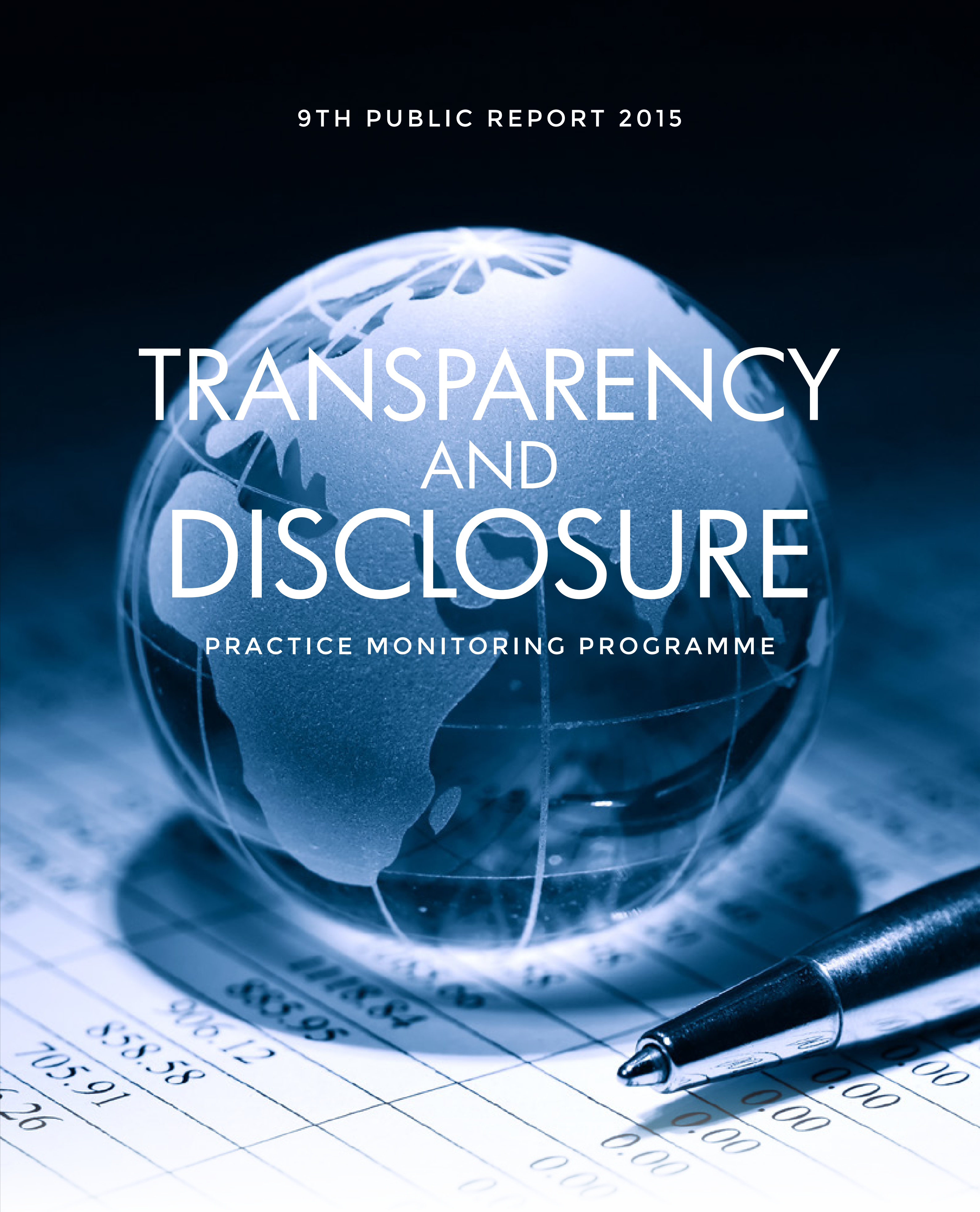
9TH PUBLIC REPORT 2015

TRANSPARENCY AND DISCLOSURE

PRACTICE MONITORING PROGRAMME



ACRA

Accounting And Corporate Regulatory Authority

The Accounting and Corporate Regulatory Authority ("ACRA") is the national regulator of business entities and public accountants in Singapore. ACRA also plays the role of a facilitator for the development of business entities and the public accountancy profession. The mission of ACRA is to provide a responsive and trusted regulatory environment for businesses and public accountants.

Scope / Disclaimer

ACRA's oversight of the profession has been stringent and its inspection methodologies have evolved to be more rigorous but also more targeted and risk based. Therefore, the observations in this report, while raising some concerns, reflect a rigorous approach and a high benchmark reflecting the need to maintain a high degree of confidence in the financial information that underpins Singapore's markets.

In presenting the specific findings in this report, efforts have been made to provide as much of the context as possible under which these findings arose in the PMP. The findings should not be read in isolation or regarded as creating mandatory rules in addition to the auditing standards. Public accountants should read and assess the applicability and severity of each of the findings in the broader context of upholding the profession's standards and in careful consideration of the uniqueness of individual audit engagements.

Published September 2015

Acronyms

AARG	ASEAN Audit Regulators Group
IFIAR	International Forum of Independent Audit Regulators
SSA	Singapore Standard on Auditing
FRS	Financial Reporting Standard
PAOC	Public Accountants Oversight Committee
PMP	Practice Monitoring Programme
SSQC1	Singapore Standard on Quality Control 1

Contents

Section 1:

Executive Summary

Transparency and disclosure are critical for strong corporate governance and ACRA's initiatives aim to enhance transparency and disclosure in the financial reporting value chain.

Quality audits are the cornerstone of public confidence in capital markets. ACRA continues to raise the quality of audits in Singapore thereby boosting stakeholder confidence and reinforcing our reputation as a trusted place for business.

Upholding Transparency and Disclosure in Our Markets

1.1 **Transparency and disclosure** are key pillars for a robust corporate governance framework. They ensure that shareholders, stakeholders and potential investors have access to timely and reliable information in order to make informed decisions in relation to capital allocation, corporate transactions and financial performance monitoring.

1.2 A key instrument in ensuring sufficient transparency and disclosure in our markets is the external audit. It is therefore crucial that the quality of audits and the level of transparency in the audit process itself remains high. To achieve this, ACRA focuses its **efforts on providing more information to key stakeholders** to better understand the audit process undertaken to arrive at the audit opinion, the quality controls that audit firms have put in place and the areas of remediation needed for auditors or firms that have failed to meet the quality bar. These efforts hinge on **three key initiatives**:

(i) Enhanced auditor reporting standards;

(ii) Audit quality indicators; and

(iii) Audit inspection findings and results.

Enhanced Auditor Reporting Standards

1.3 The 2008 financial crisis prompted calls from investors and other stakeholders for more robust corporate governance measures as well as questions about the effectiveness of audits. In particular, concerns were raised about whether the binary auditor's report provided adequate transparency about the audit and the auditor's insights about the company, based on its work. In response, the International Auditing and Assurance Standards Board ("IAASB") issued the International Standard on Auditing ("ISA") 701 *"Communicating Key Audit Matters in The Independent Auditor's Report"* in January 2015. It requires more pertinent information to be included in the auditor's report to augment investors' and other stakeholders' decision-making.

1.4 The enhanced standards will be a **game changer** as it discloses Key Audit Matters ("KAM") and the audit approach taken by the auditor to address these KAM. For the first time, investors and other users of financial statements will have **insights into the key audit risk areas** identified by auditors and the audit process undertaken to address those risks before the auditor provides his/her opinion. Such transparency will help investors better assess the potential risks that may affect the value of the company.

1.5 On 30 July 2015, ACRA, together with the Institute of Singapore Chartered Accountants ("ISCA"), issued the Singapore equivalent of the enhanced auditor reporting standards. The expanded auditor's report would be adopted for audits of public listed entities with the same effective date as the international standard i.e. for audits of financial statements for periods ending on or after 15 December 2016.

Audit Quality Indicators

1.6 In July 2015, to aid investors and Audit Committees in evaluating and determining the quality of audits and better understand how high quality audits are achieved, the IAASB, the US PCAOB[1] and the US CAQ[2], drew up a preliminary set of Audit Quality Indicators ("AQI"). These are inputs, outputs, interactions, and contextual factors that are believed to increase the likelihood of quality audits being consistently performed and could be a **proxy measure of audit quality**.

1.7 In Singapore, ACRA has been referring to AQIs provided by firms to **detect risk areas where audit quality is likely to be low**. For example, based on the AQI of the number of listed entity audits per partner, ACRA closely monitors public accountants that audit a high number of listed entities with the same financial year-end as it indicates risks that the public accountant would not be able to spend adequate time performing a thorough audit. Another AQI closely monitored is the time spent by partners in supervising and reviewing the work of junior staff. It is encouraging to note that ACRA's audit inspections have noted **improvements** in this AQI. However, the improvement was not sustainable as seen in the most recent audit inspections (see paragraph 3.9).

