

Copper Ltd is a travel agency operating in three locations. The directors have recently taken the decision that they should cease their operations and convert into a dot.com. The new operation, Copper.com, will benefit from enlarged markets and reduced overheads, as they will be able to operate from single, cheaper premises.

Such a business decision has opened Copper Ltd up to significant new business risks.

**Customers**

Converting to a dot.com company in this way enforces a loss of ‘personal touch’ with customers. Copper Ltd staff will no longer meet the customers face to face. In a business such as a travel agency, this could be a significant factor. Customers may have appreciated the service given in branches and may feel that this level of service has been lost if it is now redirected through computers and telephones. Copper Ltd should be aware of the possibility of loss of customers due to perceived reduction in service and guard against this.

**Competition**

Whereas previously, Copper Ltd competed with other local travel agents, it will now be competing theoretically with travel agents everywhere that have internet facilities. Price transparency and therefore price competition increase.
Technology issues

As Copper Ltd has moved into a market that necessitates high technological capabilities, a number of business risks are raised in relation to technological issues:

Viruses

There is a threat of business being severely interrupted by computer viruses, particularly if the employees of Copper Ltd are not very computer literate or the system the company invests in is not up to the standard required.

Viruses could cause loss of data, interrupted sales and loss of customer goodwill, which could have a significant impact on the going concern status of the company.

Hackers

Hackers gain unauthorised access to computer systems with the aim of obtaining confidential information, initiating unauthorised transactions and changing or destroying computer data.

Loss of existing customers

Technology could be another reason for loss of existing customers. Their existing customers might not have internet access or ability to use computers. We do not know what Copper Ltd's demographic was prior to conversion.

However, if conversion means that Copper Ltd lose their existing client base completely and have to rebuild sales, the potential cost in advertising could be excessive.

Cost of system upgrades

Technology is a fast moving area and it will be vital that Copper Ltd's website is kept up to current standards. The cost of upgrade, both in terms of money and business interruption, could be substantial.

New supply chain factors

Copper Ltd may keep existing links with holiday companies and operators. However, they will have new suppliers, such as internet service providers to contend with.

Personnel

Because of the conversion, Copper.com will require technical staff and experts. They may not currently have these staff. If this is the case, they could be at risk of severe business interruption and customer dissatisfaction. Hiring of these technical staff may be costly.

If the directors are not computer literate, they may find that they are relying on staff who are far more specialised than they are to ensure that their business runs efficiently.

Legislation

There are a number of issues to consider here. The first is data protection and the necessity to comply with laws governing personal details given over the computer. It is important that the website is secure.

E-commerce is also likely to be an area where there is fast moving legislation as the law seeks to keep up with developments. Copper Ltd must also keep up with developments in the law.

Lastly, trading over the internet may create complications as to what national domain Copper Ltd is trading in for the purposes of legal and tax compliance.

Fraud exposure

The company may find that it is increasingly exposed to fraud in the following ways:

- Credit card fraud arising from transactions not being conducted face to face
- Hacking and fraud arising from the website not being secure
- Over-reliance on computer expert personnel could lead to those people committing fraud
• Lack of human scrutiny of transactions. Once a transaction is initiated it may proceed to its conclusion without any human intervention that might have identified unusual or suspicious transactions.

Copper Ltd's auditors will have to closely monitor this conversion as this significantly affects audit risk.

Impact on audit risk

Inherent risk

Many of the business risks identified above could have significant impacts on going concern. Inherent risk is the risk that items will be misstated due to characteristics of those items. If a computer program is wrong and, for example, applied the wrong amount of tax to transactions, then an error can be committed many times. Some computer algorithms are very complex and it can be difficult to ensure that correct results are produced for every permutation of circumstances.

Inherent risk is particularly important whenever computer programs are being altered. A mistake in coding can be devastating and indeed this is what caused the problem described above at the Royal Bank of Scotland.

Control risk

The new operations will require new systems, many of which may be specialised computer systems. For example:

• Passwords or biometric measurement to permit log-on
• Activity logs which summarise transactions and who carried them out
• Physical controls to safeguard computer hardware and in particular the data held
• Back-up procedures to safeguard against loss of data

Detection risk

The conversion may have the following effects:

• Create a ‘paperless office’ as all transactions are carried out online – this may make use of special computer aided audit techniques (CAATs) essential.
• The auditors may have no experience in e-commerce which may increase detection risk.
• There are likely to be significant impacts on analytical procedures as results under the new operations are unlikely to be very comparable to the old.
• There may be a significant need to use the work of experts to obtain sufficient, appropriate audit evidence.

1.4 Fundamental shifts in business models

New technology can fundamentally change how businesses can operate successfully. Additionally, the internet can provide all businesses with a global stage and this has important effects on the competitive environment in which the business operates. In some cases IT can cause going concern issues if a business is being overtaken by newer commercial approaches. Examples include:

• Music recording and production companies. Not long ago, these companies made profits by making, distributing and selling CDs. Now most music is distributed by MP3 downloads and there is little money in CD sales. If a music business had not successfully responded to these changes its going concern status would be bleak.
• Travel agents. Now many people go directly to airline or hotel websites and brick and mortar travel agents have become rare.
• Book shops. The growing popularity of eBooks and devices such as the Amazon Kindle have caused many book shops to close.
Therefore, when reviewing the going concern basis of accounting that underlies most financial statements, auditors have to assess whether their client's survival is threatened by the rise of IT and the new trading methods that might exist or which are being developed.

1.5 Other trends

**Mobile computing:** tablet devices and smart phones are now very common and can affect accounting transactions and records. For example, sales personnel can input new orders whilst visiting customers and these can be transmitted over the internet back to their company for further processing. Unfortunately, tablet computers and smart phones are common targets for theft. Unless properly secured by passwords this might give access to confidential information or they might allow improper transactions to be processed.

**Voice recognition:** computers and software are becoming increasingly successful at recognising and responding to spoken information. This can permit transactions to be entered or information obtained by speaking rather than by keyboard input. There can be audit implications arising from this technology. For example, mistakes can be made when people speak with different accents and this can cause incorrect processing.

**Biometrics:** passwords have been used for decades to control access to IT systems. However, their use is often abused if the passwords are too easy to guess or are made public. Biometrics, the measurement of a personal quality such as finger-print or retina recognition, can provide very high levels of access control.

**Contactless payment cards:** debit and credit cards with the following symbol:

![Contactless payment symbol](image)
can be used as contactless payment cards. The card is simply waved at or tapped on a reader and funds are transferred without the need for PIN numbers of signatures. Transaction values are kept low to limit losses should a card be lost or stolen. The advantage to the retailers and customers is that transactions are faster to process. It is envisaged that this will increase sales. Transactions are processed over the same networks as traditional chip and pin cards and these devices should pose no greater risk to accounting records and internal control as older card technology.

**Cloud computing:** maintaining and processing of information data in a hosted network environment instead of in-house. Cloud computing aims to cut costs and help the users focus on their core business instead of investing heavily in IT infrastructure. However, this may increase risk of data security and loss of control.

1.6 Cyber incidents

**KEY TERM**

A **cyber incident** is an incident that can cause harm to functions and services by impairing the confidentiality, integrity, or availability of electronic information, information systems, services, or networks. Cyber incidents may also be known as 'cyber attacks' or 'computer network attacks'.

Increasing connectivity and the openness of computer networks in the global business environment exposes businesses to system and network failures and to cyber attack. The 2013 *Norton Report* found that the total cost of consumer cybercrime over the 24 countries being reported on was over US$113 billion (S$144 billion), with the average cost per victim being US$298 (S$379) and more than one million people becoming victims of cybercrime every day. Fraud, repairs, theft and loss make up 83% of the direct financial costs of consumer cybercrime.
CASE STUDY

In December 2013, the US-based retailer Target announced a security breach had resulted in unauthorised access to customer data. Details of up to 40 million customer names, credit or debit card numbers, the expiration date and CVV (Card Verification Value) codes had all been illegally obtained. Target claimed the issue was resolved soon after the announcement but gave advice to all customers to ‘remain vigilant for incidents of fraud and identity theft by regularly reviewing bank statements and monitoring free credit reports.’


