SAAC Singapore Accountancy And Audit Convention Series

ACRA
ACCOUNTING AND CORPORATE REGULATORY AUTHORITY

ISCA
INSTITUTE OF SINGAPORE CHARTERED ACCOUNTANTS

PRACTITIONERS CONFERENCE

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Practice Monitoring Programme: ACRA's Observations from Firm-level and Engagement Inspections

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Agenda

1. Scope of Practice Monitoring Programme
2. Firm-level Inspection findings
3. Engagement Inspection findings
4. Key Observations
5. Key Messages

Scope of Practice Monitoring Programme

Scope of Practice Monitoring Programme

Firm-level Inspections	Engagement Inspections
▪ Inspect audit firms' quality controls	▪ Inspect audit engagements performed by public accountants (PAs)
▪ Applies to firms that audit listed companies	▪ Applies to PAs who audit: - Listed companies - Non-listed companies
▪ Assessed based on Singapore Standard of Quality Control (SSQC) 1	▪ Assessed based on Singapore Standards of Auditing (SSAs)
▪ Advisory basis	▪ Mandatory under Accountants Act

Firm-level Inspection Findings

Firm's Quality Control - Six elements of SSQC 1

- Leadership
- Ethics and Independence
- Human Resource
- Client Acceptance and Continuance
- Engagement Performance
- Monitoring

Leadership – Factors Reflective of Audit Quality

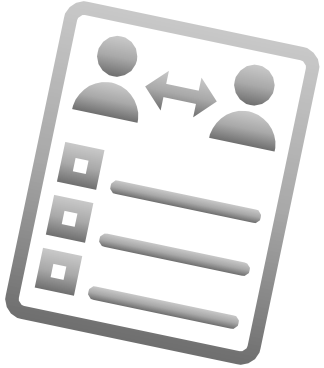
<u>Observation</u>

In certain audit firms, factors that define "Quality" are not clearly spelt out in the appraisal system for partners

Firms should:

- Establish a strong and well-integrated performance management system
- Link audit quality to performance evaluation and compensation of audit personnel and partners
- Consider defining key criteria relating to quality in the appraisal system for partners
- Consider assigning assessment weightage to quality-related factors

Compliance with Independence Requirements



<u>Observation</u>

- Instances of independence violations continued to surface during firms' independence testing, e.g. untimely and inaccurate updates of investment portfolios maintained by the partners and their spouses
- Whilst not non-compliant with the ACRA Code, they were in breach of the audit firm's more stringent global independence policies
- Threats on independence due to relative fee sizes

Firms should:

- Ensure regular communication with audit personnel (including partners) on ethical requirements
- Take non-compliance seriously
- Impose severe financial penalties to deter independence violations
- Develop practice aids on assessing relative sizes of audit and non-audit fees

Acceptance and Continuance – Policies and Procedures

<u>Observation</u>

Lapses noted in the execution of policies and procedures for the acceptance and continuance of client relationships:

- Acceptance or continuance forms were not approved by authorised personnel prior to commencement of engagement
- Letters of consent to act issued prior to obtaining internal approvals
- Acceptance or continuance forms were not dated

Firms should:

- Undertake or continue relationships and engagements only upon proper adherence to policies and procedures

Human Resources – Staff Turnover and Leverage Ratios

Observation

- High staff-to-partner ratio for some firms
- High staff turnover
  - Leads to loss of knowledge and experience
  - Is disruptive to efficient and effective audits

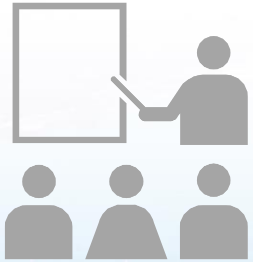
Firms should:

- Ensure HR management policies and systems remain relevant and effective in improving retention rate
- Ensure engagement partners and managers remain actively involved and provide adequate supervision at all times
- Standardise audit workflow and processes to ensure smooth transition

Human Resources – Training

Observation

- Continuing professional development of staff is vital in ensuring that audit personnel deliver quality audits



Firms should:

- Identify staff's learning and developmental needs and direct them to appropriate training programmes
- Ensure training programmes are updated for latest developments to continuously improve skills and competency of their staff in today's dynamic environment

Engagement Performance – Repeated Lapses in Archival of Audit Working Papers

<u>Observation</u>

- Repeated late archival of audit working papers and in certain cases, repeated late archival by the same engagement partners
- Incomplete archival of audit working papers

- Firms should ensure proper processes and controls in place for timely and proper audit documentation and archival of engagement files
- Partners should be held accountable for timely archival and any archival lapses
- Repeated lapses should be severely dealt with

