Signpost

The purpose of this chapter is to provide a general introduction to financial statements audit (thereafter referred as ''audit'') and other engagements. Reference is made to the detailed development of the topics in later chapters. In addition, this chapter will cover why audits are performed and what audits are.

THE OBJECTIVE AND GENERAL PRINCIPLES OF EXTERNAL AUDIT ENGAGEMENTS

¶1-100 Introduction to auditing standards in Singapore

Auditing standards in Singapore are called the Singapore Standards on Auditing (SSAs), which are based on the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

¶1-110 Objectives of external audit engagements

The objective and general principles governing an audit of financial statements according to SSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the Singapore Standards on Auditing* are:

Purpose

To provide guidance on the objective and general principles governing an audit of financial statements.

Objectives of audit

To enable the auditor to express an opinion whether the financial statements are prepared in all material respects, in accordance with an identified financial reporting framework.

The phrase used to express the auditor's opinion is:

(a) ''to give a 'true and fair' view'' — statutory auditor's report opinion; or

(b) ''present fairly in all material respects'' — in all other situations.

The auditor's opinion enhances the credibility of the financial statements. However, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity and the auditor is not and cannot be held responsible for the prevention of fraud and error [SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*].

SSA 200

SSA 200 contains an overview of an audit to aid in understanding its purpose, nature and scope; defines the respective authority of the requirements and guidance in SSAs; and contains the fundamental requirements for auditors. It emphasises the importance of sound and consistent professional judgment by the auditor, and the necessity for sufficient audit evidence to support the auditor's opinion.

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It codifies the principles underpinning the interpretation of standards. As the overarching standard to all other SSAs, SSA 200 establishes the basic objective and responsibilities of the auditor, and sets out how the objectives, requirements and guidance in all SSAs are to be understood.

¶1-120 General principles of external audit engagements

The auditor should comply with the Accounting and Corporate Regulatory Authority (ACRA) Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (the Code) and the ''Code of Professional Conduct and Ethics'' issued by Institute of Singapore Chartered Accountants (ISCA) (ISCA Code).

The Code is found in the Fourth Schedule of the Accountants (Public Accountants) Rules which was revised and issued and effective 1 July 2015, and further amendments were made in 2017. The ISCA Codes were also revised and issued in November 2015, and effective from 1 January 2016. Both the ACRA and ISCA Codes are based on the ''Code of Ethics for Professional Accountants'' published by the International Ethics Standards Board for Accountants (IESBA) of the International Federation of Accountants (IFAC) in 2013 (the IFAC Code).

The Code contains Parts A and B, consisting of general application and application guidance for public accountants respectively. The ISCA Code contains Parts A to C covering general application of the code, professional accountants in public practice and also professional accountants in business.

Ethics principles governing the auditor's professional responsibilities are:

(a) independence;

(b) integrity;

(c) objectivity;

(d) professional competence and due care;

(e) confidentiality; and

(f) professional behaviour.

The auditor should conduct an audit in accordance with SSA. He or she should plan and perform the audit with an attitude of professional skepticism recognising that circumstances may exist which cause the financial statements to be materially misstated.

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THE NATURE AND DEVELOPMENT OF AUDIT AND OTHER ENGAGEMENTS

¶1-210 The scope of auditing

Limitations of audit

The auditors' opinion is not a guarantee of the future viability of the entity, nor an assurance of the management's effectiveness and efficiency.

Most importantly, auditors do not bear any responsibility for the preparation and presentation of the financial statements.

Responsibility of those charged with governance

The responsibility for the preparation and presentation of the financial statements lies with the directors and the management of the entity with oversight from those charged with governance, who also assume primary responsibility for the prevention and detection of fraud and error. Auditors are responsible for forming and expressing an opinion on the financial statements. The audit of the financial statements does not relieve those charged with governance and management of any of their responsibilities.

Furthermore, by explaining what reasonable assurance is, SSA 200 attempts to breach the expectation gap between what people think auditors do, and what auditors really do in practice.

Exercise of auditor's judgement

It is important to note that financial statements are neither "absolute" nor "precise" as they represent a combination of fact and judgement. Audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements.

The work undertaken by auditors to form an opinion is permeated by the exercise of judgement, in particular regarding:

(a) the gathering of audit evidence eg scope, coverage and materiality level; and

(b) the drawing of conclusions based on the evidence gathered eg assessing the reasonableness of estimates, accounting treatments and entity's policies.

The audit risks, ie that auditors may give an inappropriate opinion on financial statements, which cannot be reduced are:

(a) the impracticality of examining all items within an account balance or class of transactions;

(b) the inherent limitations of any accounting and control system;

(c) the possibility of collusion or misrepresentation for fraudulent purposes; and

(d) most audit evidence being persuasive rather than conclusive.

¶1-220 Audit versus review

Audit is generally defined as follows:

> "The independent examination of and expression of opinion on the financial statements of an entity by an appointed auditor in pursuance of that appointment, and in compliance with any relevant statutory obligations" — *Auditing: Principles and Practice* by Ravinder Kumnar and Virender Sharma.

In the context of auditing an entity, an audit is an exercise whose objective is to enable auditors to express an opinion on whether the financial statements are properly drawn up in accordance with the provisions of the *Companies Act, (Cap 50)* and Singapore Financial Reporting Standards and so as to give a "true and fair" view of the entity's financial position (ie Statement of Financial Position) at period end and of the financial performance (ie Statement of Comprehensive Income) for the period then ended, including the other matters required by s 201 of the *Companies Act* to be dealt with in the financial statements.

Review, which is different from audit, is another form of examination performed by the auditor. Singapore Standards on Review Engagements (SSREs) are to be applied

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in the review of historical financial information. The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework. A similar objective applies to the review of financial or other information prepared in accordance with appropriate criteria.

A review will ordinarily include obtaining an understanding of the entity's business and the industry in which it operates, followed by inquiry and analytical procedures, which are designed to review the reliability of an assertion that is the responsibility of one party for use by another party. While a review involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily involve an assessment of accounting and internal control systems, tests of records and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation and computation, which are procedures ordinarily performed during an audit.

¶1-230 Extension in the scope of audit and review assignments

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Before the turn of the century, audit firms extended their range of services to provide other services such as tax consultancy, bookkeeping, payroll, training etc.

In some cases, these services have given rise to independence issues. Consequent to scandals such as Enron and Worldcom, the US authority released the *Sarbanes-Oxley Act* in 2002. The Code spells out the services prohibited for public interest entities by the auditors which may impair the auditors' independence in particular. Public interest entities are defined in the Code as:

- all listed entities and any entity defined by regulation or legislation as a public interest entity;
- any entity that is listed or is in the process of issuing debt or equity instruments for trading on a securities exchange in Singapore;
- any entity that is incorporated in Singapore and the securities of which are listed on a securities exchange outside Singapore or financial institution;
- audit of large charities and large institutions of a public character.

For audit clients which are not considered as public interest entities, the auditors may provide certain services which are routine or mechanical in nature, and the significance of any threats have been evaluated and safeguarded or are reduced to an acceptable level.

Below is a summary of the services which are prohibited or may be rendered if the significance of any threats to independence are assessed and evaluated and safeguards are applied to eliminate threats or reduce these to an acceptable level as prescribed in the Code.

financial information. It is clear from the *Caparo Industries plc* v *Dickman & Others* (UK 1990) decision that the auditor's primary responsibility is the client entity itself.