WEBSITE

The following remarks made at the opening of the DigiSAFE Cyber Security Centre also highlight some recent cyber incidents.


Cyber attacks can involve:

- Identity theft, fraud, extortion
- Malware (such as viruses), phishing (masquerading as a website), spamming, and spyware,
- Stolen hardware, such as laptops or mobile devices
- Denial-of-service attacks in which internet systems are overwhelmed by messages or access demands.
- Password sniffing
- System infiltration
- Website defacement
- Instant messaging abuse
- Intellectual property (IP) theft or unauthorised access

Auditors must obtain an understanding of how the entity has responded to risks arising from IT. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process. Some main considerations are:

- Has management established an information and internet security policy?
- How does the entity identify critical information assets and the risk to these assets?
- Does the entity have cyber insurance (many general policies now exclude cyber events)?
- Is there a process for assuring security when linked to third party systems (eg partners/contractors)?
- What controls are in place to ensure that employees only have access to files and applications that are required for their job?
- Are regular scans carried out to identify malicious activity?
- Are procedures in place to ensure that security is not compromised when the company's systems are accessed from home or on the road?
- What plans are in place for disaster recovery in case of an incident?

These issues will be built into the auditor's assessment of the control environment of the entity and in some cases may influence the auditor's view as to whether there are any uncertainties relating to the going concern status of the entity.
SECTION SUMMARY

As more and more organisations adopt increasingly complex computerised accounting systems, and use increasingly ingenious IT techniques, auditors have to be aware of both the benefits and risks that these systems bring to their clients.

2 Use of IT in audit process

SECTION INTRODUCTION

IT is increasingly used in auditing. There are three main types of computer assisted audit techniques:

- Audit software (auditor’s programs read and analyse client’s data)
- Test data (operated on by client’s programs)
- Embedded audit facilities (testing is built in and reporting can take place during the accounting period)

Current developments in auditing include the use of ‘data analytics’ which the IAASB is at the forefront of exploring.

2.1 The relevance of IT to audit

IT is relevant to auditing because both audit client and auditors are likely to operate in a sophisticated IT environment.

The development of IT is rapidly changing the nature of audit work. Auditors will consider IT-related issues in meeting the requirements of many SSAs during the audit. For example, as technology develops, paper-based audit files may become redundant as all evidence can be stored electronically, however, the electronic files must still meet the requirements of SSA 230. Auditors might use computer packages such as a spreadsheet to assist in the calculation of materiality. If doing so, it will be important to ensure that audit judgment is still applied and that the calculation does not simply get done by the computer program, and that the requirements of SSA 320 are still followed.

As well as how the auditor records their work, the impact of IT can be seen on the type of work required as well. For example, SSA 315 states that the auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.

Understanding the implications of IT is likely to be an important aspect of complying with SSA 315, and obtaining an understanding of the client’s internal control system and information systems, which are highly likely to be computerised. The company’s use of IT and/or business risks it is exposed to as a result of IT will influence the assessment of audit risk and the resultant audit approach and the nature of procedures. How IT literate the AE is might affect whether computer assisted audit techniques are used during the audit, and this may affect timing of procedures in particular.

2.1.1 Computer controls

The internal controls in a computerised environment include both manual procedures and procedures designed into computer programs. Such control procedures comprise two types of control, general controls and application controls.
KEY TERMS

**General IT controls** are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

**Application controls in information technology** are manual or automated procedures that typically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to procedures used to initiate, record, process and report transactions or other financial data.

(SSA Glossary)

<table>
<thead>
<tr>
<th>General controls</th>
<th>Examples</th>
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<tr>
<td>Development of computer applications</td>
<td>Standards over systems design, programming and documentation</td>
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<td></td>
<td>Full testing procedures using test data</td>
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<tr>
<td></td>
<td>Approval by computer users and management</td>
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<tr>
<td></td>
<td>Segregation of duties so that those responsible for design are not</td>
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<td></td>
<td>responsible for testing</td>
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<td></td>
<td>Installation procedures so that data is not corrupted in transition</td>
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<td></td>
<td>Training of staff in new procedures and availability of adequate</td>
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<tr>
<td></td>
<td>documentation</td>
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<tr>
<td>Prevention or detection of unauthorised changes to</td>
<td>Segregation of duties</td>
</tr>
<tr>
<td>programs</td>
<td>Full records of program changes</td>
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<td></td>
<td>Password protection of programs so that access is limited to computer</td>
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<td></td>
<td>operations staff</td>
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<td></td>
<td>Restricted access to central computer by locked doors, keypads</td>
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<tr>
<td></td>
<td>Maintenance of programs logs</td>
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<tr>
<td></td>
<td>Virus checks on software: use of anti-virus software and policy</td>
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<tr>
<td></td>
<td>prohibiting use of non-authorised programs or files</td>
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<tr>
<td></td>
<td>Back-up copies of programs being taken and stored in other locations</td>
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<td></td>
<td>Control copies of programs being preserved and regularly compared with</td>
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<td>actual programs</td>
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<td></td>
<td>Stricter controls over certain programs (utility programs) by use of</td>
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<td>read-only memory</td>
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<tr>
<td>Testing and documentation of program changes</td>
<td>Complete testing procedures</td>
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<td>Documentation standards</td>
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<td>Approval of changes by computer users and management</td>
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<td></td>
<td>Training of staff using programs</td>
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<td>Controls to prevent wrong programs or files being</td>
<td>Operation controls over programs</td>
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<td>used</td>
<td>Libraries of programs</td>
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<tr>
<td></td>
<td>Proper job scheduling</td>
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</table>
PART G CURRENT ISSUES AND DEVELOPMENTS

18: Information technology

<table>
<thead>
<tr>
<th>General controls</th>
<th>Examples</th>
</tr>
</thead>
</table>
| Controls to prevent unauthorised amendments to data files | Password protection  
Restricted access to authorised users only  
Policy to change passwords periodically |
| Controls to ensure continuity of operation | Storing extra copies of programs and data files off-site  
Protection of equipment against fire and other hazards  
Back-up power sources  
Disaster recovery procedures eg availability of back-up computer facilities  
Maintenance agreements and insurance  
Sequential control of input and output |

The auditors will wish to test some or all of the above general IT controls, having considered how they affect the computer applications significant to the audit.

General IT controls that relate to some or all applications are usually interdependent controls, ie their operation is often essential to the effectiveness of application controls. As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of general IT controls first, before reviewing the application controls.

The purpose of application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis.

<table>
<thead>
<tr>
<th>Application controls</th>
<th>Examples</th>
</tr>
</thead>
</table>
| Controls over input: completeness | Manual or programmed agreement of control totals  
Document counts  
One-for-one checking of processed output to source documents  
Programmed matching of input to an expected input control file  
Procedures over resubmission of rejected controls |
| Controls over input: accuracy | Programmes to check data fields (for example value, reference number, date) on input transactions for plausibility:  
- Digit verification (eg reference numbers are as expected)  
- Reasonableness test (eg sales tax to total value)  
- Existence checks (eg customer name)  
- Character checks (no unexpected characters used in reference)  
- Necessary information (no transaction passed with gaps)  
- Permitted range (no transaction processed over a certain value)  
Manual scrutiny of output and reconciliation to source  
Agreement of control totals (manual/programmed) |
| Controls over input: authorisation | Manual checks to ensure information input was:  
- Authorised  
- Input by authorised personnel |
| Controls over processing | Similar controls to input must be in place when input is completed, for example, batch reconciliations  
Screen warnings can prevent people logging out before processing is complete |
### Application controls

<table>
<thead>
<tr>
<th>Application controls</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controls over master files and standing data</td>
<td>One-to-one checking</td>
</tr>
<tr>
<td></td>
<td>Cyclical reviews of all master files and standing data</td>
</tr>
<tr>
<td></td>
<td>Record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions</td>
</tr>
<tr>
<td></td>
<td>Controls over the deletion of accounts that have no current balance</td>
</tr>
<tr>
<td></td>
<td>Access controls</td>
</tr>
</tbody>
</table>

Controls over input, processing, data files and output may be carried out by IT personnel, users of the system, a separate control group and may be programmed into application software. The auditors may wish to test the following application controls.