Engagement Performance – Repeated Lapses in Archival of Audit Working Papers *(cont'd)*

<u>Good practices observed</u>

- Firm-wide policy of shorter archival time
- Use of audit software to trigger automated reminders to engagement teams
- Instituting full paperless processes by mandating the use of the firm's audit software to house all audit evidence
- Central monitoring mechanisms allow more frequent reviews on archival statistics to prevent and detect late archival

Monitoring – Robustness and Timeliness of Completion of Internal Reviews

Firm's pre- or post-issuance review		ACRA's inspection
• Focus on significant risk areas and other focus areas • No issues noted	vs	• Focus on significant risk areas • Inspection findings noted in engagements that were also subject to firm's internal quality reviews

Observation

- Indication that firms' internal reviews may not be robust, in instances where findings arising from ACRA's review relate to risk areas that would have existed when internal reviews were performed
- Instances where reviews were not completed on a timely basis

Firms should:

- Develop a robust framework for such internal reviews
- Disseminate results of reviews to all engagement partners and staff at least annually

Monitoring – Root cause analysis

<u>Observation</u>

- Recurring findings arising from external and internal reviews reflect absence of robust root cause analysis and the need for a sustained focus on continual improvement
  - E.g. recurring findings in the area of SSA 620 *Using the Work of an Auditor's Expert*

Firms should:

- Perform comprehensive root cause analysis on a timely basis to remediate deficiencies before commencement of the next audit and to avoid any recurring findings
- Assess the effectiveness of its root cause analysis

Engagement Inspection Findings

Engagement Inspections – Non-Case Studies

- **Going Concern**
- Provisions
- Risk assessment

- Going concern assumption is a fundamental principle in the preparation of financial statements
- Auditors should:
  - Perform audit procedures to identify conditions and events that may cast doubt on the entity's ability to continue as going concern, determine whether or not a material uncertainty exists, and review financial statement disclosures
  - Consider engaging management, directors and those charged with governance on the entity's ability to continue as a going concern at an early stage as this would allow the management adequate time to prepare its assessment and action plan to address the going concern issue.
- Management's assessment of the entity's ability to continue as going concern should cover a period of **at least** twelve months from the date of the financial statements

Engagement Inspections – Non-Case Studies

- Going Concern
- **Provisions**
- Risk assessment

- Provisions involve some uncertainty over either how much will be paid or the timing of such payment

- Recurring finding: Inadequate evidence obtained to ascertain completeness of provisions

- Examples of audit procedures
  - vouching to subsequent settlement
  - review of past trend or history of payment for similar provision
  - review of agreements or relevant documents
  - inquiries with internal and external legal counsel of the entity
  - seeking written confirmations on terms and condition of arrangement forming basis of the provision

Engagement Inspections – Non-Case Studies

- Going Concern
- Provisions
- **Risk assessment**

- ACRA noted instances where audit procedures were designed and performed to test significant account balances without understanding how the entity conducts its operations
- Examples of ways to gather information for effective risk assessment
  - Inquiries with management
  - Analytical procedures
  - Deploying data analytics tools

- Continuous assessment and re-assessment to be performed to reflect new or inconsistent information obtained
- Auditors need to transform and build capabilities to respond to impact of new technologies

Engagement Inspections – Case Studies

Case Study	Illustrative Audited Entity	Area
1	1 (Company A)	Amount due from Related Parties
2		Assessment of Impairment of Investment in Subsidiary
3		Group audits
4	2 (Company B)	Construction Contracts
5	3 (Company C)	Opening Balances
6	4 (Company D)	Revenue Recognition
7	5 (Company E)	Valuation of Inventories

Illustrative Audited Entity 1

<u>Company A</u>

- Engaged in the trading of electronic products, parts and accessories
- Subsidiary S1 (Singapore) is audited by the PA
- Subsidiary S2 (Malaysia) is audited by an audit firm in Malaysia

<u>Other information on Company A</u>

- Financial year end: 31 December 2017
- Audit opinion: Unmodified
- Overall materiality: $600,000

<u>Significant risks identified</u>

- At Group level
  - Cut-off of revenue
  - Valuation of inventories
  - Valuation of amount due from related parties
- At Company level
  - Cut-off of revenue
  - Valuation of inventories
  - Valuation of amount due from related parties
  - Impairment of investment in subsidiaries

Case Study 1 – Amount Due from Related Parties

Case Facts

- Receivables (trade and non-trade) from related parties amounted to $4,300,000 as at 31 December 2017