1.8 There is also potential for AQIs to be a **useful tool for audit committees** to start a meaningful conversation with audit firms on the quality of their audits including deliberating over auditor appointments and the audit process. ACRA is currently working with the firms and other industry players to facilitate an **AQI disclosure framework**. The AQIs will also enable audit firms to be **differentiated on their ability to deliver on quality**.

Audit Inspection Findings and Results

1.9 Since 2007, ACRA has published its audit inspection findings on an aggregated non-attributable basis. The purpose of our annual PMP Public Report is twofold. First, to bring to the attention of firms the **key inspection findings that require priority remediation**. Second, to help users of audit services **understand the potential risks when relying on an audit report**.

1.10 In this 2015 (ninth edition) report, ACRA has highlighted in **Section 3**, the key inspection findings in the areas of identification of significant risks, substantive analytical procedures, construction contracts, and sufficiency of audit evidence as group auditors. Since 2014, the findings have been presented in a case study format to help public accountants understand them in a practical context.

[1] United States Public Company Accounting Oversight Board ("US PCAOB")

[2] United States Centre of Audit Quality ("US CAQ")

1.11 Looking ahead, the trend for full public reporting on audit inspections continues to gain traction with audit regulators in the US, UK and Europe adding their support. There is strong consensus that transparency and disclosure of inspection findings and results can be an important **impetus for firms to remediate and improve audit quality**. Locally, some Audit Committees ("AC") in Singapore have already adopted the recommended practice[3] of **inquiring the outcome of regulatory inspections** when evaluating their auditors. ACRA will continue to keep a close watch on this new development as it works with partners and stakeholders in the business community on measures to keep the quality bar for audits high.

Root Cause Analysis to tackle Audit Deficiencies

1.12 Globally, audit inspections are surfacing similar recurring audit deficiencies in areas such as fair value measurements, internal control testing and revenue recognition. This suggests that remediation actions taken by firms are not addressing the root causes. The International Forum of Independent Audit Regulators ("IFIAR"[4]) has issued a strong call for audit firms to perform a Root Cause Analysis ("RCA") to stem recurring findings[5]. In Singapore, the RCA has been incorporated into ACRA's enhanced inspection programme since 2014. **Section 4** of this report discusses some possible root causes as well as challenges that firms may face in performing a **robust and unbiased** RCA.

Quality Audits for a Fair and Transparent Business Environment

1.13 To stay abreast of international developments in audit regulation and represent Singapore's interests, ACRA continues to be actively involved in IFIAR and the ASEAN Audit Regulators Group ("AARG"[6]). Further details of the international activities are summarised in **Section 5**.

1.14 In a volatile and uncertain global economic environment, calls for enhanced market transparency and disclosure continue to gain momentum and in tandem, growing expectations for **quality audits**. Audit quality is constantly a work-in-progress, and ACRA will continue to take all necessary steps to further raise the quality of audit. In so doing, stakeholder confidence in our markets will be further boosted and reinforces Singapore's position as a leading trusted and transparent financial and business hub in the region.

[3] Recommended in Section 6: External Audit of the Guidebook for Audit Committees in Singapore.

[4] Established in 2006, the IFIAR brings together independent audit regulators from over 50 jurisdictions to promote collaboration and consistency in regulatory activity and share knowledge on the audit market environment.

[5] The recurring inspection findings of IFIAR members are summarised in the IFIAR survey conducted in March 2015 which mirrors the inspection findings noted by ACRA, see paragraph 5.5.

[6] The AARG is an informal cooperation group comprising ACRA, Malaysia's Audit Oversight Board ("AOB") and Thailand's Securities and Exchange Commission ("SEC").

Section 2: Overview of the PMP

A strong system of firm-level quality controls is key to ensuring a sustainable, consistent high standard of audit quality. Firm-level inspections will be institutionalised as a statutory requirement.

The continued trend of Financial Reporting Standard 11 related inspection findings indicates the need for more urgent and effective remediation by the profession.

Introduction

2.1 This 2015 report is the ninth edition of ACRA's Annual PMP Public Report. The report summarises the findings from inspections concluded from 1 April 2014 to 31 March 2015, covering nine of the 17 public accounting firms in the listed companies segment, including the Big-Four firms. Similar to prior year's report, the findings in this report are not meant to be exhaustive and instead highlight the areas requiring attention from the profession.

The Scope of ACRA's Regulatory Activities

2.2 ACRA's regulatory scope includes all public accountants who provide public accountancy services. For a more effective calibration of risks and efficient use of resources in ACRA's inspection activities, public accountants are broadly categorised into two categories:

(i) Those practising in firms that perform audits of listed companies; and

(ii) Those practising in firms that perform audits of ***only*** non-listed companies.

2.3 The number of firms and public accountants registered with ACRA as at 31 December 2014 were as follows:

Figure 1: Number of Firms and Public Accountants

As at 31 Dec 2014	Firms that perform audits of listed companies	Firms that perform audits of only non-listed companies	Total
Number of firms	17	647	664
Number of public accountants	308	675	983

2.4 Due to higher public interest, ACRA has direct monitoring oversight of firms and public accountants that perform audits of listed companies. In addition to detailed engagement inspections, these firms are subject to firm-level inspections on an advisory basis, which entails a review of the firm's quality controls and procedures against the requirements of SSQC 1[7].

[7] Singapore Standard on Quality Control 1 ("SSQC 1") *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.*

2.5 Therefore, ACRA's primary focus would be the 17 public accounting firms and 308 public accountants who perform audits of listed companies. Given that the Big-Four firms[8] in Singapore audit about 60%[9] of the 774 companies listed on the Singapore Exchange (representing about 64% of the total market capitalisation of $997 billion[10]), ACRA had revised its inspection cycle in 2014 to carry out annual inspections of Big-Four firms. On the other hand, firms that audit less than 10% share of the market capitalisation of listed entities would be subject to triennial inspections unless there are reasons to conduct inspections more frequently.

2.6 ACRA believes that a strong system of firm-level quality controls is key to ensuring a sustainable, consistent high standard of audit quality in the long term. This has led ACRA to propose amendments to the Accountants Act to **institutionalise firm-level inspections as a statutory requirement**. The amendments are currently undergoing legislative drafting and when passed, will be applicable to firms performing audits in both listed companies and non-listed companies segments.

2.7 Following the enhancement of ACRA's inspection programme, the scope of the 2014 detailed engagement inspections focused only on **significant risks areas**. The number of public accountants inspected in both segments was as follows:

Figure 2: Number of Public Accountants Inspected from 1 April 2014 to 31 March 2015

	Audits of listed companies segment	Audits of only non-listed companies segment	Total
Number of public accountants	50	88	138

2.8 Inspections of firms that perform audits of non-listed companies were outsourced to Singapore's national accountancy professional body, ISCA, with oversight by ACRA. As these firms are mostly sole proprietors who audit small and medium enterprises, these public accountants are currently only subjected to detailed engagement inspections.

[8] The Big-Four firms comprise Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.

[9] The proportion is based on the number of listed entities on the Mainboard and Catalist Listings on the Singapore Stock Exchange as at 31 December 2014.

[10] Market capitalisation as at 31 December 2014.

2.9 The detailed engagement inspections carried out by ACRA and ISCA are for the sole purpose of assessing whether a public accountant's work is in compliance with the Singapore Standards on Auditing ("SSAs"). Findings from the detailed engagement inspections of both listed and non-listed companies segments are presented to the Public Accountants Oversight Committee ("PAOC") for their decision on the inspection outcomes and sanctions.

2.10 From the detailed engagement inspections performed, **whilst the 2014 inspections continue to have recurring findings similar to 2013 in the areas of fair value measurements, revenue recognition and group audits**, ACRA noted, in particular, in **firms which audit only non-listed companies, a high incidence of findings in the following areas**:

(i) Inadequate/Lack of identification of significant risk areas

(ii) Audits of companies which apply Financial Reporting Standard ("FRS") 11 *Construction Contracts*

2.11 ACRA understands that the situation for the audits of companies which apply FRS 11 is exacerbated by upstream issues of (i) poor management accounts and (ii) firms accepting such clients without first assessing the competencies of both the firm's staff and the client.

2.12 Given the importance of identifying appropriate audit risks and the prominence and/or severity of FRS 11 related inspection findings noted, ACRA has included case studies in these two areas in **Section 3** of this report.

Section 3:

Audit Inspection Findings and Results

Whilst improvements were noted in partner time spent, ACRA continues to urge engagement partners and managers to spend more time to provide sufficient and timely supervision and review in response to staff survey.