### Testing of application controls

<table>
<thead>
<tr>
<th>Manual controls exercised by the user</th>
<th>If manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system's output is complete, accurate and authorised, the auditors may decide to limit tests of control to these manual controls.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controls over system output</td>
<td>If, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, such controls may be tested by examining the system's output using either manual procedures or computers. Such output may be in the form of magnetic media, microfilm or printouts. Alternatively, the auditor may test the control by performing it with the use of computers.</td>
</tr>
<tr>
<td>Programmed control procedures</td>
<td>In the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output. The auditor may consider performing tests of control by using computers, reprocessing transaction data or, in unusual situations, examining the coding of the application program.</td>
</tr>
</tbody>
</table>

As we have already noted, general IT controls may have a pervasive effect on the processing of transactions in application systems. If these general controls are not effective, there may be a risk that misstatements occur and go undetected in the application systems. Although weaknesses in general IT controls may preclude testing certain IT application controls, it is possible that manual procedures exercised by users may provide effective control at the application level.

### 2.2 Computer assisted audit techniques (CAAT)

There are three types of computer assisted audit techniques (CAAT):

- **Audit software**
- **Test data**
- **Embedded audit facilities**

#### 2.2.1 Audit software

Audit software is software which is owned by the auditor. Most commonly, it is used to read and examine clients' data.

Audit software (auditor's) \( \rightarrow \) examines \( \rightarrow \) Client data
It can perform the sort of checks on data that auditors might otherwise have to perform manually. Examples of uses of audit software are:

- Reperforming calculations. For example, adding up the values in the inventory file or adding up receivables and payables ledgers.
- Identification of noteworthy transactions and balances. For example, reporting on negative inventory balances or credit receivables balances.
- Selecting samples for investigation. For example, random samples or stratified samples.

Note that audit software can quickly examine every piece of data and can often reperform every calculation, such as the depreciation charged for each non-current asset. A manual approach can rarely be so thorough or performed so quickly. The use of audit software is therefore particularly appropriate during substantive testing of transactions and balances. By using audit software, the auditors may scrutinise large volumes of data and concentrate skilled manual resources on the investigation of results, rather than on the extraction of information and selection of samples.

Major considerations when deciding whether to use file interrogation software are as follows:

(a) As a minimum auditors will require a basic understanding of data processing and the entity's computer application, together with a detailed knowledge of the audit software and the computer files to be used. For example, the structure of client files must be known and the audit software adapted to read those files accurately.

(b) Depending on the complexity of the application, the auditors may need to have a sound appreciation of systems analysis, operating systems and, where program code is used, experience of the programming language to be utilised.

(c) Often, instead of running the audit software against the client's original data files, a copy of the data is made and transferred to the auditor's computers. Auditors will need to consider how easy it is to transfer a copy of the client's data onto the auditors' PC.

(d) The client may lack full knowledge of the computer system, and hence may not be able to explain fully all the information it produces.

Other less common types of audit software are:

- Comparison programs, which compare versions of a program. This can highlight where programs have been changed. This is important in case the changes are incorrect or unauthorised.
- Interactive software for interrogation of online systems.
- Resident (or embedded) code software to review transactions as they are processed. Resident code software is where an audit program or audit procedures are embedded in a client's accounting system. The software can be set up to carry out various auditing tasks throughout the year.

For example, in some receivables systems, sales invoices and their related receipts of cash are matched and cancelled from the receivables ledger: there is little to be gained from cluttering up receivables accounts with fully completed sales transactions. However, auditors might then find it difficult to review these matched transactions. Embedded software could be used to record major invoices in a separate memorandum file, where they will not be cancelled, and where they will be available for the auditor to examine at the end of the financial year.

Similarly, monthly salaries over certain limits could also be recorded for later examination by auditors.
2.2.2 Test data

Test data is auditor's data which is processed by the client's programs.

Auditor's data → processed by → Client's programs

An obvious way of seeing whether a system is processing data in the way that it should be is to input some test data and see what happens. The expected results can be calculated in advance and then compared with the results that actually arise. Test data can also be used to check the application controls that prevent processing of invalid data by entering data with, say, a non-existent customer code or non-existent product code or with an absurd value (for example, ordering 10,000,000,000 items), or transactions which may if processed breach limits such as customer credit limits.

Often test data can be divided into three categories:

- Data which should be processed normally. For example, a sales transaction which should be accepted.
- Data which should be rejected. For example, a sales transaction which fails a credit limit check.
- Data which might 'break' the system. For example, a sales transaction with a negative quantity ordered. This category of test data examines how resilient the system is to rogue input.

**Example: System testing**

A mail order company assures its auditors that orders are accepted only after a customer receives a satisfactory result from an automated credit check. Payments are then made for the goods in three instalments. If a customer is late with a payment then a series of follow-up letters is started, eventually threatening legal action. The customer's satisfactory credit rating is removed.

To test that this system is working correctly, the auditor can:

1. Attempt to place an order using the client's system but using a completely false name and address. This should fail the credit check, and the auditor notes if this is the case.
2. Place a legitimate order, ensure that the correct goods are received then stop making payments of the instalments. The series of follow-up letters that are received are audit evidence that the credit control follow-up procedures are as reported.
3. Place a third order after the second stage, as stated above, has been completed. This order should now be refused because the customer's credit rating should now be unsatisfactory.

A significant problem with test data is that it is false data created for test purposes and so it is liable to place false transactions in the client's carefully maintained records. Any resulting corruption of the data files has to be corrected and this is difficult with modern real-time systems, which often have built in (and highly desirable) controls to ensure that data entered cannot easily be removed without leaving a mark. Therefore, it is usual for test data to be run on a specially set up parallel system where errors will not matter. This is known as using 'dead' test data, as opposed to 'live' test data which is processed through to client's real files.

Other problems with test data are that it only tests the operation of the system at a single point of time, and auditors are only testing controls in the programs being run and controls which they know about.
Question 18.2

A standard working week in a factory is 40 hours. If someone works 41–50 hours in a week then their wage for the extra 10 hours is 1.25 times normal wages. Any excess over 50 hours should be paid at 1.5 times normal wages.

Required

What test data could be used to test that the wages calculations are being carried out correctly, and what would be the predicted output from each input? Justify each piece of test data. Note: Assume a standard hourly rate of $20.

2.2.3 Embedded audit facilities

The results of using test data would be completely distorted if the programs used to process it were not the ones normally used for processing. For example, a fraudulent member of the IT department might substitute a version of the program that gave the correct results, purely for the duration of the test, and then replace it with a version that siphoned off the company's funds into their own bank account.

To allow a continuous review of the data recorded and the manner in which it is treated by the system, it may be possible to use CAATs referred to as 'embedded audit facilities'. An embedded facility consists of audit modules that are incorporated into the computer element of the entity's accounting system.

Two frequently encountered examples are Integrated Test Facility (ITF) and Systems Control and Review File (SCARF). Such systems allow auditors to give frequent and prompt auditor's reports on a wide variety of subject matters, key performance indicators and critical success factors.

For example, in some receivables systems, once payment for an invoice has been received and matched to an invoice, the matched transactions are deleted from the file because the transaction is complete. At period end there might therefore be no trace left of substantial transactions that have gone through the receivables ledger. However, embedded audit facilities can be used to record copies of significant transactions so that the auditor can be presented with a list of transactions for investigation at period end. This is an example of SCARF.