While studying the role of the external auditor as defined by the auditing profession and as determined by regulation and statute law, it is worth considering the public's perceptions of the role of the auditor. The public has excessive expectations, which cause considerable concern within the profession. This is known as "*the expectation gap*".

Some common misconceptions in relation to the role of the auditors are as follows:

(a) the public may think that the auditors report to the directors in an entity rather than the members;

(b) the perception that it is the auditors' duty to detect fraud when in fact the detection of fraud is the primary responsibility of the directors and management; and

(c) the auditors can do a 100% check on the financial statements, whereas auditing is done on a test basis.

¶1-320 Accountability and stewardship

Accountability is a concept in ethics with several meanings. It is often used synonymously with such concepts as answerability, responsibility and other terms associated with the expectation of account-giving. In simple words, it means the willingness to stand up and be accounted as part of a process or activity.

Stewardship, in general, is responsibility for taking good care of resources entrusted to one. For example, in an organisational context, stewardship refers to management's responsibility to properly utilise and develop the talents of the employees.

Both the directors and the auditor are appointed by the shareholders to act on their behalf in their capacity as agents. However, the responsibilities of the directors and auditor for the financial statements are different:

- Directors and management: responsible for preparing "true and fair" financial statements.
- Auditor: responsible for forming and expressing an opinion on the financial statements.

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CONCEPTS OF MATERIALITY, TRUE AND FAIR PRESENTATION AND REASONABLE ASSURANCE

¶1-410 Materiality

"*Materiality*" is defined in the Accounting Standards Council's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

> "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

¶1-420 True and fair presentation

Quoted in the "Opinion" paragraph of the auditor's report, the meaning of "true and fair" has been much debated. Whilst it is mentioned in the *Companies Act* and the SSAs, "true and fair" is not defined in those authorities.

"True" relates to the factual and reasonable accuracy of the financial statements. These should be an accurate reflection on the assets and liabilities of the entity at a specific point and of its income and expenditure for the period to that date.

"Fair" relates to the impartial presentation of information and the view conveyed to the reader. The auditor must consider the overall impression created by the financial statements as a whole. It is important that information in the financial statements is presented in a manner that is free from bias and does not mislead the reader to any view that is not a reasonable reflection of the entity's financial situation.

The use of the word "view" on the financial statements indicates that a professional judgement has been reached.

The joint legal opinion obtained in the UK stated that truth and fairness could not be limited by a definition, nor restricted by a set of rules such as the Financial Reporting Standards or even the detailed requirements of the *Companies Act*. As it is a legal concept, it would be for a judge to decide on the facts of a particular case whether the financial statements gave a "true and fair" view. It would not be helpful or appropriate to be more precise.

It was, however, stated that compliance with Financial Reporting Standards represents strong evidence of truth and fairness, for two reasons: firstly that they are the combined opinion and judgement of the accountancy profession through the standard setting procedure, and so constitute a powerful "expert witness", and secondly that truth and fairness lies to a large extent in satisfying the reasonable expectations of a reader of the financial statements.

Compliance with Financial Reporting Standards and the detailed requirements of the *Companies Act* is therefore *prima facie* evidence of truth and fairness.

However, there will be occasions when departure is necessary to show a "true and fair" view, and in those circumstances non-departure will not satisfy the overriding requirements. This is reasonable as a set of rules such as Financial Reporting Standards cannot cover all situations or be invariably appropriate. Their application still requires judgement by those preparing and auditing financial statements. Circumstances requiring departure should be considered to be rare.

It cannot therefore be said to be essential to comply with Financial Reporting Standards and the *Companies Act* to show a "true and fair" view, but departure requires very good reasons and adequate disclosure so as not to mislead the reader.

¶1-430 Reasonable assurance

An audit in accordance with SSAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.

Reasonable assurance is the accumulation of audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements as a whole, ie "true and fair". Reasonable assurance relates to the whole audit process.

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REPORTING AS A MEANS OF COMMUNICATION TO DIFFERENT STAKEHOLDERS

¶1-500 Reporting as a means of communication to different stakeholders

The auditor's report is the end result of an auditor's work and as a result, many individuals place great reliance on it. Investors may be hesitant to invest in an entity where the auditor has released a qualified report and banks may not lend to that entity.

Many users rely on financial statements as their major source of information as they do not have any other means of obtaining further information.

There are many different stakeholders with different expectations and different levels of knowledge, therefore the auditor's report has been standardised so that stakeholders know what to expect.

LEVEL OF ASSURANCE PROVIDED BY AUDIT AND OTHER ENGAGEMENTS

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¶1-600 Level of assurance

The objective of a reasonable assurance engagement is for an auditor to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a "high level" of assurance about that subject matter.

The term "reasonable assurance engagement" is used to describe assurance engagements intended to provide a high, but not absolute, level of assurance. The auditor designs the engagement process so that the risk of expressing an inappropriate conclusion that the subject matter conforms in all material respects with suitable criteria, is reduced to a low level. The auditor obtains sufficient appropriate evidence through procedures such as inspection, observation, inquiry, confirmation, computation and analysis. This forms the basis for a positive form of expression of the auditor's conclusion.

The objective of a "limited assurance engagement" is to reduce assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than a reasonable assurance engagement. This forms the basis for a negative form of expression of the auditor's conclusion.

¶1-630 Other assurance engagements

The Singapore Standard on Assurance Engagements (SSAE) 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides guidance for general application to the performance of assurance engagements other than audits or reviews of historical financial information covered by SSAs or SSREs. Other SSAEs may relate to topics that apply to all subject matters or be subject matter specific.

Under the SSAE framework, the auditor is able to perform either reasonable assurance or limited assurance engagements.

¶1-640 Other related services

Agreed upon procedures

The Singapore Standard on Related Services (SSRS) 4400 *Engagements to Perform Agreed-upon Procedures Regarding Financial Information* provides guidance on agreed-upon procedures. The auditor simply provides a report of the factual findings, where no assurance is expressed. Users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor, the entity and any appropriate third parties, have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report, by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed, since others, unaware of the reasons for the procedures, may misinterpret the results.

Compilations

In a compilation engagement (SSRS 4410 *Compilation Engagements*), although the users of the compiled information derive some benefit from the accountant's involvement, no assurance is expressed in the report.

The accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed to enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit, as a result of the accountant's involvement, because the service has been performed with due professional skill and care.

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¶2-210 Regulation of auditors

All members of ISCA shall observe strictly the ISCA Code of Professional Conduct and Ethics (ISCA Code) and also the pronouncements on professional matters and professional ethics issued by ISCA from time to time. The ISCA Code provides that every member shall conduct himself in a manner consistent with the good reputation of the accountancy profession and refrain from any act or default, which is likely to bring discredit to the profession or to himself.

ISCA takes any breach of ISCA Code, rules and professional standards seriously and has in place an investigation and disciplinary process to deal with complaints against its members (see ¶2-220 below for more details).

In Singapore, ACRA only considers complaints made against public accountants who are registered with the Authority. Any member or any other person may make a complaint in writing stating the nature of the professional misconduct alleged against the public accountant and including all supporting documents relevant to the case.

Complaints against non-public accountants may be made to ISCA.

¶2-220 Complaints and disciplinary process

The following is a summary of the ISCA complaint and disciplinary process upon receipt of a written complaint with supporting documentary evidence:

(a) Acknowledgement of the complaint in writing.