Understanding the client's business and identification of significant risks areas are fundamental to an audit. An inappropriate and robust risk assessment may impact the design, nature and extent of audit procedures, and hence audit quality.

Introduction

3.1 This section summarises some of the **common inspection findings** arising from the **2014/2015 firm-level** and **detailed engagement inspections** requiring the attention of firms and public accountants. Following the enhanced inspection programme that commenced in 2014, the scope and depth of the 2014 firm-level inspections were based on the results of the previous inspections on these firms. The focus of the firm-level inspections was to obtain an **understanding or update on the design** of the firm's quality controls and **test the effectiveness** of those controls. ACRA's inspection findings on firm-level inspections are summarised in **Section 3A**.

3.2 On the other hand, the focus of the detailed engagement inspections was on **significant risk areas**. The determination of what are the significant risk areas in an audit is defined under SSA 315 *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and Its Environment*. ACRA will review the **significant risk areas as identified by the public accountant**, and may include **additional risk areas** in accordance with SSA 315.28 for the purpose of the inspection. Similar to the previous year, the inspection findings are presented in scenario-based case studies to provide a **practical perspective** on how the findings can be remediated.

3.3 The case studies in **Section 3B** clearly distinguish **audit procedures performed** and the deficiencies arising from the audit procedures that the engagement team had **failed to perform**. ACRA hopes that the presentation of the case studies in this manner, which mirrors the format of the inspection findings reports, provides **clarity and transparency** in the inspection process.

3.4 The current year's report focuses on the following topics of growing concern:

- Identification and Assessment of Significant Risks
- Substantive Analytical Procedures ("SAP")
- Audits of companies that apply FRS 11
- Group Audits – Sufficiency of Audit Evidence as Group Auditor.

These topics are not meant to be an exhaustive list of findings from ACRA's inspections.

Section 3A: Firm-level Inspections

3.5 **Leadership and the tone set at the top** drive the direction and emphasis of any organisation. In the inspections of the Big-Four firms, ACRA is heartened to note that the leadership of these firms have placed a **greater emphasis on audit quality** in the determination of the partner's overall performance. Firstly, this is seen in the clearer linkage between audit quality and partner compensation. Secondly, the Engagement Quality Control Review ("EQCR") partner is increasingly held accountable for internal/external inspection findings which he or she should have been able to detect through a robust EQCR process. However, there is still **room for improvement** for the remaining firms in the segment that audits public listed entities to **strengthen the linkage between audit quality and partner performance**.

3.6 Despite internal monitoring and sanction systems implemented in the firms, ACRA noted a high proportion of independence violations by partners particularly on the reporting of financial interests. Whilst these violations did not breach the Accountants (Public Accountants) Rules (the "Code"), they were in breach of the firm's policies, which were stricter than the Code. Notably, this is an area requiring improvement in that firms should take more serious action to stem the continued trend in independence violations.

3.7 In response to the new Ethics Pronouncement ("EP") 200[11] issued by ISCA, ACRA has extended the scope of the inspection on ethics and independence to include the new requirements and guidelines on **Anti-Money Laundering ("AML") and Countering the Financing of Terrorism ("CFT")**. ACRA's inspection includes assessing if the firms have adequate and appropriate systems and controls in place in response to these new requirements and guidelines, which are in line with the standards set by the Financial Action Task Force (on Money Laundering) ("FATF").

[11] EP 200 on *"Anti-Money Laundering and Countering the Financing of Terrorism – Requirements and Guidelines for Professional Accountants in Singapore"*.

3.8 ACRA is of the view that there is a strong correlation between the extent of involvement by senior auditors (engagement partners, EQCR partners and managers) and audit quality. As the famous saying goes **"you cannot improve what you do not measure"** and hence ACRA had adopted the audit quality indicator of time spent by the engagement partner and EQCR as measures of the extent of their involvement and tracking them for improvement. An analysis of these indicators is shown in Figures 3 and 4 below:

Figure 3: Time Recorded by Engagement Partners[12]

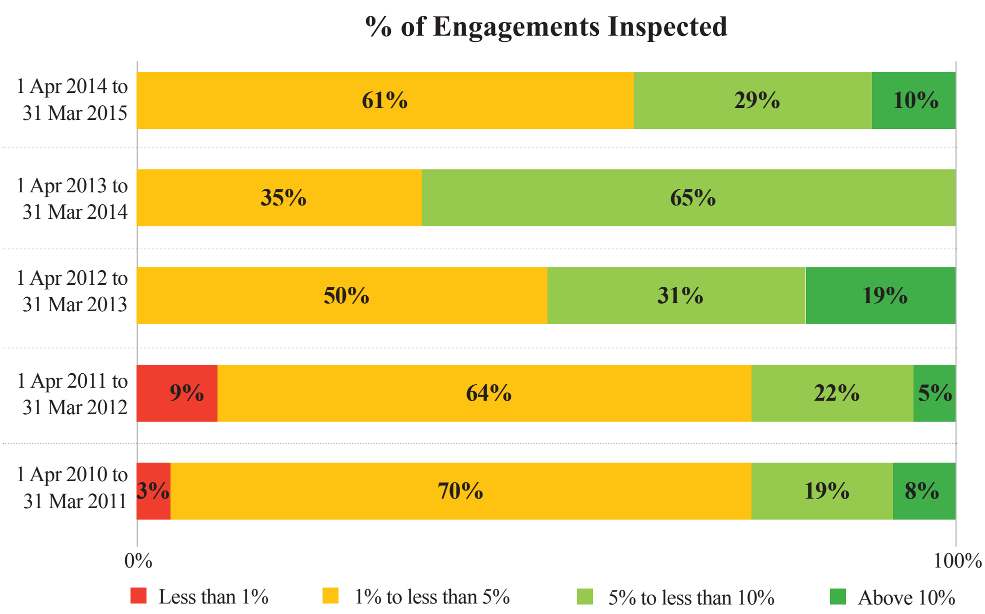
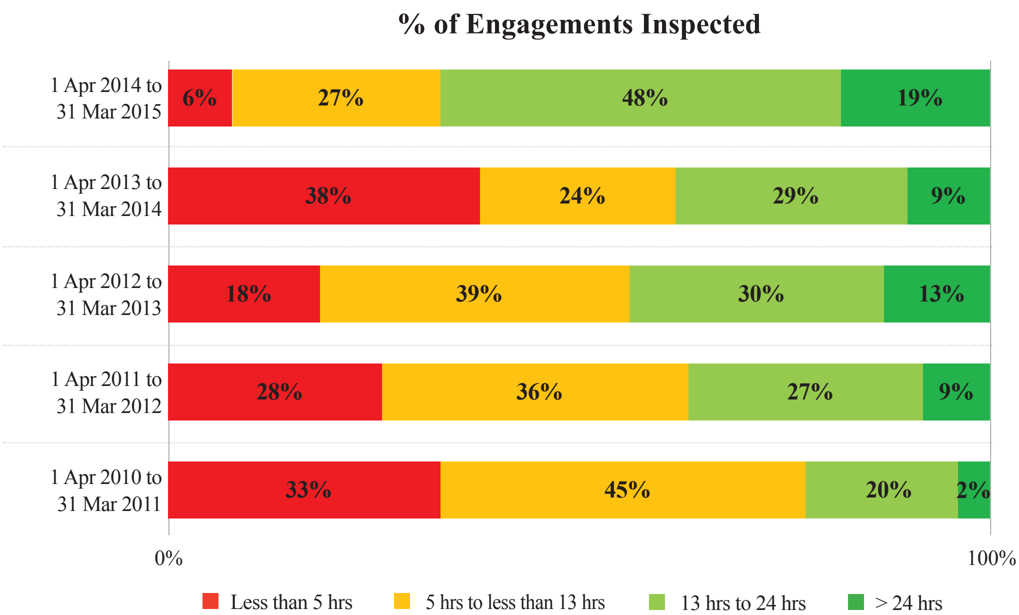


Figure 4: Time recorded by EQCR partners



[12] The statistics for time recorded by engagements partners are compiled from audits of listed and non-listed companies.

3.9 From Figure 3, it is encouraging to note that engagement partners have been spending a lot more time on the audits. There has been an **increase in the proportion of engagements** with at least 5% engagement partner involvement from **27% to 65%** in the years ended 31 March 2011 to 2014. However, this **decreased to 39%** in the year ended 31 March 2015. Hence, there is still room for improvement in that ACRA hopes to see engagement partners being more involved and engaged in the audit process (ACRA uses a benchmark of 5% of total engagement time for a low risk engagement and up to 10% of total engagement time for higher risk engagements).