The use of IT to produce such reports means additional risk to auditors. They need to ensure that the reports are filed properly and are protected from interference (hacking) by the client. It also widens the amount of expertise needed from auditors, as they will need IT skills as well as expertise in a number of different areas being reported on.

2.3 Issues encountered in automating the audit process

The main issues that arise in automating the accounting process are:

- Initial set-up costs and difficulties
- Client reservations on sharing confidential financial and other data

As mentioned earlier, when audit programs are to be used they have to be amended so that client's files are read accurately. The structure of the file and its records therefore have to be known and this information has then to be embedded in the audit program. This requires both expertise and time. So in the first year of use, audit programs might not appear to be worthwhile financially. However, in subsequent year's audits the audit programs will be capable of generating important information quickly, efficiently and cost-effectively (provided the client's system does not change!)

Similarly setting up a parallel system, getting it to work, and choosing suitable test data takes skill and time in the first year, but this should be rewarded in subsequent years as better and more efficient audits should be possible.

Because the auditors will usually be using parallel systems for their test data investigations, it is extremely important that they can confirm that the test data is being operated upon by the up-to-date version of the client's software. There is little point on operating on test data with a version of the software that the client hasn't used for some years.
Client reservations arise because clients will usually guard their data carefully and are reluctant to place the integrity of their data at risk by allowing auditors to access it with their audit programs or to alter it with their test data. This reluctance is overcome by allowing auditors to examine copies of the accounting system and data so that no damage can be done to the real data. However, this is not quite as satisfactory from the auditor's viewpoint as the actual system that the client is using every day is not being examined.

2.4 IT specialists

IT related audits are commonly carried out by an IT specialist (within the AE, where available). Therefore there should be proper communication of scope and conclusion between the engagement team and the IT specialists.

2.5 Data analytics

Since 2015, the IAASB’s Data Analytics Working Group (DAWG) has been actively considering the opportunities and challenges presented by the use of data analytics in the audit of a set of financial statements. The ability of modern computers to process significant amounts of data has opened up the possibility of 100% testing of some populations, allowing greater speed, accuracy and efficiency to be introduced into the audit.

There has been a cautious welcome from regulators, standard-setters, firms and other practitioners to DAWG's proposals for auditors to embrace data analytics further – issues include the need for enhanced scepticism, training and maintaining quality standards in such a rapidly-evolving area – however, this is surely an area where great progress must surely be expected.

WEBSITE

More information can be found on IAASB’s website.
https://www.ifac.org/publications-resources/feedback-statement-exploring-growing-use-technology-audit-focus-data

There is also a 30 minute video which explains how data analytics could be used in audits: https://www.ifac.org/publications-resources/iaasb-data-analytics-video

SECTION SUMMARY

There are three main types of computer assisted audit techniques:

- Audit software (auditor's programs read and analyse client's data)
- Test data (operated on by client's programs)
- Integrated test facilities (testing is built in and reporting can take place during the accounting period)

Although initial set-up costs can be high, CAAT will produce much better and more cost-effective audits in subsequent years.
3 Data capture and processing

SECTION INTRODUCTION

New data capture and processing techniques, such as the use of radio frequency identification tags (RFID), data warehousing and data mining can add value to client's activities by making available additional useful management information.

3.1 Data capture and processing

In addition to conventional keyboard input by client's staff, the following sources of data have become increasingly important:

Data warehouses and data mining: a data warehouse holds historical transaction data, usually in great detail. Typically, data warehouses are found in retailing organisations where loyalty cards can be used to build up a detailed picture of each consumer's spending and consumption patterns. Every time a customer uses his or her loyalty card (typically 'swiped' at the point of sale), a record is made of what was purchased. Typically this information will be held for several years. The data that is collected can then be analysed (commonly referred to as data mining) to look for individual preferences and also for overall patterns of purchasing, such as trends and associations. This information can be used to address marketing offers to individuals and also to increase the accuracy of purchasing and advertising decisions.

Radio frequency identification tags (RFID): these are small tags that can be attached to goods and which allow individual tracking of each item of inventory. A complete history of each item's locations and the processing it has undergone can be established. Analysis of these histories can allow efficiency gains in inventory management to be obtained.

Computer aided design (CAD) and computer aided manufacture (CAM): computer aided design software allows designers and engineers to develop new products much more quickly, flexibly and accurately than traditional approaches did. The CAD system can be linked to computer aided manufacture systems so that new designs can be quickly turned into prototypes for further testing and refinement. Fast, short developments times have become essential in many manufacturing industries, such as clothing and electrical goods where constant streams of new products and innovation are expected. This trend will continue with the increasing importance of additive manufacturing (3-dimensional printing) in which very complex products are gradually built up by a 3-D printer. In particular, additive manufacturing can allow unique items to be made much more cheaply and quickly than traditional manufacturing approaches.

The internet: organisations can record every click made and every page accessed by visitors to their web sites. If the user had logged-on when visiting the site that information can be recorded against their record. Therefore, if a user visited the Amazon.com site and looked at a particular book, but didn't buy, Amazon knows that some interest in that title had been shown. Upon the user's next visit, that book and others by the same author or in the same genre can be suggested. Even if log-on was not required, the site can send cookies to the user's computer. These are small pieces of data which record internet site activity. Once again, upon a subsequent visit to the same site, the cookie allows the site to target offers to the specific (though anonymous) user. The intelligence gathered from e-commerce sites can be immense and allows each user's experience of the site to be individualised. Furthermore, once a customer decides to buy goods, their purchasing decision can be integrated to allow automation of packing and delivery processes.

Internet forums: many organisations set up forums on which their clients and customers can make comments and ask questions. Often customers ask for help or advice from other customers on a company's products. Monitoring forums can provide valuable information to companies on what users think about their products or where customers are having technical difficulties.

Social media: social media, such as Facebook and Twitter, have become important marketing tools both to send out marketing information and to receive feedback form customers.
SECTION SUMMARY

New data capture and processing techniques can add value to clients' activities. Methodologies include:

- Data warehousing and data mining
- RFID tags
- CAD and CAM
- The internet
- Internet forums
- Social media

4 Internet reporting and XBRL

SECTION INTRODUCTION

XBRL is eXtensible Business Reporting Language. This allows accounting data to be tagged with its description and when the data is transferred, its description goes with it. This makes it much easier to transmit accounting data between different applications and users and the final form will be similar/consistent across different applications and users.

Auditors are not required to report on XBRL data as part of their normal auditing function. However, auditors might be asked to provide additional assurance on XBRL data, although this is not commonly seen in practice.

4.1 XBRL

KEY TERM

EXTENSIBLE BUSINESS REPORTING LANGUAGE (XBRL) is a method of recording business data in a file where each of the data items is stored with a tag which can be used to retrieve that data.

It is extensible because more tags can be created to attach to new types of data.

It is a reporting language because it is usually the final form for the data before it is displayed or passed on to another program. It is not an efficient way to store large quantities of data, and it does not compete with databases for finding data rapidly.

It is a language because it has grammar and syntax. It describes things (elements of data) and the relationships between them.

Attributes can also be used to link to other elements and to define relationships and actions, and even to indicate how the data should be displayed, such as defining the number of decimal places.

Users are not given a free rein in choosing their own tags and several XBRL taxonomies exist to ensure that consistent tags are used. A taxonomy is an electronic dictionary of business reporting elements used to report business data. An XBRL taxonomy is the set of rules about what tags and attributes can or must be used in an XBRL application. For example it would be important to know whether a tag like 'Wages' means gross wages or net wages.

One taxonomy is the Global Ledger Taxonomy (XBRL-GL) which allows the representation of anything that is found in a chart of accounts, journal entries or historical transactions, financial and non-financial. This

Because tags are used to describe each piece of data, the identification of each piece is no longer defined by its position in a file. Anywhere a piece of data described as <price currency="SGD">1200</price> is found, systems know that this data is a price defined in Singapore Dollars. Therefore, when data is transmitted over the internet (or some other file transfer mechanism) the use of that data in recipients’ reporting systems is greatly simplified. For example, financial statements could be made available in this format and the data could be quickly and automatically absorbed into a user’s spreadsheet or database system for analysis.