(b) Review of the complaint and supporting evidence to determine if a statutory declaration and/or a deposit for the sum of $1,000 is required by the complainant.

(c) Before any investigation begins, a copy of the complaint and supporting evidence (if any) will be sent to the member concerned. The member concerned is given 15 days to provide a written explanation to the Institute and to advise whether he wishes to be heard by the Investigation Committee.

(d) When the period of 15 days lapses and the member concerned has been given reasonable opportunity to submit his written explanation, the complaint will be laid before the Investigation Committee.

(e) The member concerned will be given 14 days notice of the time, date and place of the hearing of his case. The member concerned shall be entitled to be heard before the Investigation Committee, to be represented by an advocate and solicitor or an accountant as he may wish, and to call witnesses.

(f) If a member fails to furnish a sufficient and satisfactory reply in writing or fails if requested to attend and/or provide such explanation and/or produce material as required, then such failure shall be deemed to be professional misconduct and the member shall be liable to be dealt with by the Investigation Committee.

(g) The Investigation Committee will report its findings to the Disciplinary Committee.

Upon consideration of the report of the Investigation Committee, the Disciplinary Committee may make one or more of the following orders:

(a) that the member's name be removed from the register and that he shall cease to be a member;

(b) that the member's registration be suspended for such period as the Disciplinary Committee may decide;

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(c) that the member be fined a sum not exceeding $5,000;

(d) that the member be censured;

(e) that notwithstanding the Investigation Committee's findings, no further action be taken on the case;

(f) that the member obtains advice or professional assistance from such source as the Disciplinary Committee thinks appropriate; or

(g) in the case of a member who is registered with ACRA, the finding be referred to ACRA, with the recommendation that the member's registration be suspended or cancelled.

The Disciplinary Committee may order the member concerned to pay to ISCA such sums as it thinks fit in respect of costs and expenses of and incidental to any investigation and inquiry.

¶2-230 Complaints and disciplinary panel

Disciplinary proceedings against a public accountant in Singapore is stipulated in the *Accountants Act*. For the purpose of enabling Complaints Committees and Disciplinary Committees to be constituted, the Public Accountants Oversight Committee (PAOC) has appointed a panel known as the Complaints and Disciplinary Panel.

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The PAOC upon receiving a complaint or on its own motion, will refer the complaint to the Registrar for review. On the completion of a review, the Registrar will:

(a) dismiss the complaint, if without merits;

(b) in a case where the complaint relates to a conviction, recommend to the PAOC to refer the matter to a Disciplinary Committee for a formal inquiry; or

(c) in any other case, recommend to the PAOC to refer the matter to a Complaints Committee for inquiry.

The PAOC may, upon accepting the recommendation of the Registrar:

(a) direct the Registrar to appoint a Complaints Committee; or

(b) appoint a Disciplinary Committee, as appropriate.

In short, the Disciplinary Committee conducts a formal inquiry, while the Complaints Committee conducts an inquiry, deemed informal. It is important to note that the role of the two respective Committees is not mutually exclusive. When a complaint is handled by a Complaints Committee, the outcome can be one of the following:

(a) if it is of the view that no further action should be taken, the Complaints Committee will dismiss the complaint;

(b) if it is of the view that the complaint is valid but that no formal inquiry is necessary, the Complaints Committee will recommend to the PAOC for an action or a penalty; or

(c) if it is of the view that a formal inquiry is necessary, the Complaints Committee will recommend to the PAOC to constitute a Disciplinary Committee to hold the formal inquiry.

At the conclusion of the formal inquiry, the Disciplinary Committee will:

(a) dismiss the complaint if it is of the view that it is not valid; or

(b) recommend to the PAOC to take any of the following actions; if it is of the view that the complaint is valid:

(1) cancel the registration of the public accountant ie, strike-off;

(2) suspend the public accountant;

(3) restrict the practice of the public accountant;

(4) impose a penalty not exceeding $10,000;

(5) censure the public accountant;

(6) require the public accountant to give an undertaking as to the PAOC thinks fit; or

(7) whatever order as PAOC thinks just and expedient.

TYPES OF OPINION

¶2-300 Types of opinion provided in statutory audit

An opinion is the end product of an auditor's work and it is based upon all the tests, procedures and follow up work that the auditor has conducted in line with legislation and Singapore Standards on Auditing (SSAs). The auditor's opinion on the presentation in the financial statements of the entity's financial position and the results of its operations should be clearly expressed.

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¶2-310 Unmodified opinion

An unmodified opinion should be expressed when the auditor concludes that the financial statements give a "*true and fair*" view or are presented fairly, in accordance with the identified financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

An unmodified opinion implies that in view of the requirements of the applicable financial reporting framework:

(a) the financial statements adequately disclose the significant accounting policies selected and applied;

(b) the accounting policies selected and applied are consistent with the applicable financial reporting framework and are adequate;

(c) the accounting estimates made by management are reasonable;

(d) the information presented in the financial statements is relevant, reliable, comparable and understandable;

(e) the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) the terminology used in the financial statements, including the title of each financial statement, is appropriate.

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¶2-320 Modified opinions

SSA 705 *Modifications to the Opinion in the Independent Auditor's Report* establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

(a) the nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) the auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The types of modified opinions are as follows:

Qualified opinion

A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed; but the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being "except for" the effects of the matter to which the qualification relates.

Adverse opinion

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. Hence the auditor states that the financial statements "do not give a true and fair" view.

Disclaimer of opinion

A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is "unable to express an opinion" on the financial statements.

OBJECTIVES AND PRINCIPAL ACTIVITIES OF STATUTORY AUDIT

¶2-410 Objectives of statutory audit

The objective of an audit of financial statements is to enhance the degree of confidence of intended users in the financial statements. In conducting an audit, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

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Phase III

In the event of effective controls existing, the objective will be to perform tests to establish compliance with the system.

Phase IV

These tests are designed for the purpose of supporting the figures in the financial statements and to assess the effect in monetary terms if any error exists.

Phase V

The aim of the overall review (including an analytical review) is to determine the overall reliability of the financial statements. Letter to the management with suggestions for improvement is an important non-statutory end product.

Phase VI

The report to the members is the end product of the audit in which the auditors express their opinion of the financial statements.

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¶2-430 Value of statutory audit

SSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, requires the auditor to obtain an understanding of the entity and its environment, including its internal control system, sufficient to identify and assess the risks of material misstatement in the financial statements whether due to fraud or error, and to design and perform further audit procedures.

If the auditor identifies risks of material misstatement during the course of audit, which the entity has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgement there is a material weakness in the entity's risk assessment process, then the auditor includes such internal control weaknesses in the communication of audit matters of governance interest. This is further illustrated in Chapter 3, in relation to SSA 260 *Communications with Those Charged with Governance*. Under SSA 260, which will be further discussed in Chapter 3, the auditor has specific responsibility to take steps to achieve effective two-way communication.

The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.

Communications may be oral or in writing. Significant matters should always be communicated in writing in the form of management letter. The management letter may identify the material internal control weaknesses which have come to the auditor's attention, the implications of the weaknesses identified, recommendation to improve the internal controls and management responses.

When matters are communicated orally, the auditor should document the matters communicated and any responses to those matters in the audit working papers. In certain circumstances, depending on the nature, sensitivity, and significance of the

matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communications on audit matters of governance interest.

From the stakeholders' perspective, the real value of a statutory audit is that it lends credibility to the financial statements. However, the communication of control weaknesses and relevant recommendation by the auditor is also considered a value-added service to management in assisting risk reduction and performance improvement.