3.10 ACRA expects the EQCR partner to spend at least 13 to 24[13] hours in an engagement. The analysis in Figure 4 shows that the EQCR partner has been increasingly involved in the engagements. This is evidenced by the increased proportion of engagements inspected that had EQCR hours of at least 13 hours from 43% in the year ended 31 March 2013 to 67% in the year ended 31 March 2015. ACRA continues to urge **engagement partners and EQCR partners** to be **adequately involved in the audit**.

3.11 The involvement of partners and managers is not only important to ACRA from the perspective of audit quality but it is equally if not more important to the junior audit staff who require close supervision and guidance. During our inspections, ACRA noted that the lack of involvement by partners and managers not only give rise to a higher number of inspection findings but also contributed to factors that drove up staff turnover.

3.12 To understand the effects of the lack of involvement by partners and managers on staff, ACRA conducted a survey of 300 staff in the Big-Four firms to assess their perception on the extent and timeliness of their engagement partners' and managers' supervision and review. Two survey results as shown in Figures 5 and 6 offered insights that **staff value and would like to see greater and more timely involvement of engagement partners and managers**.

[13] Based on an activity-based estimate in ACRA's Audit Practice Bulletin No. 1 of 2011: Engagement Quality Control Review, accessible at https://www.acra.gov.sg/training-and-resources/publications/bulletins-and-guidance/audit-practice-bulletin

Figure 5: Staff perception on how they can perform a good audit

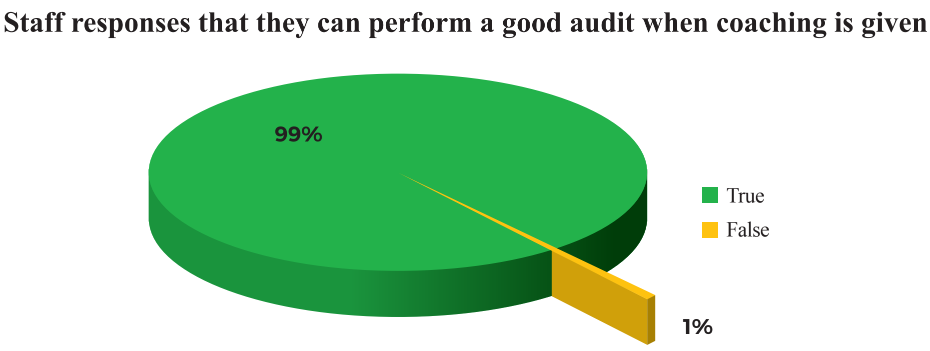


Figure 6: Staff responses on the actual coaching received during the audit fieldwork

3.13 Figure 5 above indicated that junior auditors would like to receive **more coaching** from their engagement partners and managers. Of the 300 staff surveyed, 99% responded positively to the question that "I can do a good audit when my supervisor (senior, manager and/or engagement partner) gives me clear instructions and coaches me".

3.14 However, Figure 6 above indicated that the **actual coaching received by the junior auditors was lagging behind the expected level of coaching junior auditors would like to receive** during the audit fieldwork. There is an expectation gap which engagement partners and managers need to close by ensuring that they are onsite at the audit fieldwork to provide sufficient and timely coaching to staff.

3.15 In summary, ACRA is of the view that the extent of involvement of engagement partners and managers strongly correlates to audit quality. As such, ACRA strongly encourages firms to track the time spent by engagement partners and managers, as well as by the EQCR partner, as AQIs which, along with a few other AQIs, could be disclosed to the Audit Committees to demonstrate the firm's level of commitment to audit quality.

Illustrative Audited Entity 1

Section 3B: Detailed File Inspections

Background information:

Company H, the holding company, manufactured and sold commercial fans and turbines. It also owned a large warehouse and leased the excess warehouse space to customers for storage of goods on a short term basis ranging from one week to three months.

Company S was a 100% owned subsidiary and its principal activity was manufacturing and sale of household fans.

Both companies were incorporated in Singapore and audited by the same public accountant. Company H prepared consolidated financial statements as it did not meet the criteria for exemption from presenting consolidated financial statements.

Other information on Companies H and S were as follows:

- Financial year-end: 31 December 2014
- Group audit report date: 15 May 2015
- Group audit opinion: Unqualified
- Overall group materiality was determined to be $300,000

Note:

(i) ACRA would like to stress that the case studies below **only serves as guidance and is not meant to set any standard on the nature and extent of the audit work**. Public accountants and their audit engagement teams are **cautioned to consider the application of the principles and guidance**, based on the distinct characteristics of each engagement.

(ii) As the case studies are also meant to be focused on specific areas of the audit and deficiencies noted, the listed audit procedures in the case studies below **may not be exhaustive** for purposes of addressing all the audit assertions relating to any particular account balance or transaction. Public accountants and their engagement teams need to **exercise sound professional judgement and knowledge** in ensuring that the necessary procedures are performed to cover all related audit assertions.

Identifying and Assessing Risks of Material Misstatements

Case Study 1: Identifying and Assessing Significant Risks – Risk of Fraud/ Revenue Recognition

Case Facts:

The public accountant had been the auditor for the past five years. Similar to prior years, the public accountant arranged for copies of the draft management accounts for review in March 2015 before commencement of the onsite audit.

From the review, it was noted that Company H's revenue for 2014 had increased by $13 million or 52% as compared to 2013:

Figure 7: Revenue in Company H

	2014	2013	Increase
Total revenue	$38 m	$25 m	$13 m or 52%

In response to the public accountant's query on the reason for the significant increase in revenue, management informed that besides trading fans and turbines to third parties, Company H also started providing systems solutions services that integrated the fans and turbines that it manufactured to the overall ventilation system in marine vessels. In such cases, Company H provided the labour for the manufacture, design and installation services for the customer. Such projects may take approximately three to six months to complete. The contribution from this new revenue stream was $10 million in the current year.

The Group recognised revenue when invoices were raised.

Assume that the provision of systems solutions services was the only main key development of Company H during the year.

Work Performed by the Engagement Team

3.16 As part of audit planning, the engagement team performed a risk assessment to identify the significant risk areas and the corresponding planned audit responses. Similar to prior year, sales and purchases cut-offs were identified as Company H's significant risks due to the voluminous sale and purchase transactions, and cut-off tests would be performed to address these risks.

3.17 In addition, the cut-off test for revenue was performed by selecting 5 samples before and another 5 samples after the year-end. Details of the sales cut-off test as documented in the audit working papers were as follows:

Extracted below were the last 5 sales invoices for the year tested by the engagement team:

	Invoiced amount	Invoice number	Date of acknowledgement by customer (see Note 1)	Additional comments from substantive testing
Invoice 1	$5,000	I-300	10 October 2014	–
Invoice 2	$250,000	I-180	12 June 2014	Progress bill 2 was attached to the customer acknowledgement slip
Invoice 3	$3,200	I-360	21 November 2014	–
Invoice 4	$25,000	I-120	8 March 2014	Progress bill 1 was attached with the customer acknowledgement slip
Invoice 5	$2,000	I-450	20 December 2014	–

Note 1

(i) Traced to the acknowledgement slip signed off by the customer as evidence of the acceptance of the goods delivered; and

(ii) Checked that the quantity invoiced agreed to the quantity delivered to the customer.

Work Not Performed by the Engagement Team

3.18 The engagement team failed to identify that there were **two separate revenue streams** (i.e. trading revenue and project revenue) that had **separate characteristics**, and therefore, the significant risks associated to the current year's audit may be more than just sales and purchases cut-off. The engagement team **did not assess the revenue from the provision of systems solutions services to determine the appropriateness of management's revenue recognition policy based on sales invoices** by performing the following work:

- Obtained and reviewed the terms of the contract with customers to whom Company H provided systems solutions to;
- Based on the characteristics and terms of the contract, assess whether project revenue should be accounted for as "sale of goods" or "rendering of service" in accordance with FRS 18.14 and FRS 18.20 respectively. Depending on the assessment, the audit procedures would differ if project accounting is the appropriate accounting treatment. For example, instead of checking to customer acceptance of goods, the work performed would then be to gather evidence to verify the completion of agreed milestones which will determine the percentage of completion; and

- As a consequence, considered the application of FRS 11 for the recording of costs.

3.19 Additionally, the public accountant **failed to note the existence of progress bills in the sales cut-off test which was an indicator of the existence of project revenue in Company H**. The relatively high amounts of $250,000 (Invoice 2) and $25,000 (Invoice 4) in comparison to the other samples tested should have alerted the public accountant of the higher than usual amounts invoiced and triggered the need to re-assess the significant risk areas and perform additional work in accordance with SSA 315.31[14].

Finding:

The engagement team did not appropriately identify the significant risk areas on revenue during the planning stage for Company H and the public accountant did not perform an adequate review of the audit working papers to note the additional significant risk area in the current year.