In January 2010 the IAASB issued a Question and Answer paper to highlight the growing interest in, and use of, XBRL, and to raise awareness of how XBRL-tagged data is prepared and how it may affect financial reporting. The paper contained the following key messages:

- XBRL is an electronic business information format expected to provide benefits in the preparation, analysis and communication of business information.
- The use of XBRL can vary by jurisdiction and may be driven by regulatory requirements or voluntary application.
- Under the current auditing standards, auditors are not required to perform procedures or provide assurance on XBRL-tagged data in the context of audited financial statements. Accordingly, the auditor’s report on the financial statements does not cover the process by which XBRL data is tagged, the XBRL-tagged data that results from this process, or any representation of XBRL-tagged data.
- The IAASB is currently undertaking a consultation to determine the needs of preparers and users of XBRL-tagged data. This consultation will assist the IAASB in assessing whether it is necessary and in the public interest to develop a pronouncement addressing association with and/or assurance on XBRL-tagged data.

4.2 Singapore requirements

Since 3 March 2014, all incorporated companies in Singapore which are either unlimited or limited by shares (apart from a few described exceptions) have been required to file a full set of financial statements in XBRL format. This filing must comply with the minimum requirement list within the new ACRA Taxonomy 2013.

ACRA describes the minimum requirement list as ‘a set of elements within ACRA Taxonomy 2013 which companies are required to file if the information is available in the financial statements’. If an element is within the minimum requirements list but not in the financial statements, a company may leave it blank. Companies may choose to report more information in XBRL format than is required by the minimum requirement list if they so wish.

4.3 Duties of the auditor

As mentioned above, auditors are not routinely required to report on XBRL tagged data as part of their audit responsibilities and duties. They need only report on conventional printed financial statements. However, because the use of XBRL is growing so as to allow easy distribution of financial data, practitioners who are not the auditors of a company’s financial statements may be asked to provide other
services. Examples of these are given in the IAASB Question and Answer paper XBRL: The Emerging Landscape.

- Agreed-upon procedures engagements on XBRL-tagged data
- Assurance engagements, for example, assurance on the controls related to the XBRL-tagging process and examinations of the accuracy of the XBRL-tagged data itself
- Advice on the XBRL implementation process, where not prohibited by relevant independence requirements
- Preparation of the XBRL-tagged data, where not prohibited by relevant independence requirements

SECTION SUMMARY

XBRL is eXtensible Business Reporting Language. This allows accounting data to be tagged with its description and when the data is transferred, its description goes with it. This makes it much easier to transmit accounting data between different applications and users.

The tags are defined by taxonomies.

Auditors are not required to report on XBRL data as part of their normal auditing function. However, auditors might be asked to provide addition assurance on XBRL data. For example, that both the correct amounts are used and that the correct tags are used so that the data is not inaccurately described.
Chapter Roundup

IT

- In business
  - Accounting transactions
  - Provision of management information
  - E-commerce/E-business
  - Change in business models
  - Cyber incidents

- In audit process
  - CAATs
    - Audit software
    - Test data
    - Embedded audit facilities

- Data capture/processing
  - Data warehouses
  - Data mining
  - RFID tags
  - CAD/CAM
  - Internet
  - Internet forums
  - Social media
  - Data Analytics

- XBRL
  - Required for all incorporated companies in Singapore (some exceptions)
  - Not part of statutory audit
  - Auditors may be asked to provide assurance

Auditors

- Required for all incorporated companies in Singapore (some exceptions)
- Not part of statutory audit
- Auditors may be asked to provide assurance
Quick Quiz

1. What advantages arise from the simple automation of accounting transactions and record-keeping?
2. What management information could arise from the computerisation of invoicing and receivables accounting?
3. What is meant by ‘e-commerce’ and ‘e-business’?
4. What is meant by ‘price transparency’?
5. Give two examples of biometric access control.
6. Name three types of cyber attack or cyber incident.
7. There are two main types of computer assisted audit techniques. What are they?
8. An auditor wants to use a CAAT to look for slow-moving inventory. Which type of CAAT would be used?
9. What is data warehousing and data mining?
10. How can a company record what an internet user, who has not logged in, has looked at on the company's internet site?
11. What does XBRL stand for?
12. How do XBRL systems ‘know’ what a particular figure represents?
13. What is an XBRL taxonomy?
Answers to Quick Quiz

1. Cost savings (fewer accounting staff), increased processing speed, increased reliability and accuracy.

2. The management information available includes: sales analyses by customer, by product and by geographical area; key customer analysis; slow payers; Cr balances, customers over credit limit, dormant customers.

3. E-commerce is buying and selling over the internet. E-commerce looks at interior processes also, such as scheduling production work and so on.

4. Price transparency means that customers and competitors can easily see your prices and compare them to other suppliers' prices.

5. Any two from the following:
   - Fingerprint recognition
   - Retina scans
   - Face recognition
   - Voice recognition
   - Palm-print recognition

6. Any three from the following:
   - Viruses
   - Hackers
   - Theft of hardware
   - Denial of service
   - Phishing
   - Interception of data
   - Destruction of hardware
   - Malware
   - Identity theft

7. Audit software (examines client data); test data (examines the operation of client programs). There is also the technique of integrated test facilities.

8. Audit software would be used to read the inventory file and to identify slow-moving inventory.

9. Data warehousing means recording and keeping vast amounts of historical transaction data. This is then assessed (mined) in the hope of finding patterns, association and other information of value.

10. Cookies can be sent to the user's computer where they can be stored until the next visit to the internet site. The cookies contain data that records activities during prior visits.

11. eXtensible Business Reporting Language

12. The piece of data is tagged and the tag defines the nature of the data. For example: 
    <wage>1500</wage> indicates that this figure is a wage.

13. XBRL taxonomy defines the tags and thus provides users with a common unambiguous language that allows data to be shared very flexibly.
18.1 Management information

The management information could include:

- Wage cost analysed by department/cost centre
- Wage costs over time presented graphically
- Wage costs analysed by contract or job number
- Wages costs compared to budgeted wages costs (variances)
- Sick pay
- Overtime amounts
- Absentees
- Wages greater than a certain amount (for investigation)
- Missing clock-card or time sheet information
- Employees on this week’s wages list, but not on last week’s (new joiners); employees on last week’s wages list but not on this week’s (leavers)
- Defined contribution plans
- Foreign worker levy
- Skill development levy

18.2 Test data

The following test data could be used:

<table>
<thead>
<tr>
<th>Hours</th>
<th>Predicted result (SGD)</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>30 × 20 = 600</td>
<td>Normal, but short week, no overtime</td>
</tr>
<tr>
<td>40</td>
<td>40 × 20 = 800</td>
<td>The upper limit of normal pay</td>
</tr>
<tr>
<td>45</td>
<td>800 + 5 × 1.25 × 20 = 925</td>
<td>First band of overtime</td>
</tr>
<tr>
<td>50</td>
<td>800 + 10 × 1.25 × 20 = 1,250</td>
<td>End of first band of overtime</td>
</tr>
<tr>
<td>55</td>
<td>1,250 + 5 × 1.5 × 20 = 1,400</td>
<td>High overtime</td>
</tr>
<tr>
<td>170</td>
<td>Error report</td>
<td>There are only 168 hours available in a week so 170 must be wrong and an error report should be produced</td>
</tr>
<tr>
<td>-10</td>
<td>Error report</td>
<td>This should not be allowed</td>
</tr>
</tbody>
</table>

Additionally test data for 41 and 51 hours could be used to ensure that overtime bands start correctly.
At this level in your studies you are expected to be familiar with current developments affecting the audit and assurance profession. You must read the wider professional press to keep up to date with local and international developments.