LIMITATION

¶2-500 Limitation of statutory audit

There is an expectation gap between the role of an auditor and what the general public thinks an auditor should do. The role of the auditor is to express an opinion as to the truth and fairness of financial statements.

This implies that:

- the accounting principles adopted are appropriate in the circumstances;
- the financial statements, including the related notes are informative of matters that may affect their use, understanding and interpretation;
- the information presented is classified and summarised in a reasonable manner (neither too detailed or condensed); and
- the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations and changes in the financial position.

The purpose of the audit is NOT to ensure that the financial statements are 100% correct or to find any fraud that may be present in the company.

The auditors' opinion is not a guarantee of the future viability of the entity, nor an assurance of management's effectiveness and efficiency.

Most importantly, auditors do not bear any responsibility for the preparation and presentation of the financial statements.

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(b) notifying all known relevant parties that the practising member is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to so act; or

(c) notifying the client that the practising member does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.

¶4-150 Second opinions

Situations where a practising member is asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions by or on behalf of a company or an entity that is not an existing client may give rise to threats to compliance with the fundamental principles. For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant, or is based on inadequate evidence. The significance of the threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgement.

When asked to provide such an opinion, a practising member should evaluate the significance of the threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

If the entity seeking the opinion will not permit communication with the existing accountant, a practising member should consider whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

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¶4-160 Fees and other types of remuneration

When entering into negotiations regarding public accountancy services, a practising member may quote whatever fee deemed to be appropriate. The fact that one practising member may quote a fee lower than another is not in itself unethical. Nevertheless, there may be threats to compliance with the fundamental principles arising from the level of fees quoted. For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

The significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. In view of these potential threats, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards which may be adopted include:

(a) making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee; and

(b) assigning appropriate time and qualified staff to the task.

A firm shall not accept or charge a contingent fee, or receive instructions on a contingent fee basis, for any form of professional work provided to a financial

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statement audit client that is a listed entity or public company, except where such remuneration is provided for under the provisions of any written law.

In certain circumstances, a practising member may receive a referral fee or commission relating to a client. For example, where the practising member does not provide the specific service required, a fee may be received for referring a continuing client to another practising member or other expert. A practising member may receive a commission from a third party (eg, a software vendor) in connection with the sale of goods or services to a client. Accepting such a referral fee or commission may give rise to self-interest threats to objectivity and professional competence and due care.

A practising member may also pay a referral fee to obtain a client, for example, where the client continues as a client of another practising member but requires specialist services not offered by the existing accountant. The payment of such a referral fee may also create a self-interest threat to objectivity and professional competence and due care.

A practising member should not pay or receive a referral fee or commission, unless the practising member has established safeguards to eliminate the threats or reduce them to an acceptable level. Such safeguards may include:

(a) disclosing to the client any arrangements to pay a referral fee to another practising member for the work referred;

(b) disclosing to the client any arrangements to receive a referral fee for referring the client to another practising member; and

(c) obtaining advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client.

¶4-170 Marketing public accountancy services

When a practising member solicits new work through advertising or other forms of marketing, there may be potential threats to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behavior is created if services, achievements or products are marketed in a way that is inconsistent with that principle.

A practising member should not bring the profession into disrepute when marketing public accountancy services. The practising member should be honest and truthful and should not:

(a) make exaggerated claims for services offered, qualifications possessed or experience gained; or

(b) make disparaging references to unsubstantiated comparisons to the work of another.

If the practising member is in doubt whether a proposed form of advertising or marketing is appropriate, the practising member should consult with the relevant professional body.

¶4-180 Gifts and hospitality

A practising member, or an immediate or close family member, may be offered gifts and hospitality from a client. Such an offer ordinarily gives rise to threats to compliance with the fundamental principles. For example, self-interest threats to objectivity may be created if a gift from a client is accepted; intimidation threats to objectivity may result from the possibility of such offers being made public.

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The significance of such threats will depend on the nature, value and intent behind the offer. Where gifts or hospitality which a reasonable and informed third party, having knowledge of all relevant information, would consider clearly insignificant, are made a practising member may conclude that the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information. In such cases, the practising member may generally conclude that there is no significant threat to compliance with the fundamental principles.

If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a practising member should not accept such an offer.

¶4-190 Custody of client assets

A practising member should not assume custody of client monies or other assets unless permitted to do so by law and, if so, in compliance with any additional legal duties imposed on a practising member holding such assets.

¶4-200 Objectivity

A practising member should consider when providing any public accountancy services whether there are threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or directors, officers or employees. For example, a familiarity threat to objectivity may be created from a family or close personal or business relationship.

A practising member who provides an assurance service is required to be independent of the assurance client. Independence of mind and in appearance is necessary to enable the practising member to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest or undue influence of others.

The existence of threats to objectivity when providing any public accountancy service will depend upon the particular circumstances of the engagement and the nature of the work that the practising member is performing.

A practising member should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

(a) withdrawing from the engagement team;

(b) supervisory procedures;

(c) terminating the financial or business relationship giving rise to the threat;

(d) discussing the issue with higher levels of management within the firm; and

(e) discussing the issue with those charged with governance of the client.

¶4-210 Independence

In the case of an assurance engagement it is in the public interest that members of assurance teams, firms and, when applicable, network firms be independent of assurance clients.

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Independence requires:

(a) **Independence of mind**

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) **Independence in appearance**

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

More examples that describe specific circumstances and relationships that may create threats to independence for assurance engagements are illustrated in ¶4-410.

¶4-300 Anti-money laundering and countering the financing of terrorism

Singapore is a member of the Financial Action Task Force (FATF) and a founding member of the Asia/Pacific Group on Money Laundering. In October 2014, EP 200 *Anti-money Laundering and Countering the Financing of Terrorism — Requirements and Guidelines for Professional Accountants in Singapore* was issued in support of Singapore's effort to combat money laundering and counter terrorist financing, and last updated in March 2017.

All ISCA members are required to comply with EP 200 and failure to do so may attract investigation by ISCA. EP 200 was also adopted by ACRA and is applicable to all public accountants and accounting entities registered under the *Accountants Act*.

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ACCOUNTANTS (PUBLIC ACCOUNTANTS) RULES

¶4-400 Introduction

All public accountants in Singapore have to comply with the *Accountants (Public Accountants) Rules*. A public accountant means a person who is registered or deemed to be registered in accordance with the *Accountants Act* (Cap 2). Under the Fourth Schedule of *Accountants (Public Accountants) Rules*, it sets out the Code of Professional Conduct and Ethics (the Code). Compliance with the Code is mandatory for all public accountants, accounting firms, accounting corporations and accounting limited liability partnership.

¶4-410 Independence — assurance engagements

Part IV of the *Accountants (Public Accountants) Rules* lays out Code of Professional Conduct and Ethics as follow:

(a) failure to observe the prescribed code of professional conduct and ethics or any of the pronouncements on professional matters and ethics issued or adopted by the PAOC may result in disciplinary action;

(b) the Code refers to the Code of Professional Conduct and Ethics as set out in the Fourth Schedule; and the Ethics Pronouncements issued by ISCA; and

(c) every public accountant and accounting entity must observe the pronouncements on professional matters and professional ethics issued from time to time.

The independence requirements for assurance engagements prescribed in the Code are elaborated below.