[14] SSA 315.31 states that *"The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly."*

Case Study 2: Identifying and Assessing Significant Risks – Risks Related to Significant Developments Requiring Special Attention

Case Facts:

Assume in addition to the facts in case study 1, the engagement team held a planning meeting in March 2015 with the Finance Director who shared the following developments of the Group in FY2014:

1) In November 2014, Company H completed the delivery of a systems solution in a marine vessel of Customer P located in Singapore. This was one of the largest contracts signed by Company H. During the installation and commissioning stage, Company H noted that the ventilation system installed in the vessel was incompatible with the other existing systems. Company H claimed that the technical specification provided by Customer P was not accurate. On the other hand, Customer P claimed that the instructions and specifications provided were not adhered to. Given this dispute, the project was halted. As at 31 December 2014, there was an outstanding receivables balance of $2,000,000 (20% of Company H's trade receivables).

2) In March 2014, Company S launched a new range of household fans. The new launch was well received and revenue of $8 million was recognised in 2014. Commencing from October 2014, there had been returns from customers for this fan. Preliminary assessment by Company S indicated a possible default in the motor of the fan. The new product was sold with a two-year warranty period.

Work Performed by the Engagement Team

3.20 The engagement team documented the dispute with Customer P and the returns of the new fans launched in March 2014 in the minutes of meeting held with the Finance Director. However, there were no additional significant risks identified at the Group.

Work Not Performed by the Engagement Team

3.21 The **risk assessment performed by the group engagement team was not robust**, in that the following **risk assessments were omitted**:

- The dispute between Company H and Customer P of $2 million would impact the revenue recognised in 2014 and the recoverability of the outstanding receivables which was a material balance as at year-end;
- Customer returns of the new fans in Company S involved management's estimates on the provision for returns to be made; and
- Potential provision for warranty to be made for the sale of these fans given that they were sold with a two-year warranty period.

As a result, the significant risks identified by the group engagement team were not complete.

3.22 The **inappropriate identification of significant risk areas was likely to impact the design, nature and extent of planned audit procedures**. For example, the dispute between Company H and Customer P would cast doubts on the recognition of revenue and the recoverability of the outstanding receivables of $2 million. Hence, instead of concurring with management that the receivable was current and not long overdue in the assessment of recoverability of Company H's trade receivables, the appropriate identification of this dispute as a specific significant risk would result in the group engagement team having to perform specific procedures to assess the likelihood of recovery or the need to make a provision for doubtful debts against the outstanding receivables balance.

3.23 In the case of Company S' customer returns and provision for warranty of household fans, as the customer returns were a result of a manufacturing fault and the fans were still within the warranty period, Company S would have a contractual obligation to make good the faulty fan motors. Such provisions involve management's estimates and if the engagement team had not appropriately identified these as significant risks, it was likely that management's estimates on customer returns and provision for warranty would not have been robustly tested.

Finding:

The group engagement team had not performed an appropriate and robust risk assessment to identify the significant risk areas of the Group. This may consequently impact the design, nature and extent of audit procedures performed by the group engagement team.

3.24 The importance of appropriate identification of significant risks would become more apparent when the Proposed ISA 701 *"Communicating Key Audit Matters in the Independent Auditor's Report"* becomes effective for firms who perform audits of public listed entities. Engagement teams would be required to **identify KAM** which may include the following areas:

- Significant risks or areas involving significant auditor judgement;
- Considerable difficulty pertaining to obtaining sufficient relevant audit evidence during the audit; and
- Circumstances that require crucial modification of the auditor's planned approach to the audit as a result of the identification of a significant deficiency in the internal controls.

Substantive Analytical Procedures

Case Study 3: Use of SAP to Test Revenue

Case Facts:

Company H owned a large warehouse with excess space which was leased to customers for storage of goods on a short term basis ranging from one week to three months. The large warehouse enabled Company H to lease space to more than one lessor at any point in time.

The Group's accounting policy stated that revenue from rental income was recognised on a straight-line basis over the period of the lease agreement.

The engagement team documented in the audit working papers that *"As expectations of rental income can be developed with reasonable precision, SAP in accordance with SSA 520 Analytical Procedures would be used to test the reasonableness of rental income."*

Assume that SAP were the only work performed to ascertain the reasonableness of rental income. There was no other substantive work performed.

Work Performed by the Engagement Team

3.25 The following were documented in the audit working papers:

Extract of the audit working papers on rental income:

	2014	2013	Increase
Rental income	$8.0 m	$5.5 m	$2.5 m or 45%

<u>Substantive Analytical Review</u>

The increase in rental income of $2.5 million was due to:

- An additional warehouse lot B5 that was made available for lease in 2014 as Company H had not required the space for its own use. This increased the total floor area for lease from 8,000 square feet in 2013 to 9,500 square feet in 2014; and
- An increase in the occupancy rate of the warehouse from 60% in 2013 to 75% in 2014 (extracted from the Company H's system).

Work Not Performed by the Engagement Team

3.26 The audit procedures performed by the engagement team was **a fluctuation analysis and not a substantive analytical procedure in accordance with the requirements of SSA520.5 (a) to (d)**[15]. Specifically, there was no independent expectation of the rental income that was of sufficient precision and reliable to be used for analysis. The fluctuation analysis was a comparison against prior year's actual rental income and **does not form an independent benchmark** against which the 2014 rental income can be compared with. There was also no determination if the difference between the expected and actual revenue required further analysis and explanation.

3.27 Additionally, the engagement team had also relied on the occupancy rates of 60% in 2013 and 75% in 2014 to explain the fluctuation analysis **without testing if the data used was reliable**.

[15] SSA 520.5 states that *"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: (b) Evaluate the <u>reliability of data</u> 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; (d) Determine <u>the amount of any difference of recorded amounts from expected values</u> that is acceptable without further investigation as required by paragraph 7.*

3.28 In performing the substantive analytical procedures, the engagement team should **form an independent expectation** of the 2014 rental income based on the actual lease agreements in 2014 and the rental rate for each warehouse lot. See example below.

What the engagement team should have performed:

- Obtained the lease agreements for the warehouse lots leased out;
- Extracted the daily rental rate and period from the contracts; and
- Formed an independent expectation of the daily rental income for each warehouse lot.

[ ] – represents which of the four steps in SSA520.5.

Expected rental income for warehouse lot A1 [SSA 520.5(c)]:

Daily rental rate x period of lease agreement (by customers):-

Customer A : $300# x 60 days# = $18,000
Customer B : $450# x 45 days# = $20,250
Customer C : $340# x 50 days# = $17,000
Customer D : $425# x 90 days# = $38,250

Expected rental income for warehouse lot A1 : $93,500

The engagement team should perform the same for **all warehouse lots that were leased out during 2014**.

Daily rental rate and period of lease agreement should be checked to the respective lease agreements [SSA 520.5(b)].

Assume that arising from the procedures above, it was noted that:

1) The expected total rental income in 2014 was $7,500,000;
2) The actual total rental income in 2014 was $8,000,000; and
3) Difference noted: $500,000 [SSA 520.5(d)]

The engagement team should then assess if the difference noted of $500,000 was consistent with their understanding of the business. If the difference was of a significant amount, the engagement team should **perform further investigation**, such as inquiry with management and other procedures in accordance with SSA 520.7[16].

Finding:

In the absence of other substantive work performed, the audit work performed on rental income was inadequate in that it did not comply with the requirements of SSA520.

[16] SSA 520.7 states that *"If analytical procedures performed in accordance with this SSA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by: (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20-A21)*

Illustrative Audited Entity 2

Background information:

Build-A-Ship Limited (the "Group") was a reputable ship builder in the South East Asia ("SEA") region. The principal activities of the Group were (i) investment holding; (ii) ship building, and (iii) ship repairs.

In order to support its ship-building and ship repair activities, the Group had three ship yards in the SEA region: One in Singapore and two in Thailand.

Other information on Build-A-Ship Limited are as follows:

- Financial year-end: 31 December 2014
- Group audit opinion: Unqualified on 7 April 2015
- Functional and presentation currency of the Group: Singapore Dollars
- The Group was profitable with positive net assets

Audit Considerations

- The group engagement team had appropriately identified the significant components in the Group:

Figure 8: Principal Activities and Significant Components of the Group

Companies	Country of incorporation	Principal Activities	Significant component for group reporting?
Holding company	Singapore	Investment holding	Not applicable
Subsidiary A	Singapore	Ship building	Yes
Subsidiary B*	Thailand	Ship building	Yes

* Revenue of subsidiary B arising from ship repair activities contribute to 40% of total group revenue. The audit of the overseas subsidiary in Thailand was performed by an overseas network firm.