Sources include:

- The newsroom section of the ISCA website for local audit news (http://www.isca.org.sg/the-institute/newsroom/isca-viewpoint/).
- The IAASB website for international auditing developments (http://www.ifac.org/auditing-assurance).
- The ethics section of the ISCA website for ethical updates (http://www.isca.org.sg/ethics/).

Note that this is not an exhaustive list.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Professionalism and ethics</strong></td>
<td></td>
</tr>
<tr>
<td>Identify and assess relevant emerging ethical issues and evaluate the safeguards available.</td>
<td>3</td>
</tr>
<tr>
<td>Discuss ethical issues in the context of current developments in Asia and internationally.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Other current issues</strong></td>
<td></td>
</tr>
<tr>
<td>Explain current developments in Singapore and international auditing standards including the need for new and revised standards and evaluate their impact on the conduct of audits.</td>
<td>1</td>
</tr>
<tr>
<td>Discuss other current legal, ethical, other professional and practical matters that affect accountants, auditors, their employers and the profession.</td>
<td>1</td>
</tr>
<tr>
<td>Explain the circumstances in which listed entity audit failures have mostly taken place in Singapore and overseas in the preceding 20 years, paying particular attention to the apparent ethics of management (including family-owned companies), internal and statutory auditors and others involved in the financial reporting chain.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

- IESBA Responding to Non-compliance with Laws & Regulations
- IAASB Supporting Credibility and Trust in Emerging Forms of External Reporting: Ten Key Challenges for Assurance Engagements

1 Ethical issues

**SECTION INTRODUCTION**

ACRA has issued changes to the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities.

In September 2016, ACRA issued changes to the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities. These changes took effect on 1 Jan 2017 and parallel changes have not yet been proposed or implemented in the ISCA Code.

The changes in the ACRA Code result in certain non-assurance services no longer being permitted in certain circumstances that were previously allowed. Auditors can no longer provide accounting and bookkeeping services, including payroll services, or prepare financial statements for audit clients that are public-interest entities in an emergency situation.

Updates have also been made to paragraphs relating to assuming management responsibility where non-assurance services are provided to audit clients.
SECTION SUMMARY

Changes have been made to the ACRA Code which have not been reflected in the ISCA Code.

2 International developments

SECTION INTRODUCTION

The International Auditing and Assurance Standards Board (IAASB) has issued a number of discussion papers and exposure drafts.

2.1 Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations (NOCLAR)

In July 2016, IESBA published Responding to Non-compliance with Laws & Regulations (NOCLAR). The aim of this publication was to develop a framework to guide auditors, other professional accountants in public practice, and professional accountants in business (PAIBs) in deciding how best to act in the public interest when they come across an act or suspected act of NOCLAR.

The IAASB noted that its auditing and assurance standards contain inconsistencies or perceived inconsistencies with IESBA’s publication. In order to eliminate these inconsistencies, the IAASB published ISA 250 (Revised) Consideration of Laws and Regulations in an Audit of Financial Statements in October 2016. ISCA has not yet published a revised version of SSA 250 or an exposure draft.

2.2 Supporting Credibility and Trust in Emerging Forms of External Reporting

In August 2016, the Integrated Reporting Working Group of the IAASB published a discussion paper (DP) entitled Supporting Credibility and Trust in Emerging Forms of External Reporting: Ten Key Challenges for Assurance Engagements.

Over the past decades, demand for reporting of non-financial information from investors and other stakeholders has grown. This has developed alongside a movement towards more social, environmental, sustainability and governance reporting. In some countries and jurisdictions, formal requirements for reporting non-financial information has emerged, for example, in the European Union 6,000 companies have been affected by a European Directive which requires disclosure of certain non-financial information.

These developing types of reporting of non-financial information are known as Emerging Forms of External Reporting (EER). The increase of EER has resulted in greater demand for assurance and other professional services relating to this non-financial information. The DP notes that differences between EER frameworks and financial reporting frameworks give rise to challenges in providing this assurance. Questions have been raised about the need to enhance the credibility and trust in EER reports, which are mainly assurance reports.

The Discussion Paper explores:

- The factors that can enhance credibility and trust, internally and externally, in relation to emerging forms of external reports;
The types of professional services covered by the IAASB’s international standards most relevant to these reports, in particular assurance engagements;

- The key challenges in relation to assurance engagements; and

- The type of guidance that might be helpful to support the quality of these assurance engagements.

It also sets out the principal findings from research and outreach regarding developments in EER frameworks and professional services most relevant to EER reports.

### SECTION SUMMARY

A number of publications have been issued by the IAASB which are expected to be adopted by ISCA in future years.

### 3 Audit Quality

#### SECTION INTRODUCTION

In August 2016, ACRA announced new regulatory measures to ensure that high quality audit standards are upheld in Singapore.

#### 3.1 New regulatory measures

Following the review of a decade of audit inspections carried out under its Practice Monitoring Programme (PMP), ACRA has developed a number of regulatory measures aimed at improving audit quality in Singapore. The measures are as follows.

(a) Setting a target for the six audit firms that are part of the Global Public Policy Committee (GPPC) networks that perform listed company audits, to achieve a 25% reduction in the percentage of inspected audit engagements with at least one finding over a four year period (from 2015 to 2019). A finding is described as where an audit inspection discovers audit work carried out in significant risk areas does not comply with the requirements of the auditing standards. It does not necessarily mean the wrong audit opinion was issued.

(b) Introduction of six non-compulsory Audit Quality Indicators targets that will provide AEs as well as audit committees with a common yardstick to compare audit quality.

(c) Publication of inspection outcomes for public accountants who have failed at least two successive inspections (the latter being a revisit) and received a hot review, or restriction followed by a hot review outcome imposed in their later inspection.

ACRA have announced that these new regulatory measures will be implemented ‘soon’ and at the time of going to print, no implementation date has been announced.
3.2 Toward enhanced professional scepticism

In August 2017, a working group consisting of IAASB, IESBA and IAESB published observations about the ongoing need for improvements in audit quality called ‘Toward enhanced professional scepticism’. In overview, this is how they see audit quality improving:

- Awareness of companies and their business models (business acumen) is essential when displaying professional scepticism
- Professional scepticism can be adversely affected by engagement-specific factors such as tight reporting deadlines, resource constraints and a firm’s rewards systems
- Individual personality traits such as confidence, inquisitiveness and even cultural background can affect an auditor’s professional scepticism
- It is never too early to start behaving with professional scepticism as suitable education and training at the start of your career can enhance and reinforce this attitude
- More work is needed to improve professional scepticism, both now and long term
- Professional scepticism could be relevant to all professional accountants, not just auditors
- Stakeholders in general have a responsibility to improve professional scepticism, not just standard setting bodies

WEBSITE
The observations of the working group can be read in full here.
https://www.ifac.org/publications-resources/toward-enhanced-professional-skepticism

SECTION SUMMARY
New regulatory measures are being implemented in Singapore aimed at improving audit quality.

4 Convergence with IFRS

SECTION INTRODUCTION
The Singapore Accounting Standards Council (ASC) requires all listed companies to report using a new framework from January 2018.

In May 2014, it was announced that from 2018, all companies listed on the Singapore Stock Exchange (SGX) will need to apply a new financial reporting framework. The new framework is identical to the IFRSs issued by the IASB and is known as ‘IFRS-identical Financial Reporting Standards’ or Singapore Financial Reporting Standards. Early adoption of this framework is not permitted.
Additional considerations will arise for auditors in respect of listed companies adopting Singapore Financial Reporting Standards (International) (SFRS(I)s) for the first time. These are covered by SFRS(I) 1 First-Time Adoption of International Financial Reporting Standards.

Auditors may be asked for technical advice by a company implementing SFRS(I) for the first time. Auditors must guard against a self-review or management threat to independence which could occur where an auditor provides advice on specific accounting entries.

## 5 Audit failures

### SECTION INTRODUCTION

Corporate failure and audit failure are often closely linked.