The overriding principles are that an ''assurance team'' shall not act in a way affected by the following threats:

- self-interest threat;
- self-review threat;
- advocacy threat;
- familiarity threat; and
- intimidation threat.

An ''assurance team'' is defined as:

(a) all members of the engagement team for the assurance engagement;

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

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

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

(3) those who provide quality control for the assurance engagement, including those who perform the engagement quality control review; and

(c) for the purposes of a financial statement audit engagement, all those within a network firm* who can directly influence the outcome of the financial statement audit engagement.

*An entity that belongs to a network might be a firm, which is defined as an accounting entity, and an entity that controls or is controlled by an accounting entity, or the entity might be another type of entity, such as a consulting practice or a professional law practice.

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Circumstances and relationships that create independence threats

The following examples describe specific circumstances and relationships that may create threats to independence. The examples also describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance.

(a) Financial interests

A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or interest held (eg, a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control (eg, as a trustee) or is able to influence investment decisions.

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In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy.

When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control, the financial interest should be considered indirect.

(b) Loans and guarantees

A loan, or a guarantee of a loan, to the firm from an assurance client that is a bank or a similar institution, would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm, or network firm, to review the work performed.

A loan, or a guarantee of a loan, from an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements.

Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

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(c) Close business relationships with assurance clients

A close business relationship between a firm or a member of the assurance team, and the assurance client or its management; or between the firm, a network firm and a financial statement audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client;
- arrangements to combine services or products of the firm with services or products of the assurance client and to market the package with reference to both parties; and
- distribution or marketing arrangements under which the firm acts as a distributor/marketer of the assurance client's products or services, or the assurance client acts as the distributor/marketer of the products or services of the firm.

(d) Family and personal relationships

Family and personal relationships between a member of the assurance team and a director, officer or employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including:

- the individual's responsibilities on the assurance engagement;
- the closeness of the relationship; and
- the role of the family member or other individual within the assurance client.

Consequently, there is a wide spectrum of circumstances that needs to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.

(e) Employment with assurance clients

Independence of a firm or a member of the assurance team may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

(f) Recent service with assurance clients

To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter information he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.

(g) Serving as an officer or director on the board of assurance clients

If a practising member, partner or employee of the firm serves as an officer or as a director on the board of an assurance client; the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of a financial statement audit engagement, if a practising member, partner or employee of a network firm were to serve as an officer or as a director on the board of the audit client, the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position; the only course of action is to refuse to perform, or to withdraw from the assurance engagement.

(h) Long association of senior personnel with assurance clients

Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- the length of time that the individual has been a member of the assurance team;
- the role of the individual on the assurance team;

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- the structure of the firm; and
- the nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- rotating the senior personnel off the assurance team;
- involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- independent internal quality reviews.

(i) Provision of non-assurance services to assurance clients

Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases, no safeguards are available to reduce the threat to an acceptable level. The various type of non-assurance services are discussed below.

(1) *Preparing accounting records and financial statements*

For listed entities, the provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, may impair the independence of the firm or network firm or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services can reduce the threat to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions, provide such services to a listed entity or public company that is a financial statement audit client.

For non-listed entities, the firm, or a network firm, may provide a financial statement audit client with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- recording transactions for which the audit client has determined or approved the appropriate account classification;
- posting coded transactions to the audit client's general ledger;
- preparing financial statements based on information in the trial balance; and
- posting the audit client approved entries to the trial balance.

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Signpost

Planning is an important element of an auditor to perform the audit effectively. Documentation is important in providing audit evidence to support the auditor's opinion and evidence that the audit was carried out in accordance with Singapore Standards on Auditing (SSAs).

ASSESSING THE RISKS OF MATERIAL MISSTATEMENT AND FRAUD

¶9-100 Risks of material misstatement and fraud

The concept of "true and fair" is linked with the concept of materiality. The auditor's task is to decide whether financial statements give a "true and fair" view. Checking correctness of every transaction would take up a great deal of time and effort. The resulting benefit may not justify the effort. Therefore, most of the audit firms have formalised the planning of the materiality level for an audit engagement.

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¶9-110 Concepts of materiality and performance materiality

"Materiality" could be defined in the context of the preparation and presentation of financial statements as follows in accordance with SSA 320 *Materiality in Planning and Performing an Audit*:

(a) misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

(b) judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

(c) judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

SSA 320 further illustrates the application of the concept of materiality. It is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements and in forming the opinion in the auditor's report.

Performance materiality is determined to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds the materiality for the financial statements as a whole. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgement. It is affected by the auditor's understanding of the entity, risk assessment and other relevant information.

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¶9-120 Considerations

To determine materiality, the auditor should take the following into consideration:

(a) Size

This is a relative concept and can be viewed from two perspectives as follows:

(1) *Individual items* — Comparing an item to its category as a whole, eg, an inventory error of $40,000 compared to the total inventory value of $1,000,000 is likely to be considered immaterial.

(2) *Financial statements as a whole* — In a general context by looking at the item in relation to the financial statements as a whole, eg, compared to:

- revenue;
- profit before taxation; and
- total net assets.

> **Note:**
> It is important that the "yardstick" chosen must be relevant to the user of the financial statements eg, a misstatement may have a significant influence on the users of the financial statements if it turns a profit into a loss or net current assets to net current liabilities.

(b) Nature

Certain items in the financial statements require "precision", eg, "directors' remuneration" and "share capital". Therefore, any misstatement (regardless of the amount) in respect of these items would be considered material and should be adjusted.

(c) Influence on user

The auditors must decide whether a misstatement would influence the users of the financial statements. This means that if the users know the misstatement, this would likely change their economic decisions and assessment of the entity.

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¶9-130 Some rules for materiality determination

It is often argued that the most important figure in a set of financial statements is profit before tax for profit-oriented entities, and this is the most commonly used benchmark to determine materiality. It is generally agreed that:

(a) a misstatement of less than 5% of profit before tax is not material;

(b) a misstatement of more than 10% of profit before tax is material; and

(c) a misstatement of between 5% and 10% of profit before tax may be material.

For the above purpose, the term "misstatement" includes error, fraud and irregularity.

In line with the above principle, the materiality is normally determined based on a range from 5% to 10% of profit before tax depending on the audit engagement risk, where profit before tax is set as the benchmark.

Where the profit before tax is very low, or the entity is making losses, the benchmark of profit before tax (eg, 5%) may not be appropriate. It will be unreasonable to expect auditors to check that profit is as close as 5% to the true figure. Under such

The purposes of analytical procedures	
Risk assessment	As risk assessment procedures to obtain an understanding of the entity and its environment (eg, financial performance relative to prior years and relevant industry and comparison groups), to help assess the risk of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
Substantive analytical procedures	As substantive procedures where their use can be more effective or efficient than tests of details in reducing the risk of material misstatements at the assertion level to an acceptably low level.
Forming an overall conclusions	As an overall review of the financial statements at the end of the audit to assess whether they are consistent with the auditor's understanding of the entity.

¶9-220 Key ratios used in analytical procedures

The objectives of the analytical procedure will also dictate the type of analytical procedure used and the techniques involved in investigating a significant difference. The three common types of analytical procedure are as follows:

(1) *Trend analysis* — the analysis of changes in an account over time.

(2) *Ratio analysis* — the comparison, across time or to a benchmark, of relationships between financial statement accounts and between an account and non-financial data.