The group engagement team had appropriately identified the following significant risk areas:

- Revenue recognition;
- Impairment of ships (owned and for sale) and provision for liquidated damages;
- Impairment of shipyard classified under property, plant and equipment; and
- Group reporting from component auditors.

For the purposes of this case study, it is assumed that:

- Significant risks of the Group had been appropriately identified;
- Overall group materiality was determined to be $15 million;
- The materiality of the holding company and subsidiaries had been appropriately determined. Reporting instructions, including component materiality, were communicated to the component auditors in Thailand; and
- Subsidiary A constructed large ships for the offshore oil and gas industry. It took approximately one to two years to complete the construction of a ship. Customers were third parties located in the SEA region.

Note:

(i) ACRA would like to stress that the case studies below **only serve as guidance and are not meant to set any standard on the nature and extent of the audit work**. Public accountants and their audit engagement teams are cautioned to **consider the application of the principles and guidance**, based on the distinct characteristics of each engagement.

(ii) As the case studies are also meant to be focused on specific areas of the audit and deficiencies noted, the listed audit procedures in the case studies below **may not be exhaustive** for purposes of addressing all the audit assertions relating to any particular account balance or transaction. Public accountants and their engagement teams need to e**xercise sound professional judgement and knowledge** in ensuring that the necessary procedures are performed to cover all related audit assertions.

Construction Contracts

Case Study 4: Existence and Accuracy of Contract Revenue

Case Facts:

The Group's accounting policy was to recognise contract revenue when the amount of revenue and related costs can be reliably measured and it was probable that the collectability of the related receivables was reasonably assured. Revenue from shipbuilding was recognised by reference to the stage of completion of the shipbuilding contract. The stage of completion was measured by reference to physical surveys of construction work completed.

Contract cycle in Subsidiary A

The contract with the customer stated specific milestones to be achieved by Subsidiary A. The valuations team in Subsidiary A ("Subsidiary A's experts") would value the physical extent of construction work completed. However, before Subsidiary A raised a progress bill to the customer, Subsidiary A was required to submit the internal valuation to its customers. Subsequent to the agreement by the customers, a Certificate of Billing would be raised by the customer to Subsidiary A which then allowed Subsidiary A to raise the progress bill to the customer. The progress bill contained details such as customer details, contract reference number, progress bill reference number, date when the valuation was performed and the value of the construction work.

Subsidiary A recognised contract revenue in the Profit or Loss based on the valuation performed by Subsidiary A's experts.

Work Performed by the Engagement Team

3.29 The work performed by the engagement team were as follows:

- Obtained the most recent valuation of the ships performed by Subsidiary A's experts and ensured that the value of the extent of construction work completed agreed to the revenue recognised in the Profit or Loss;
- Agreed the value of the contract and variation orders (if any) to the signed contracts with customers; and
- Reviewed key contractual terms and milestones in the construction contracts with customers.

Work Not Performed by the Engagement Team

3.30 The engagement team had not ensured that the contract revenue recognised in the Profit or Loss represented the extent of construction work that had been agreed with customers. As the engagement team had checked only to the valuation performed by Subsidiary A's experts, there were **no corresponding testing performed to the Certificate of Billing (a third party document)** and progress bills (an internal document subsequently raised) **that evidenced the customer's agreement to the extent of construction work completed**. Additionally, should there be differences between the valuation by Subsidiary A's experts and the Certificate of Billing, the engagement team should investigate the differences and assess the impact to the Profit or Loss.

3.31 The engagement team had also relied on the work of Subsidiary A's experts without obtaining an understanding of their work and assessing their competence, capability and objectivity in accordance with SSA 500.8 *"Audit Evidence"*. It was also **not evident that the engagement team had assessed the appropriateness of the work of Subsidiary A's experts to address the existence and accuracy assertions of contract revenue**. For example, the engagement team could use the cost method of computing the stage of completion as a proxy to assess the reasonableness of the valuation performed by Subsidiary A's experts.

Finding:

The engagement team had not:

(i) Ensured that contract revenue recognised in the Profit or Loss represented construction work that had been completed and agreed by the customers;

(ii) Checked if there were differences between the valuation of Subsidiary A's experts and the Certificate of Billing and investigated the differences, if any; and

(iii) Assessed the competence, capability and objectivity of Subsidiary A's experts.

Case Study 5: Completeness of Contract Revenue and Contract Costs

Case Facts:

As at 31 December 2014, the three largest ships that commenced construction in 2014 were as follows:

Figure 9: Contract values and valuations of the three largest ships in Subsidiary A

Ship name	Valuation in 2014		Valuation in 2015		Total contract value, inclusive of variation orders	Stage of completion computed by management in 2014
	Date when valuation was last performed by Subsidiary A's experts	Valuation by Subsidiary A's experts	Date of valuation	Valuation		
	(A)	(B)	(C)	(D)	(E)	(F) = (B) / (E)
Agony	10 Dec 2014	$60 m	12 Jan 2015	$100 m	$250 m	24%
Behman	12 Dec 2014	$160 m	31 Jan 2015	$200 m	$450 m	36%
Cenron	22 Nov 2014	$200 m	5 Jan 2015	$280 m	$500 m	40%

Consistent with the Group's accounting policy, contract revenue was recognised in the Profit or Loss based on the valuation performed by Subsidiary A's experts.

Management computed the stage of completion of the contract based on the valuation of Subsidiary A's experts relative to the contract sum. Contract costs were recognised in the Profit or Loss as follows:

Contract costs in the Profit or Loss = Stage of completion (%) x Total estimated contract costs

Work Performed by the Engagement Team

3.32 The engagement team checked that the contract revenue recognised in the Profit or Loss agreed to the most recent valuation report signed off by Subsidiary A's experts in 2014. As reflected in Columns A and B, the most recent valuation performed by Subsidiary A's team was performed in late November and early December 2014.

Work Not Performed by the Engagement Team

3.33 The engagement team **failed to ensure completeness of contract revenue recognised** till 31 December 2014. The most recent valuation performed by Subsidiary A's experts in November and December 2014 omitted the construction work that was completed and up till 31 December 2014, hence resulting in the under-recognition of contract revenue in the Profit or Loss.

3.34 The under-recognition of contract revenue **impacted the computation of the stage of completion of contracts** as at 31 December 2014 and the **contract costs recognised in the Profit or Loss**.

3.35 The engagement team should have assessed the impact of the under-recognition of contract revenue, contract costs and the stage of completion of the contracts in the 2014 Profit or Loss. The **valuation report in January 2015** could be used as a **proxy** to measure the extent of physical construction work (and the stage of completion) as at 31 December 2014. As an additional cross-check measure, the engagement team could **compare this stage of completion against that computed using the cost method** (i.e. total contract costs incurred to-date / total estimated contract costs).

Finding:

The engagement team had not ensured completeness of contract revenue recognised in the 2014 Profit or Loss. Failure to do so had a consequential impact on the computation of the stage of completion and the recognition of contract costs in 2014.

Case Study 6: Testing the Accuracy of Estimated Costs-to-Complete

Case Facts:

Following from the previous case study, the information on the contract costs of uncompleted ships as at 31 December 2014 were as follows:

Figure 10: Contract costs of uncompleted ships as at 31 December 2014

Ship name	Total contract value	Date the contract was awarded	Total estimated contract costs	Total contract costs incurred to-date	Estimated costs-to-complete	Estimated profit margin
Agony	$250 m	31 Oct 2013	$232.5 m	$80 m	$152.5 m	7%
Behman	$450 m	24 Jul 2013	$396.0 m	$140 m	$256.0 m	12%
Cenron	$500 m	18 Sep 2013	$460.0 m	$220 m	$220.0 m	8%

The total estimated contract costs were based on management's budgets prepared prior to the commencement of the construction of the ships. The estimated costs-to-complete were derived based on the difference between the total estimated contract costs and the actual contract costs incurred to-date.

Comparison between the actual and estimated profit margins of ships completed in 2014 and 2013 were as follows:

Figure 11: Comparison between the estimated and actual profit margins for ships completed in 2014 and 2013

Ships completed in 2014

Completed ships	Estimated profit margin	Actual profit margin
Desco	18%	18%
Eyco	12%	5%

Ships completed in 2013

Completed ships	Estimated profit margin	Actual profit margin
Falcon	15%	11%
Gladiator	10%	8.5%

Work Performed by the Engagement Team

3.36 For purposes of testing contract costs, the engagement team selected 25 samples and verified the actual costs incurred in 2014 to the supporting documents (e.g. invoices from suppliers, sub-contractors and payroll records).

3.37 The engagement team obtained management's budgets prepared for the ships above and ensured that the estimated costs-to-complete were accurately computed by taking the difference between the total estimated contract costs and the total contract costs incurred to-date.