Over the last 20 years or so there have been a number of high profile corporate failures. These have also had an impact on the audit profession as the role and work of the auditor has been scrutinised in the aftermath of these events. A number of examples are outlined below which show the importance of management integrity, good corporate governance and effective audit.

### 5.1 Enron

The collapse of Enron in America in 2002 is probably one of the most significant corporate collapses of the last 20 years. Subsequent investigations revealed that the bankruptcy of the company was primarily due to misleading and dishonest behaviour and in particular the use of questionable accounting practices that kept millions of dollars of debt off the statement of financial position. The investigation also identified a number of weaknesses in the company's corporate governance including the following:

- A lack of transparency in the financial statements
  
  A number of investment vehicles were used that were not recognised on the statement of financial position and various methods were used to inflate revenue.

- Poor governance structure
  
  The Chief Executive officer was said to be a dominant personality, non-executive directors were not effective and conflicts of interest existed relating to the chair of the audit committee.
• External audit failure

The auditors, Arthur Anderson, did not identify or investigate the accounting issues which resulted in the collapse of the company. A conflict of interest was also identified due to the amount of consultancy work provided to Enron by the Anderson consultancy arm.

5.1.1 Implications

Apart from the implications for shareholders and employees there were also wider consequences. Arthur Anderson were found guilty of obstructing justice by shredding documents relating to the failed company. Following their conviction lawsuits by investors and shareholders bankrupted the AE.

In the US the response to the Enron scandal and other perceived breakdowns in corporate governance arrangements was the Sarbanes-Oxley Act 2002. This has major implications for public companies. Key provisions include the following:

• Provision of non-audit services are severely restricted. Auditors are not allowed to provide the following services to audit clients:
  – Internal audit
  – Bookkeeping
  – System design and implementation
  – Appraisal or valuation services, actuarial services
  – Management functions and human resources
  – Investment management
  – Legal and expert services

• The lead or reviewing audit partner should be rotated every five years

• Audit committees should be established by all listed companies

5.2 Worldcom

Worldcom, the US telephone carrier, was involved in a fraud which in 2002 created the largest bankruptcy in US history. The fraud involved the falsification of accounts to increase profits primarily through the capitalisation of line costs which should have been treated as operating expenses resulting in a US$662 million (S$843 million) loss being reported as a US$2.4 million (S$3.1 million) profit in 2001.

One of the interesting aspects of this case is that it demonstrates the role that good corporate governance can play in protecting shareholders' interests and the role of internal audit in particular. Cynthia Cooper, the vice president for internal audit has been credited with uncovering the fraud and reporting it to the board. She took this action in spite of being assured by the company's auditors, Arthur Andersen that they had not identified any problems and that she should not be concerned.

5.3 Barings Bank

Barings Bank, founded in 1762, was Britain's oldest merchant bank. In 1995 the bank was declared bankrupt as the result of losses of £827 million (S$1,736 million) generated by unauthorised derivatives speculation undertaken by Nick Leeson, a trader in Barings Futures (Singapore) Pte Ltd. Subsequent investigations revealed that the following weaknesses in governance enabled Nick Leeson to carry out the unauthorised transactions:

• Lack of segregation of duties. Nick Leeson oversaw both trading and back office functions.

• Lack of effective supervision and monitoring. Senior management of the bank did not fully understand the nature of the trading activities as they came from a merchant banking background. They did not appreciate the risks involved and did not appoint anyone with appropriate experience or expertise to monitor the activities of the Singapore office.
The bank's auditors PricewaterhouseCoopers also came in for criticism from both the liquidators and the appeals panel of the UK's Joint Disciplinary Scheme for failing to spot that records had been falsified to hide the losses. PricewaterhouseCoopers received a fine and a severe reprimand for its involvement although it was agreed that it could not have prevented the collapse from occurring.

5.4 Citiraya

Citiraya was a company founded by two brothers Ng Teck Lee and Raymond Ng in 1988. The company was involved in the growing area of recycling of electronics waste and went public in 2002.

In 2005, computer chips belonging to a client in the USA which should have been crushed and recycled were discovered in Taiwan. It emerged that computer chips that were meant to be scrapped were being sold overseas. Ng Teck Lee and Raymond Ng had managed to make $161 million from the sale of computer chips which they should have destroyed between 2003 and 2005. Ng Teck Lee was also found to have paid almost $1.8 million in bribes to Citiraya employees and the staff of its clients.

Ng Teck Lee fled the country and was not found. Eleven other Citiraya employees were jailed for various charges. A director of Alvertex Pte Ltd was also jailed for falsifying the financial statements of two private companies including the issue and receipt of false documents and concealing stolen property, mostly electronic scrap.

5.5 National Kidney Foundation

The National Kidney Foundation (NKF) is a charitable organisation which aims to help Singaporeans afford the cost of kidney dialysis and related care.

In April 2004, an article published in the Straits Times accused T.T. Durai, the then Chief Executive officer of NKF of misusing donations for extravagant purchases such as gold-plated taps and expensive toilet bowls.

NKF began a legal case against the Singapore Press Holdings (SPH), the owner of the Straits Times for defamation, claiming damages of $3.24 million. The trial began on 11 July 2005. Very soon into the trial, T.T. Durai admitted to the misuse of NKF funds including the following.

- Using NKF funds to travel first class on many occasions
- Extravagant fittings in the NKF headquarters
- An extravagant salary of $600k per annum

He also admitted the following misrepresentations.

- Overstating patient numbers to give the impression more donations were required from the public
- Stating that the charity only had enough reserves to last for three more years when in fact it has enough to last for thirty

T.T. Durai dropped the suit against SPH on the second day of the trial. On 14 July 2005, he and the entire NKF board resigned.

A report by KPMG in 2005, found there was poor corporate governance at NKF and too much power was concentrated in T.T. Durai.

5.6 Other cases

WEBSITE

Other examples of local cases can also be found on the ISCA website.

http://www.isca.org.sg/ethics/resources/case-studies/
SECTION SUMMARY

A number of high profile corporate failures have resulted in wide-ranging consequences for the audit profession and individual AEs.

6 Conceptual framework for financial reporting

SECTION INTRODUCTION

The IASB has recently issued a revised Conceptual Framework for Financial Reporting.

In March 2018, the IASB issued its revised Conceptual Framework for Financial Reporting, which replaces the original version that was published in 1989. The framework is designed to support the creation of international financial reporting standards by IASB and their subsequent adoption by accountants and auditors alike. It is effective immediately for the IASB to publish new standards, but will not lead to any retrospective application in the use of existing accounting standards.

A number of issues have been addressed by the IASB to ensure accounting standards are fit for purpose in the modern world – these include the following:

- Reintroduction of the terms stewardship and prudence
- Changes to the definitions of both assets and liabilities
- Consideration of different measurement bases for certain assets and liabilities
- Discussions about financial performance measures and other topical matters

Existing accounting standards have been amended to the extent that any references to the framework contained within the standard now reflect the 2018 revised framework – however, other than this reference, at the time of going to press, no other changes have yet been made to accounting standards.

You should refer to your FR materials for more details about the 2018 revised Conceptual Framework for Financial Reporting.