(3) *Reasonableness testing* — the analysis of accounts, or changes in accounts between accounting periods, that involves the development of a model to form an expectation based on financial data, non-financial data, or both.

Further, there are two types of basic financial statement trend and ratio analysis that may be useful as a stand-alone analytical procedure or in conjunction with the three types of analytical procedures discussed above:

(1) *Comparative amounts analysis* — Side-by-side comparisons of two or more periods of a financial statement to analyse trends. Trends can be analysed across time and to benchmark information.

(2) *Financial ratio analysis* — Converting financial statement amounts into percentages of a related total, such as sales for income statement items or either sales or total assets for balance sheet items, and performing comparisons across time or to benchmark information to analyse the internal structure of the financial statement.

PLANNING AN AUDIT

¶9-310 The need for planning

As required by SSA 300 *Planning an Audit of Financial Statements*, the auditor should plan the audit so that the engagement will be performed in an effective manner.

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level.

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Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.

Adequate planning helps to ensure that:

- appropriate attention is devoted to important areas of the audit;
- potential problems are identified and resolved on a timely basis; and
- the audit engagement is properly organised and managed in order to be performed in an effective and efficient manner.

Adequate planning also assists in:

- proper assignment of work to engagement team members;
- facilitating the direction and supervision of engagement team members and the review of their work; and
- where applicable, coordination of work done by auditors of components and experts.

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

¶9-320 Contents of audit strategy and audit plan

The overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

The establishment of the audit strategy involves:

(a) determining the characteristics of the engagement that define its scope;

(b) ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(c) considering the important factors that will determine the focus of the engagement team's efforts;

(d) considering the results of preliminary engagement activities (eg, acceptance and continuance of client and engagement) and the relevant knowledge gaind on other engagements for the engagement; and

(e) ascertaining the nature, timing and extent of resources necessary to perform the engagement.

The overall audit strategy sets out clearly:

(a) the resources to deploy for specific audit areas;

(b) the amount of resources to allocate to specific audit areas;

(c) when these resources are deployed, such as whether at an interim audit stage or at key cut-off dates; and

(d) how such resources are managed, directed and supervised.

The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

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The audit plan includes:

- a description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement;
- a description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance, and disclosure; and
- such other planned audit procedures required to be carried out for the engagement to comply with SSAs.

¶9-330 Relationship between audit strategy and audit plan

Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. Although the auditor ordinarily establishes the audit strategy before developing the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

¶9-340 Develop and document audit plan

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The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.

The auditor's documentation of the overall audit strategy records the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarise the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The auditor's documentation of the audit plan is sufficient to demonstrate the planned nature, timing and extent of risk assessment procedures, and further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. The auditor may use standard audit programs or audit completion checklists. However, when such standard programs or checklists are used, the auditor appropriately tailors them to reflect the particular engagement circumstances.

The auditor's documentation of any significant changes to the originally planned overall audit strategy and to the detailed audit plan includes the reasons for the significant changes and the auditor's response to the events, conditions, or results of audit procedures that resulted in such changes. For example, the auditor may significantly change the planned overall audit strategy and the audit plan as a result of a material business combination or the identification of a material misstatement of the financial statements.

The form and extent of documentation depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement.

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AUDIT DOCUMENTATION

¶9-410 The need for and the importance of audit documentation

As required by SSA 230 *Audit Documentation*, the auditor should prepare documentation that provides a sufficient and appropriate record of the basis of the auditor's report and evidence that the audit was carried out in accordance with SSAs and applicable legal and regulatory requirements.

"Audit documentation" means the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" are sometimes used). Working papers may be in the form of data stored on paper, electronic media or other media.

Audit documentation serves the following additional purposes:

(a) assist in the planning and performance of the audit;

(b) assist in the supervision and review of the audit work; and

(c) enable the engagement team to be accountable for its work.

¶9-420 Form, content and extent of audit documentation

The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the following:

(a) the nature, timing, and extent of the audit procedures performed to comply with the SSAs and applicable legal and regulatory requirements;

(b) the results of the audit procedures performed, and the audit evidence obtained; and

(c) significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

Audit documentation would include the auditor's discussion of significant matters with the entity's management, those charged with governance and others including the nature of the significant matters discussed and when and with whom the discussion took place.

The extent of audit documentation is a matter of professional judgement since it is neither necessary nor practical to document every matter the auditor considers. In assessing the extent of working papers to be prepared and retained, it may be useful for the auditor to consider what would be necessary to provide another auditor who has no previous experience with the audit with an understanding of the work performed and the basis of the principle decisions taken.

The form and content of working papers are affected by matters such as the following:

- the size and complexity of the entity;
- the nature of the audit procedures to be performed;
- the identified risks of material misstatement;
- the significance of the audit evidence obtained;
- the nature and extent of exceptions identified;

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- the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
- the audit methodology and tools used.

The use of standardised working papers (eg, checklists, specimen letters, and standard organisation of working papers) may improve the efficiency with which such working papers are prepared and reviewed. They facilitate the delegation of work while providing a means to control its quality.

To improve audit efficiency, the auditor may utilise schedules, analysis and other documentation prepared by the entity as part of audit documentation. In such circumstances, the auditor would need to be satisfied that those materials have been properly prepared.

Audit documentation ordinarily include:

- information obtained in understanding the entity and its environment, including its internal control, such as the following:
  (1) information concerning the legal and organisational structure of the entity;
  (2) extracts or copies of important legal documents, agreements and minutes;
  (3) information concerning the industry, economic environment and legislative environment within which the entity operates; and
  (4) extracts from the entity's internal control manual.
- evidence of the planning process including overall audit strategy and audit strategy and any changes thereto;
- evidence of the auditor's understanding of the accounting and internal control systems;
- evidence of inherent and control risk assessments and any revisions thereof;
- evidence of the auditor's consideration of the work of internal auditing and conclusions reached;
- analysis of transactions and balances;
- analysis of significant ratios and trends;
- the identified and assessed risks of material misstatements at the financial statement and the assertion level;
- a record of the nature, timing and extent of audit procedures performed in response to risks at the assertion level and the results of such procedures;
- evidence that the work performed by engagement team members was supervised and reviewed;
- an indication as to who performed the audit procedures and when they were performed;
- details of audit procedures applied regarding components whose financial statements are audited by another auditor;
- copies of communications with other auditors, experts and other third parties;
- copies of letters or notes concerning audit matters communicated to or discussed with management or those charged with governance of the entity, including the terms of the engagement and material weaknesses in internal control;
- letters of representation received from the entity;

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TESTS OF CONTROL FOR REVENUE EXPENDITURE AND CAPITAL EXPENDITURE

Some suggested procedures may include the following:

¶13-310 Capital expenditure

(a) Recorded fixed asset acquisitions represent property, plant and equipment acquired by the entity.

(b) Property, plant and equipment acquisitions are accurately recorded.

(c) Property, plant and equipment acquisitions are recorded in the appropriate period.

(d) All property, plant and equipment acquisitions are recorded.

(e) Depreciation charges are valid.

(f) Depreciation charges are accurately calculated and recorded.

(g) All depreciation charges are recorded in the appropriate period.

(h) Recorded property, plant and equipment disposals represent actual disposals.

(i) All property, plant and equipment disposals are recorded.

(j) Property, plant and equipment disposals are accurately calculated and recorded.

(k) Property, plant and equipment disposals are recorded in the appropriate period.

(l) Records of property, plant and equipment maintenance activity are accurately maintained.