Related Party	Outstanding Balance	Work Performed
A	$1,500,000	Verified subsequent receipts $300,000; pending assignment of remaining outstanding balance to Related Party E
B	$800,000	Pending assignment of outstanding balance to Related Party F
C	$1,150,000	Noted Related Party C in net assets position
D	$850,000	Verified subsequent receipts $100,000; In net liabilities position as at year-end but in view of subsequent receipts after year-end, no issue on recoverability of debt
TOTAL	$4,300,000	

Case Study 1 – Amount Due from Related Parties *(cont'd)*

What should have been done

- Understand basis of assigning outstanding debts to Related Parties E & F
- Assess abilities of Related Parties E & F to repay outstanding amounts
- Assess how Related Party D (in capital deficiency position) was in a position to repay the outstanding balance

Case Study 2 – Assessment of Impairment of Investment in Subsidiary

Case Facts

- Subsidiary S1
  - Company A's cost of investment = $2.9 million
  - External debt = $800K
  - Engagement team concurred with management that there were impairment indicators (being, net losses incurred and net liabilities position)
- Management prepared DCF for S1:
  - Recoverable amount = $5.0 million
  - Headroom = $2.1 million

Work performed

Inputs used in DCF	Work performed
Revenue growth	Assessed and concluded that assumptions are reasonable
Gross profit margin	
Operating expenses	
Free cash flows (FCF)	Excluded working capital changes in deriving FCF
Weighted average cost of capital (WACC)	Compared to Group's WACC obtained from an external website and concluded to be reasonable

Case Study 2 – Assessment of Impairment of Investment in Subsidiary *(cont'd)*

<u>What should have been done</u>

- On inputs to Group's WACC obtained from external website
  - Obtain understanding of and independently verify inputs used
  - Compare debt-equity ratio input against comparable entities
- Assess appropriateness of non-adjustment of net debt of S1 in determining recoverable amount
- Assess appropriateness of exclusion of working capital changes in deriving free cash flows in DCF

To also note:

- Consider external and internal sources of information that may indicate that an existing impairment loss recognised may no longer be required
- Assess if any reversal of provision for impairment is necessary

Case Study 3 – Group Audits

Case Facts

- Group instructions sent to overseas component auditors (CA) for full scope reporting on Subsidiary S2

Work performed

- Received reporting deliverables from component auditors
- Reviewed CA's AWP and briefly summarised audit procedures performed for revenue, costs of sales, receivables and inventories

What should have been done

- Determine a materiality threshold for the group audit
- Determine allocated component materiality
- Document details on nature, timing and extent of work performed by CA to ensure sufficiency and appropriateness of audit evidence obtained to address significant risks

For further guidance on group audits, refer to ACRA's APB No. 1 of 2015

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Illustrative Audited Entity 2 / Case Study 4 – Construction Contracts

Company B

- Engaged in piping, fabrication, installation, equipment erection and other specialised construction

Other information on Company B

- Financial year end: 31 December 2017
- Audit opinion: Unmodified
- Audit report date: 15 June 2018

Case Facts

- Company B had 6 on-going projects at year end
  - Total contract sum = $40 million
  - Average project duration = 1 to 2 years
  - Amount due from customers for contract works = $900K
  - Contract revenue & costs recognised for the year = $24 million & $23 million respectively
- Disclosed in FS:
  - Contracts are primarily fixed-priced contracts
  - Contract revenue and costs recognised by reference to stage of completion, based on proportion of costs incurred

Case Study 4 – Construction Contracts *(cont'd)*

<u>Work performed</u>

- Randomly selected transactions recorded under "costs of goods sold" account
  - Vouched to suppliers' invoices, payment vouchers and bank statements for subsequent settlement
  - Checked posting to correct project codes
- For 3 ongoing projects with revised contract sums and total estimated costs, recalculated profit margins and assessed that financial impact to current year's profit was immaterial
- For a loss-making Project X
  - Noted no project certification issued subsequent to 20 November 2017
  - Documented that management was following up with contractor and did not foresee any issue in recovery of balance due

Case Study 4 – Construction Contracts *(cont'd)*

What should have been done

- Verify contract sums (initial contract sum, subsequent variation orders, relevant correspondences arising from changes in scope of construction work)
- Perform independent verification procedures to ascertain reasonableness of estimated total contract costs
- In respect of Project X where payment certificate was delayed
  - Ascertain status and expected completion date
  - Assess accuracy of management's estimates of materials and labour costs to complete
  - Determine if provision for foreseeable losses was necessary

Illustrative Audited Entity 3 / Case Study 5 – Opening Balances

Company C

- Principal activities are those of container rental services and logistics services
- Financial year end: 31 December 2017
- Audit opinion: Unmodified