3.38 To ensure completeness of contract costs recorded, the engagement team had circularised confirmations to the main suppliers and subcontractors for the shipbuilding activities. Positive confirmation replies were received from all confirmations circularised. Suppliers were also in agreement with the outstanding balances. Furthermore, the engagement team also performed a search for unrecorded liabilities.

Work Not Performed by the Engagement Team

3.39 The engagement team failed to identify that the total estimated contract costs prepared by management had not been updated on a regular basis. Whilst a substantive approach was taken to audit contract costs and the engagement team had appropriately tested total contract costs incurred to-date, they had **omitted to ensure that the estimated costs-to-complete were updated for changes to the contract costs as the contract progressed**. Consequently, the estimated costs-to-complete were not accurate. The actual profit margins of completed ships in 2014 and 2013 (see Figure 11) should have indicated to the engagement team that **management's budgets were not reliable**.

3.40 As the total estimated contract costs were not accurate, the contract costs recognised in the Profit or Loss would be misstated as it is a function of total estimated contract costs and the stage of completion of contracts.

3.41 Other than placing reliance on management's budgets, the engagement team had not performed the following procedures on the estimated costs-to-complete:

(i) Enquired with management to understand the **reasons for the lower than estimated actual profit margins** achieved for the completed ships in 2014 and 2013, and assessed how it would impact the estimated costs-to-complete of uncompleted contracts;

(ii) Obtained an understanding of the **progress and status of the uncompleted contracts** through discussions with project managers and reviewed correspondences between the customers and project managers;

(iii) **Independently evaluated the accuracy of the estimated costs-to-complete** for the uncompleted contracts (e.g. by reviewing the estimated material costs, evaluating the reasonableness of estimated labour hours, estimated labour rates and contingency costs of the contracts, if any); and

(iv) Assessed the impact of procedures (i) to (iii) above on the total estimated contract costs and the ensuing impact to contract costs recognised in the Profit or Loss.

Finding:

The engagement team had not performed any audit procedures to test the accuracy of the total estimated costs-to-complete for uncompleted contracts.

Case Study 7: Assessing Foreseeable Losses in Contracts

Case Facts:

The construction of Agony commenced on 1 February 2014 and was expected to be completed and delivered to the customer in December 2015. In June 2014, the main subcontractor for the construction of the ship met with financial difficulties and became bankrupt, suspending the construction of the ship.

In October 2014, the construction for the ship resumed following the appointment of a new subcontractor. Due to the unique specifications of the ship, the commitment to complete the contract at short notice, and quotes from the new subcontractor, management estimated that it would cost an additional $5 million to complete the construction of the ship. In the same month, Subsidiary A had written a letter to the customer to notify them that the expected delivery date of the ship was revised to July 2016.

Management had revised the revenue and cost analysis for Agony as shown on the next page:

Figure 12: Comparison between the initial and revised profit margin (%) for Agony

	Initial	**Revised**
Contract sum	$250.0 m	$250.0 m
Less: Total estimated contract costs	($232.5 m)	($237.5 m)
Estimated profit	$17.5 m	$12.5 m
Estimated profit margin (%)	7%	5%

Events subsequent to 31 December 2014

On 4 February 2015 (before the audit report date of 7 April 2015), the customer filed a legal claim of $15 million against Subsidiary A for a breach of contractual terms due to the delay in the delivery of the ship and the consequential loss of revenue (i.e. liquidated damages). Management had assessed that the likelihood of the claim was remote as the customer had acknowledged receipt of the letter informing them that the project would be delayed till July 2016.

Work Performed by the Engagement Team

3.42 The engagement team had verified the additional costs-to-complete to the agreement with the new subcontractor. The engagement team had also sighted to the written acknowledgement from the customer dated October 2014 that informed them of the delay in the delivery of the ship till July 2016.

3.43 The revised revenue and costs analysis for the construction of Agony were discussed with management and the project team in January 2015. Management represented that the contract would remain profitable, albeit at a lower margin of 5% (instead of 7%). Accordingly, the engagement team documented the following in the audit working papers that *"based on discussions held with management and the project team, the construction of Agony would still be profitable. Reliance can be placed on management's experience and expertise due to the history of strong profits made by the group in the previous years. Therefore, no foreseeable losses were expected for this contract"*.

3.44 The January 2015 management accounts of Subsidiary A were reviewed as part of the post balance sheet events review. The engagement team had not noted any unusual activities that would require further investigation.

Work Not Performed by the Engagement Team

3.45 Whilst the engagement team had reviewed the revised revenue and costs analysis for Agony showing a profit margin, the engagement team **had relied on management's expertise and experience** that the initial or revised profit margins of 7% and 5% respectively were an acceptable range of completed ships in 2013 and 2014 (see case study 6). The **triggering event** such as the delay in the delivery of the contract should have alerted the engagement team to perform additional audit procedures **to assess if the contract would end up to be loss-making**, given that a change in the subcontractor had given rise to an increase in contract costs.

3.46 Additionally, the engagement team **failed to perform a robust post balance sheet events review**. Such audit procedures may include:

- Reviewing project status report, legal correspondences, correspondences with customers and subcontractors to assess if there had been any major construction delays, disputes, cost overruns and/or termination of contracts resulting in lawsuits;
- Requesting for a legal confirmation of the probability of success of the customer's claim of $5 million;
- Reviewing minutes of meetings of the Board of Directors, management meetings and Board resolutions to identify any issues that would impact the engagement; and
- Extending the post balance sheet events review till the date of the Group audit opinion on 7 April 2015.

3.47 Had a robust post balance sheet review been performed, the engagement team would have followed up on the legal claim of $15 million against Subsidiary A. Furthermore, the engagement team should have obtained the contract to assess if the customer had a claim on liquidated damages over Subsidiary A. **Independent legal advice** should have been obtained to **corroborate management's assessment** of the legal claim. **Assuming that the probability of the customer winning the claim was high**, the contract would have resulted in a **foreseeable loss of $2.5 million[17] which required immediate recognition to the Profit or Loss**.

Finding:

In view of the circumstances relating to Agony, the engagement team had not:

(i) Independently assessed if the contract would be loss-making but placed undue reliance on management's representations;

[17] Provision for foreseeable losses computed as the revised profit margin ($12.5 million) less estimated legal claim ($15.0 million).

(ii) Performed a robust post balance sheet review to ensure events affecting the construction of Agony had been appropriately assessed for its financial implication; and

(iii) Assessed the customer's contract to understand if the customer had a claim over liquidated damages suffered from the delay in the delivery of the ship.

Failure to perform (i) to (iii) would lead to a failure to recognise the provision for foreseeable losses of $2.5 million in 2014.

Group Audits

Case Study 8: Sufficiency of Audit Evidence as the Group Auditor

Case Facts:

Subsidiary B in Thailand had been suffering losses in the last two financial years. It had not been able to secure any significant shipbuilding contracts since 2013. Revenue was generated from ship repair services. In 2014, the component auditor had followed up on the impairment of shipyard (a significant risk area) raised in the prior year. As there were no exceptions noted during the audit of this significant risk area, the component auditor had not provided details of the procedures performed in the current year's reporting memorandum.

Work Performed by the Engagement Team

3.48 The component auditors in their Summary Review Memorandum ("SRM") to the group engagement team, had concluded that ***"based on the work performed, no exceptions were noted. No impairment on the shipyard was necessary"***. Additionally, the group engagement team had reviewed the audit working papers of the component auditor in Thailand on the significant risk areas, which included the assessment of the impairment on the shipyard. Arising from the review of the component auditor's audit working papers, the group engagement team concluded that there was no impairment on the shipyard in Thailand and had documented in the audit working papers that *"we have reviewed the component auditor's audit working papers and concurred with the conclusion reached by the team"*.

Work Not Performed by the Engagement Team

3.49 There was inadequate audit evidence in the audit working papers of the group engagement team to support the conclusion that the shipyard in Thailand was not impaired. Specifically, it was not evident that the group engagement team had:

- Assessed the changes in factors and circumstances relating to Subsidiary B in 2014 that led to the conclusion that there was no impairment on the shipyard; and
- Tested the reasonableness and sustainability of the change in factors and circumstances in 2014.

3.50 Whilst there was a SRM from the component auditors in Thailand, the SRM was of **insufficient detail** to demonstrate the audit procedure performed by the component auditors. Additionally, given the lack of details in the SRM, it was **not evident how the group engagement team could have assessed whether the procedures performed were satisfactory** and that the **conclusion reached was appropriate in accordance with SSA 600.44**[18].