(m) Property, plant and equipment are adequately safeguarded.

(n) Property, plant and equipment maintenance records are updated regularly.

(o) Property, plant and equipment reflect the existing business circumstances and economic conditions in accordance with the accounting policies being used.

(p) Financial information is not presented in a misleading way, and all information that is necessary for fair presentation and compliance with professional standards or legal requirements is disclosed.

(q) Only valid changes are made to the property, plant and equipment register and/or master file.

(r) All valid changes to the property, plant and equipment register and/or master file are input and processed.

(s) Changes to the property, plant and equipment register and/or master file are accurate.

(t) Changes to the property, plant and equipment register and/or master file are processed regularly.

(u) Property, plant and equipment register and/or master file data remains pertinent.

¶13-320 Purchasing

(a) Purchase orders are placed only for approved requisitions.

(b) Purchase orders are entered accurately.

(c) All purchase orders issued are entered into the system and processed.

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¶13-330 Processing trade payable

(a) Amounts posted to trade payable represent goods received.
(b) Amounts posted to trade payable represent services received.
(c) Trade payable amounts are accurately calculated and recorded.
(d) All amounts for goods received are entered into the system and processed to trade payable.
(e) All amounts for services received are entered into the system and processed to trade payable.
(f) Amounts for goods or services received are recorded in the appropriate period.
(g) Trade payable is only adjusted for valid reasons.
(h) Credit notes and other adjustments are accurately calculated and recorded.
(i) All valid credit notes and other adjustments related to trade payable are input and processed.
(j) Credit notes and other adjustments are recorded in the appropriate period.
(k) Assets and liabilities reflect the existing business circumstances and economic conditions in accordance with the accounting policies being used.
(l) Financial information is not presented in a misleading way and all information that is necessary for fair presentation and compliance with professional standards or legal requirements is disclosed.

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¶13-340 Processing disbursements

(a) Disbursements are only made for goods and services received.
(b) Disbursements are distributed to the appropriate suppliers.
(c) Disbursements are accurately calculated and recorded.
(d) All disbursements are recorded.
(e) Disbursements are recorded in the period in which they are issued.

¶13-350 Maintaining supplier master file

(a) Only valid changes are made to the supplier master file.
(b) All valid changes to the supplier master file are entered into the system and processed.
(c) Changes to the supplier master file are accurate.
(d) Changes to the supplier master file are processed regularly.
(e) Supplier master file data remains pertinent.

REPORTING OF STRUCTURAL AND OPERATIONAL DEFICIENCIES TO MANAGEMENT

¶13-400 Reporting of structural and operational deficiencies

As a result of obtaining an understanding of the accounting and internal control systems and performing tests of control, the auditor may become aware of deficiencies in internal controls. The auditor should make those charged with governance and management aware, as soon as practical and at an appropriate level of responsibility, of significant deficiencies in the design or operation of the accounting

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and internal control systems, which have come to the auditor's attention. The communication to those charged with governance and management of significant deficiencies in internal controls would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only significant deficiencies in internal controls, which have come to the auditor's attention as a result of the audit, have been reported and that the examination has not been designed to determine the adequacy of internal controls as a whole for management purposes.

SSA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* establishes specific requirements regarding the timely communication in writing of significant deficiencies in internal control, which the auditor has identified during the audit to those charged with governance and management.

The requirement to communicate applies regardless of cost or other considerations by the entity in determining whether to take remedial action. It also applies if significant deficiencies have been communicated in prior audits but the entity has taken no remedial action.

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Signpost

The outcome of an audit or a review is obtaining evidence. In this chapter, the value of audit evidence is examined in the context of sufficiency, relevance and reliability.

THE USE OF ASSERTIONS BY AUDITORS

¶17-100 The use of assertions in obtaining audit evidence

Management and directors, under the oversight of those charged with governance, are responsible for the fair presentation of the financial statements. In representing that the financial statements are true and fair/presented fairly, in all material respects, in accordance with the applicable financial reporting framework, management and directors implicitly makes the assertions identified below. Auditors assess risks of material misstatement at an assertion level by considering the different types of potential misstatements that may occur, and then design and perform audit procedures that are responsive to those risks.

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¶17-110 Statement of financial position assertions/account balance assertion (CREV)

(a) Completeness	Have all assets, liabilities and equity interests that should have been recorded have been recorded by entity?
(b) Rights and obligations	Does the entity hold or control the rights to assets, and are liabilities the obligations of the entity?
(c) Existence	Do assets, liabilities and equity interests exist?
(d) Valuation and allocation	Are assets, liabilities, and equity interests included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments appropriately recorded?

¶17-120 Statement of comprehensive income assertions/transaction assertion (COCCA)

(a) Completeness	Have all transactions and events that should have been recorded been recorded by entity?
(b) Occurrence	Have transactions and events that have been recorded occurred and do they pertain to the entity?
(c) Cut off	Have transactions and events been recorded in the correct accounting period?
(d) Classification	Have transactions and events been recorded in the proper accounts?
(e) Accuracy	Have amounts and other data relating to recorded transactions and events been recorded appropriately?

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¶17-130 Presentation and disclosure assertions (OCCA)

(a) Occurrence and rights and obligations	Have disclosed events, transactions, and other matters occurred and do they pertain to the entity?
(b) Completeness	Have all disclosures that should have been included in the financial statements been included?
(c) Classification and understandability	Is financial information appropriately presented and described and are disclosures clearly expressed?
(d) Accuracy and valuation	Are financial and other information disclosed fairly and at appropriate amounts?

SOURCES, RELATIVE MERITS AND QUALITY OF EVIDENCE AVAILABLE

¶17-210 Types of evidence available

"*Audit evidence*" means the information obtained by the auditor in arriving at the conclusions on which the audit opinion is based.

Audit evidence is obtained from an appropriate mix of tests of control and substantive procedures. In some circumstances, evidence may be obtained entirely from substantive procedures.

Audit evidence will comprise source documents and accounting records underlying the financial statements and corroborating information from other sources.

¶17-220 "Sufficient appropriate" audit evidence

The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

"Tests of control" means tests performed to obtain audit evidence about the suitability of design and effective operation of the accounting and internal control systems.

"Substantive procedures" means tests performed to obtain audit evidence to detect material misstatements in the financial statements at the assertion level, and comprises:

(a) tests of details of transactions and balances; and

(b) substantive analytical procedures.

When obtaining audit evidence from tests of control, the auditor should consider the sufficiency and appropriateness of the audit evidence to support the assessed level of control risk.

The aspects of the accounting and internal control systems about which the auditor would obtain audit evidence are:

(a) *Design:* the accounting and internal control systems are suitably designed to prevent, or detect and correct material misstatements; and

(b) *Operation:* the systems exist and have operated effectively throughout the relevant period.

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When obtaining audit evidence from substantive procedures, the auditor should consider the sufficiency and appropriateness of audit evidence from such procedures together with any evidence from tests of control to support financial statement assertions.

Financial statement assertions are made by management, explicit or otherwise, that are embodied in the financial statements. They can be categorised into:

(a) assertions about classes of account balances;

(b) assertions about classes of transactions and events; and

(c) assertions about presentation and disclosures.

Some examples are as follows:

(a) *Existence*: an asset or a liability exists at a given date;

(b) *Rights and obligations*: an asset or a liability pertains to the entity at a given date;

(c) *Occurrence*: a transaction or event pertaining to the entity had taken place during the period;

(d) *Completeness*: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;

(e) *Valuation*: an asset or liability is recorded at an appropriate carrying value; and

(f) *Accuracy*: amounts and other data relating to recorded transactions and events have been recorded appropriately.