WEBSITE

Further details of the revised Conceptual Framework for Financial Reporting can be found on the IASB website.

https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/

SECTION SUMMARY

The revised Conceptual Framework for Financial Reporting is now effective for the IASB to start considering changes to accounting standards, although no changes in application have yet been made at the time of going to press.
Chapter Roundup

Current and topical issues

Read widely

- ACRA Code
- IAASB – NOCLAR – EERs
- Audit Quality
- Audit failure
- IFRS – Identical FRS
- IASB Conceptual Framework for Financial Reporting
Quick Quiz

1. What does NOCLAR stand for?
2. What are EER?
3. State the regulatory measures to be implemented by ACRA in order to improve audit quality in Singapore.
Answers to Quick Quiz

1. Responding to Non-compliance with Laws & Regulations
2. Emerging forms of external reporting
3. (1) Setting a target for the six audit firms that are part of the Global Public Policy Committee (GPPC) networks that perform listed company audits, to achieve a 25% reduction in the percentage of inspected audit engagements with at least one finding over a four year period (from 2015 to 2019).
   (2) Introduction of six Audit Quality Indicators.
   (3) Publication of inspection outcomes for public accountants who have failed at least two successive inspections (the latter being a revisit) and received a hot review, or restriction followed by a hot review outcome imposed in their later inspection.
ABBREVIATION APPENDIX
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full word, name or phrase</th>
</tr>
</thead>
<tbody>
<tr>
<td>AASC</td>
<td>Auditing and Assurance Standards Committee (ISCA)</td>
</tr>
<tr>
<td>ACRA</td>
<td>Accounting and Corporate Regulatory Authority</td>
</tr>
<tr>
<td>AE</td>
<td>Accounting Entity</td>
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<tr>
<td>AGS</td>
<td>Audit Guidance Statements</td>
</tr>
<tr>
<td>AML</td>
<td>Anti-Money Laundering</td>
</tr>
<tr>
<td>APB</td>
<td>Audit Practice Bulletin</td>
</tr>
<tr>
<td>CAATs</td>
<td>Computer Aided Audit Techniques</td>
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<tr>
<td></td>
<td>Computed Assisted Audit Techniques</td>
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<tr>
<td>CAD</td>
<td>Commercial Affairs Department</td>
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<tr>
<td>CAD</td>
<td>Computer Aided Design</td>
</tr>
<tr>
<td>CAM</td>
<td>Computer Aided Manufacture</td>
</tr>
<tr>
<td>CDD</td>
<td>Customer Due Diligence</td>
</tr>
<tr>
<td>CEAOB</td>
<td>Committee of European Audit Oversight Bodies</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
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<tr>
<td>CP</td>
<td>Consultation Papers</td>
</tr>
<tr>
<td>CPF</td>
<td>Central Provident Fund</td>
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<tr>
<td>CO2</td>
<td>Carbon Dioxide</td>
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<tr>
<td>CR</td>
<td>Credit</td>
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<td>DP</td>
<td>Discussion Paper</td>
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<tr>
<td>DR</td>
<td>Debit</td>
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<td>EIA</td>
<td>Environmental Impact Assessment</td>
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<td>EC</td>
<td>European Commission</td>
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<td>ED</td>
<td>Exposure Draft</td>
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<tr>
<td>EER</td>
<td>Emerging forms of External Reporting</td>
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<tr>
<td>EP</td>
<td>Ethics Pronouncement</td>
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<tr>
<td>EPS</td>
<td>Earnings Per Share</td>
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<tr>
<td>EQM</td>
<td>Environmental Quality Management</td>
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<td>EMS</td>
<td>Environmental Management System</td>
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<td>European Union</td>
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<td>FATF</td>
<td>Financial Action Task Force</td>
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<tr>
<td>FGI</td>
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<td>Financial Intelligence Unit</td>
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<td>FRS</td>
<td>Financial Reporting Standard</td>
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<td>FV</td>
<td>Fair Value</td>
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<td>Generally Accepted Accounting Principles</td>
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<td>GHG</td>
<td>Greenhouse Gas</td>
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<td>Full word, name or phrase</td>
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<td>GLT</td>
<td>Global Ledger Taxonomy</td>
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<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
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<td>IAEPN</td>
<td>International Assurance Engagement Practice Note</td>
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<td>International Federation of Accountants</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IIA</td>
<td>Institute of Internal Auditors of Singapore</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IRAS</td>
<td>Inland Revenue Authority of Singapore</td>
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<td>International Review Engagement Practice Note</td>
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<td>IRSPN</td>
<td>International Related Services Practice Note</td>
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<tr>
<td>ISA</td>
<td>International Standards on Auditing</td>
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<td>ISAE</td>
<td>International Standard on Assurance Engagements</td>
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<td>ISCA</td>
<td>Institute of Singapore Chartered Accountants</td>
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<td>ISQC</td>
<td>International Standard on Quality Control</td>
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<td>ISRE</td>
<td>International Standards on Review Engagements</td>
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<td>ISRS</td>
<td>International Standard on Related Services</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
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<td>ITF</td>
<td>Integrated Test Facility</td>
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<tr>
<td>KAM</td>
<td>Key Audit Matters</td>
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<td>KPI</td>
<td>Key Performance Indicators</td>
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<tr>
<td>KYC</td>
<td>Know Your Customer</td>
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<tr>
<td>LLP</td>
<td>Limited Liability Partnership</td>
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<td>MAS</td>
<td>Monetary Authority of Singapore</td>
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<tr>
<td>NCI</td>
<td>Non-Controlling Interest</td>
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<tr>
<td>NOCLAR</td>
<td>Non-compliance with Laws and Regulations</td>
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<tr>
<td>NRV</td>
<td>Net Realisable Value</td>
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<tr>
<td>OCI</td>
<td>Other Comprehensive Income</td>
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<tr>
<td>PAOC</td>
<td>Public Accountants Oversight Committee (assists ACRA)</td>
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<tr>
<td>PASD</td>
<td>Public Accountancy Sector Division</td>
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<td>PBIT</td>
<td>Profit before Interest and Taxation</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board (USA)</td>
</tr>
<tr>
<td>P/E Ratio</td>
<td>Price/Earnings Ratio</td>
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<tr>
<td>PEST</td>
<td>Political, Economic, Social and Technological (analysis)</td>
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<td>PFI</td>
<td>Prospective Financial Information</td>
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<tr>
<td>Abbreviation</td>
<td>Full word, name or phrase</td>
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<td>PFY</td>
<td>Profit For the Year</td>
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<tr>
<td>PII</td>
<td>Professional Indemnity Insurance</td>
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<tr>
<td>PIOB</td>
<td>Public Interest Oversight Board (for IFAC)</td>
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<td>PMD</td>
<td>Practice Monitoring Department</td>
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<td>ACRA's Practice Monitoring Programme</td>
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<td>POD</td>
<td>Professional Oversight Department</td>
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<tr>
<td>PUP</td>
<td>Provision for Unrealised Profit</td>
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<tr>
<td>RFID</td>
<td>Radio Frequency Identification Tags</td>
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<td>ROCE</td>
<td>Return on Capital Employed</td>
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<td>SAP</td>
<td>Statements of Auditing Practice</td>
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<td>SAPN</td>
<td>Singapore Auditing Practice Notes</td>
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<tr>
<td>SCARF</td>
<td>Systems Control and Review File</td>
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<td>SEC</td>
<td>Securities and Exchange Commission (USA)</td>
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<td>SERD</td>
<td>Strategy and External Relations Department</td>
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<td>SFRS(I)</td>
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<td>SGX</td>
<td>Singapore Exchange</td>
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<td>SMEs</td>
<td>Small and Medium sized Enterprises</td>
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<td>SOFP</td>
<td>Statement of Financial Position</td>
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<td>SSA</td>
<td>Singapore Standards on Auditing</td>
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<td>SSQC</td>
<td>Singapore Standards on Quality Control</td>
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<td>SSAE</td>
<td>Singapore Standards on Assurance Engagements</td>
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<td>SSRE</td>
<td>Singapore Standards on Review Engagements</td>
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<td>SSRS</td>
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<tr>
<td>STRO</td>
<td>Suspicious Transaction Reporting Office</td>
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<tr>
<td>SWOT</td>
<td>Strengths, Weaknesses, Opportunities and Threats</td>
</tr>
<tr>
<td>TCI</td>
<td>Total Comprehensive Income</td>
</tr>
<tr>
<td>URA</td>
<td>Urban Redevelopment Authority</td>
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<tr>
<td>UK FRC</td>
<td>UK Financial Reporting Council</td>
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<tr>
<td>XBRL</td>
<td>eXtensible Business Reporting Language</td>
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