[18] SSA 600.44 states that *"The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion."* (Ref: Para. A62)

Section 4:

Root Cause Analysis

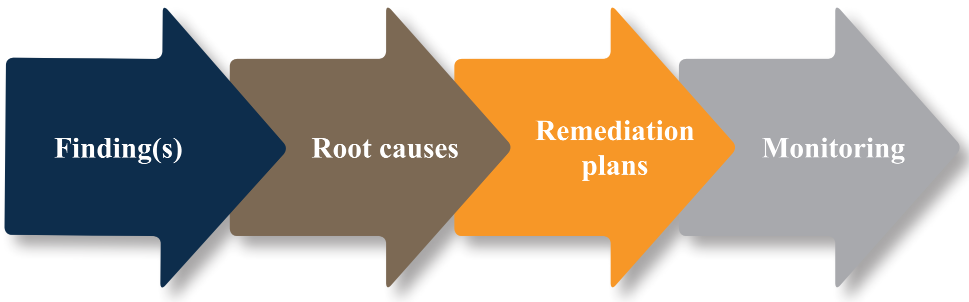
ACRA continues to note similar findings or deficiencies from previous inspections. In response, remediation plans are required to mitigate these deficiencies.

RCA helps to develop effective remediation plans that address the underlying problems rather than the symptoms.

Introduction

4.1 While ACRA has seen continuing efforts by firms to improve audit quality, recurring inspection findings may suggest that firms have not arrested the root causes of those findings. Hence, ACRA has incorporated the **requirement for an RCA to be performed at the end of each inspection** as seen in the process below. Thereafter, firms can tailor the remediation plans to address the root causes and ACRA will monitor the effectiveness of such remediation plans in follow-up inspections.

4.2 It is also heartening to note that globally, the larger network firms have also adopted the RCA in their international quality monitoring programmes. As such, the member firms of these global networks operating in Singapore would already be accustomed to performing the RCA during the annual international reviews.



Possible Root Causes

4.3 From ACRA's past inspections, **the possible root causes of the audit deficiencies** noted can be attributed to the following broad categories:

- Structural and organisational issues such as acute staff shortage, high staff turnover, ambiguous team structure or excessive workload concentration;
- Knowledge and competency issues stemming from insufficient understanding of the business or industry, financial reporting or auditing standards' requirements;
- Accountability issues such as lack of supervision and review (see paragraphs 3.13 and 3.14) or excessive delegation of work to less experienced or junior staff, ineffective EQCR; and
- Behavioural issues such as lack of professional scepticism or lack of willingness to challenge management representations and estimates.

Remediation Plans

4.4 It is crucial to identify the correct root causes of the inspection findings in order to devise an effective remediation plan. Whilst the causes of certain findings may appear to be engagement specific, an evaluation is needed to assess whether there are any implications to other engagements of the firm. If a thematic pattern is observed in the findings across all engagements, the remediation plan should be implemented throughout the firm and not be confined to only a particular engagement.

4.5 ACRA also noted that **inspection findings are seldom caused by one single root cause but more likely caused by a few root causes that are intricately linked and can be remediated from a firm-wide quality control perspective**. Some of the remediation plans that have been implemented on a firm-wide basis are as follows:

- Reallocation of partners' portfolios and workload to ensure sufficient time for review and supervision;
- Review of client portfolio vis-à-vis capacity and competency of staff resources;
- Review of policies e.g. mandatory consultation for complex issues;
- Strengthen linkage of audit quality to performance of partners and managers;
- Implement relevant changes to audit methodology, policies and procedures; and
- Revamp training methodology and materials to enable better knowledge retention.

Effectiveness of Root Cause Analysis

4.6 To have an effective remediation plan, firms and public accountants need to do a detailed and unbiased RCA. It is important that firms and public accountants alike acknowledge the issues and identify the actual root causes that resulted in the inspection finding. Remediation plans not based on the actual root causes may resolve only the symptoms in the short term. Meanwhile, the unidentified root causes, will still persist into the long term.

4.7 ACRA understands that firms and public accountants may face some of the following **challenges in performing an RCA**:

- Disagreement on the finding
- Lack of ownership of the RCA process by the partner
- Unwillingness to own up to actual root cause
- Inability to dive deep enough to identify actual root cause
- Convenience of attributing root causes to poor quality clients, lack of staff or low audit fees

4.8 Despite the challenges, ACRA would like to urge all firms, big and small, to **adopt a robust and unbiased RCA so as to be able to devise effected remediation plans that can sustain audit quality in the long term**. This in turn will help public accountants to grow and strengthen their practices.

4.9 ACRA will continue to monitor and evaluate the RCA and remediation plans submitted by the firms and public accountants for effectiveness and sustainability. Through regular engagements with the profession, ACRA will also continue to identify the drivers that lead to consistent quality audits and make the appropriate recommendations to help firms and public accountants stay on the right track for improvement.

Section 5:

International Activities

5.1 Recognising the interdependencies of capital markets and business activities, ACRA is committed to contributing towards the global development of independent audit oversight and audit quality. For this reason, **ACRA is actively involved in international audit regulator platforms such as IFIAR and AARG to foster closer collaboration amongst regulators to raise audit quality standards**.

International Forum of Independent Audit Regulators

5.2 Established in 2006, IFIAR brings together independent audit regulators from over 50 jurisdictions to promote collaboration and consistency in the audit regulatory activities and to share knowledge on the audit market environment and audit oversight activities.

5.3 As a founding member of IFIAR, ACRA's commitment to IFIAR is demonstrated through its involvement in the following:

- Member of the IFIAR Advisory Council for a four-year term since April 2013[19];
- Member of IFIAR's Global Public Policy Committee Working Group ("GPPC WG") since 2011;
- Member of IFIAR's Investor and Other Stakeholders Working Group ("IOS WG") since 2014.

5.4 Through the work of the GPPC WG, IFIAR monitors the progress of the six largest audit networks in addressing the root causes of audit quality findings. This is further supplemented by efforts of the IOS WG to extend conversations on audit quality matters with relevant stakeholders such as audit committees and investors.

5.5 On 3 March 2015, IFIAR published its third annual survey of findings in the *"International Forum of Independent Audit Regulators Report on 2014 Survey of Inspection Findings* ("Survey"). The Survey on the inspection findings in the PIE segment were contributed by 29 IFIAR members, which included Singapore. There **continues to be similarities in the findings[20] submitted by IFIAR members and the findings from the inspections carried out by ACRA** in the following categories:

(i) Fair value measurement;

(ii) Revenue recognition;

(iii) Substantive Analytical Procedures; and

(iv) Group Audits

[19] This represents ACRA's second term on the council. ACRA's first term was from October 2008 to April 2011. Further information on the IFIAR Advisory Council and IFIAR's Working Groups can be accessed at *www.ifiar.org*.

[20] Internal Control Testing and Adequacy of Financial Statements and Disclosures are inspection themes that are outside the scope of ACRA's PMP inspection programme.

5.6 At the IFIAR Plenary in Taipei, Taiwan in April 2015, the GPPC WG and IOS WG, of which ACRA are both members of, jointly organised a panel session to discuss current trends in the audit industry. The session offered valuable and thought-provoking insights into the future of the audit model as it is being shaped by current developments and their impact to audit quality and investor protection. ACRA also assisted to source for a Singapore investor representative to present on the trends observed from an Asian perspective.

ASEAN Audit Regulators Group

5.7 Formed in 2011, the AARG is an informal cooperation group comprising ACRA, Malaysia's Audit Oversight Board ("AOB"), and Thailand's Securities and Exchange Commission ("SEC"). Its formation is aimed at fostering closer collaboration among audit regulators in the ASEAN region to raise audit quality.

5.8 The AARG complements IFIAR's efforts to promote audit quality in the following ways:

- Annual Inspection Workshop held between members and other regulators in the ASEAN region to share developments from inspection activities carried out in this region.
- The AARG holds annual meetings with the regional leadership and international representatives from the Regulatory Working Group of the GPPC firms to discuss a variety of current and emerging topics affecting audit quality in the region. At the 2015 meeting held in Kuala Lumpur, Malaysia, the AARG and the firm's representatives **discussed the use and communication of Audit Quality Indicators to Audit Committees and the implementation of the expanded auditor's report**. For the first time, the meeting was also attended by other audit regulators in the ASEAN region and the Financial Reporting Council, Hong Kong. The objective is to promote greater awareness and provide added perspectives on the issues discussed.
- The AARG also reaches out to assist other economies in the ASEAN region that are looking to institute independent audit regulation and to promote greater awareness of IFIAR and its activities. This is carried out through the AARG's inclusive approach of inviting non-AARG members to participate in its events such as the inspection workshop and meetings. ACRA also believes the further strengthening of independent audit oversight in the region would bode well for the ASEAN capital markets, while engendering greater investor confidence in the markets.

ACRA

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