Case Facts

- Disclosed in "Other Matter" paragraph of the independent auditor's report that:
  - Prior year FY2016's FS were audited by another auditor
  - Unmodified opinion issued on 8 May 2017 on the FY2016 FS
- Engagement team was denied access by the predecessor auditor to perform a review on the FY2016 AWP

Case Study 5 – Opening Balances *(cont'd)*

Work performed

- Obtained from management the following FY2016 listings, agreed balances to prior year's audited FS and noted no exception:
  - Listings of sales and purchases
  - Listings of debtors, creditors and bank borrowings
  - Listings of operating lease commitments for premises and equipment ($1.2 million were due within one year)
- Out of FY2017's rental expenses for premises and equipment of $400K, randomly selected 3 samples (totalling $25K) to verify occurrence

What should have been done

- Perform audit procedures to verify opening balances, particularly significant account balances (receivables, payables, borrowings)
- Perform cut-off testing on revenue and purchases for year ended 31 December 2016
- Understand nature of material operating lease commitments of $1.2 million as at 31 December 2016 (in light that there were no corresponding rental expenses of such quantum in FY2017)

Illustrative Audited Entity 4 / Case Study 6 – Revenue Recognition

Company D

- Principal activities are those of manufacture and repair of ship engines and parts
- Financial year end: 31 December 2017
- Audit opinion: Unmodified
- Materiality: $450,000

Case Facts

- Revenue = $38 million
- Revenue recognition policy: *service income is recognised when services are rendered and accepted by customer and the collectability of related receivables is reasonably assured*
- Based on AWP, Company D builds and sells engines on project basis, with project durations ranging from 2-3 years

Case Study 6 – Revenue Recognition *(cont'd)*

Work performed

- Tested 40 samples of invoices pertaining to revenue
  - Coverage approx. 80%
- Performed sales cut-off testing on 5 sales invoices each in December 2017 and January 2018
- Documented that invoice amount and timing of issuance of invoice was subject to approval by customer

What should have been done

- Assess whether the projects would fall within construction contracts under FRS 11
- Assess appropriateness of accounting treatment for revenue arising from rendering of services
- Assess appropriateness of recognising revenue at the point of issuance of sales invoices vis-à-vis basing on extent of work performed and services rendered

Illustrative Audited Entity 5 / Case Study 7 – Valuation of Inventories

Company E

- Principal activities are those of supply of rigging and lifting equipment
- Financial year end: 31 December 2017
- Audit opinion: Unmodified
- Materiality: $700,000

Case Facts

- Inventories of $50 million mainly comprised heavy lift slings, crane wires and cables
- Allowance of $13 million recognised during the year to write down inventories to NRV
- Classification of inventories:
  - No sales in last 12 months = slow-moving
  - Slow-moving for last 3 years = deadstock and sold as scrap or written off
- Allowance provided at 28%, 56% and 85% for inventories classified as slow-moving for 1, 2 and 3 years respectively
- In estimating attributed scrap values of inventories, assumed that metal content was 30% of cost price

Case Study 7 – Valuation of Inventories *(cont'd)*

Work performed

- Obtained understanding of management's:
  - basis for identifying slow-moving inventories
  - method used to compute provision for inventory obsolescence
- Checked computations of provisions
- Tested key inputs included in computation (cost price of new material, scrap steel price approx. 50% of new materials, quantity of inventories)
- Assessed appropriateness of management's assumption that inventories aged more than 3 years should be provided to scrap value (i.e. 15% of cost)
- Researched and noted deteriorating market conditions, physical deterioration and decrease in steel prices and scrap values

What should have been done

- Assess appropriateness of assumption that metal content of inventory is at 30% of cost price
- Assess appropriateness of rates (namely 28%, 56% and 85%) applied to make provisions for slow-moving inventories
- Assess that inventories were stated at lower of cost and NRV despite that certain items were sold above their written-down values during the year

Key Observations

- Linkage between audit quality and performance evaluation and compensation
- Compliance with independence requirements by audit personnel
- Compliance with acceptance and continuance policies and procedures
- Improvement in staff retention rates and leverage ratios
- Adequacy of training for all audit personnel
- Compliance with requirements to archive audit working papers
- Robustness and timeliness of pre-issuance and post-issuance review programs

Key Messages

- Firm commitment to create a strong and sustainable foundation of **quality control**
- Involvement of **senior audit personnel** throughout the audit
- Emphasis on **comprehensive root cause analysis** and **effective remediation actions**
- Firms to devote adequate **time and resources** to develop and implement effective guidance for engagement teams
- Ensure sufficient audit procedures performed and **adequate** audit evidence obtained and lockdown of audit documentation
- Embrace **new technologies** to improve audit effectiveness