Financial statement assertions are further tabulated in ¶17-110 to ¶17-130.

The auditor's judgement as to what is sufficient appropriate audit evidence is influenced by such factors as:

(a) an understanding of the entity and its environment, including the entity's internal control;

(b) the effectiveness of management's responses and controls to address the risks;

(c) the significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements;

(d) the experience gained during previous audits;

(e) the results of audit procedures, including fraud or error which may have been found;

(f) the source and reliability of information available; and

(g) the persuasiveness of the audit evidence.

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Simply put, the audit evidence should be:

(a) Relevant	(b) Reliable	(c) Sufficient
Relates to overall audit objectives of forming an opinion and reporting on the financial statement ie to draw conclusion from CREV.	(1) Documents and written representations are more reliable than oral representations. (2) External sources are more reliable than those generated internally. (3) Auditor generated is more reliable than that generated by management.	Influenced by auditor's assessment of: • entity and its internal controls; • management's response and controls to risk; • past experience; • results (eg errors); • audit procedures; • source and reliability of information available; • persuasiveness of audit evidence.

Sources of evidence:

(1) Internal evidence (ie from the entity):
- books and records;
- management representations; and
- board minutes.

(2) External evidence (ie from third parties directly to the auditors):
- bank confirmation letters;
- debtors circularisation replies;
- solicitor's confirmation letters;
- trade media and press; and
- expert report;

(3) Self-generated evidence (ie created by the auditor):
- inspection;
- observation;
- recomputation; and
- analytical procedures.

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¶17-230 External confirmation

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.

External confirmation is frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. Other examples of situations where external confirmation may be used include the following:

- bank balances and other information from banks;
- accounts receivable balances;
- inventories held by third parties at bonded warehouses for processing or on consignment;
- property title deeds held by lawyers or financiers for safe custody or as security;
- investments purchased from stockbrokers but not delivered at the end of the reporting period;
- loans from lenders; and
- accounts payable balances.

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The reliability of external confirmation as audit evidence depends on whether the auditor had applied appropriate procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmation include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. At the same time, the auditor should evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmation, or if the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall

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communicate with those charged with governance in accordance with Singapore Standards on Auditing ("SSA") 260 *Communicating with Those Charged with Governance*. The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SSA 705 *Modifications to the Opinion in the Independent Auditor's Report*.

When performing confirmation procedures, the auditor should maintain control over the process of determining the information to be confirmed or requested, selecting the appropriate confirming party, designing, preparing and sending of confirmation requests and receiving the responses to those requests.

The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.

When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence.

The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.

¶17-240 Audit techniques for obtaining audit evidence

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Inspection

(a) Is examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

(b) Provides audit evidence of varying degree of reliability depending on the source of audit evidence and the internal controls over their processing.

Example:
• Evidence created and held by third party;
• Evidence created by third party and held by entity; or
• Evidence created and held by entity.

Observation

Look at the process or procedures being performed by others.

Example: Attending inventory counts.

Inquiry

Seek information from knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

Example: Enquire about sale of old inventories from sales managers; enquire about pending litigations from solicitors.

- the degree to which available information may be disaggregated. For example, a detailed review of gross profit margins by major product would be more effective than the review of an overall gross profit;
- the availability and reliability of financial data (eg budgets) and non-financial data (eg units produced). Independently prepared non-financial data should facilitate more effective procedures;
- the nature and relevance of available information. For example, budgets based on expectation are more useful than targets; and
- the comparability of available information. For example, summary statistics such as the Retail Price Index (RPI) may not be relevant in technologically advanced industries.

The auditor is more likely to use analytical procedures for:

- existing well-established clients;
- in well-known, stable industries;
- where predictive information is readily available; and
- accounting and internal control systems are effective.

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¶17-320 Extent of reliance

Factors determining the extent of reliance on substantive analytical procedures include:

- *The accuracy of predictions.* Income and expenditure accounts tend to be more predictable than statement of financial position accounts because they are composed of large numbers of like transactions (whereas balances tend to be a net amount). Non-recurring accounting entries (eg asset revaluations) and discretionary expenses (eg research and development) do not lend themselves to effective analytical procedures.
- *Risk assessments and effectiveness of controls, if any, over the preparation of information used for analytical procedures.* For example, if internal control over the processing of sales orders is weak (ie, control risk is high) more reliance on tests of details for drawing conclusions on receivables may be required.
- *The type of analytical procedure used (see below).* The more appropriate the analytical procedure, the more reliance can be placed thereon.

¶17-330 Types of analytical procedures

The steps in designing and performing substantive analytical procedures to test a recorded amount are:

- identify the account balance and potential errors to be tested;
- develop an expectation;
- determine threshold;
- identify significant differences for investigation;
- investigate differences; and
- evaluate results.

Reasonableness tests

These provide an independent check on the total value of a population and are most useful for income and expenditure accounts. The steps are:

- calculate the expected value of a population. Base data must be independent of the population being tested (or otherwise confirmed to be materially correct);
- compare with recorded value; and
- difference should not be material.

Such "proofs in total" may remove the need for further substantive procedures.

AUDIT AND REVIEW OF ACCOUNTING ESTIMATES

¶17-400 Accounting estimates

"*Accounting estimate*" is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimates. Examples of situation where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful debts;
- Inventory obsolescence;
- Warranty obligations;
- Depreciation method or asset useful life;
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability;
- Outcome of long-term contracts; and
- Costs arising from litigation settlements and judgements.

Whereas, examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market;
- Share-based payments;
- Property or equipment held for disposal;
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets;
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

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Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgement.

There are often specific risks associated with accounting estimates. The evidence available to support an accounting estimate is frequently not conclusive, the judgements involved are often subjective, and there may be a potential for bias in their preparation.

For example, complex estimates of costs to completion on long-term construction contracts may result in an increased risk in assessing the valuation of such provisions.

Period end adjustments recording accruals and cutoffs may be based on estimates and, if so, are subject to the risks associated with other accounting estimates. Even if the transactions are not based on estimates, the auditor may identify specific risks because they are recorded infrequently and are often susceptible to manipulation by management.

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¶17-410 Audit of accounting estimates

Inherent risks may be higher for amounts derived from accounting estimates and the audit of accounting estimates often requires the exercise of more professional judgement as compared to other items in the financial statements.

Based on the assessed risk of material misstatement due to accounting estimates, the auditor should determine:

(a) whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and

(b) whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

In addition to the above, the auditor should adopt one or a combination of the following approaches taking into account the nature of the accounting estimate:

(a) test how management made the accounting estimate and the data on which it is based by evaluating the appropriateness of the method of measurement used and reasonableness of assumptions used by management in the light of circumstances (see ¶17-420 for elaboration);

(b) test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures (see ¶17-430 for elaboration);

(c) develop a point estimate or a range to evaluate management's point estimate (see ¶17-440 for elaboration); or

(d) review subsequent events, or rather, determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate (see ¶17-450 for elaboration).

For accounting estimates that give rise to significant risks, the auditor should also evaluate the following:

(a) how management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate;

(b) whether the significant assumptions used by management are reasonable; and

(c) where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If the auditor is of the view that management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor should develop a range with which to evaluate the reasonableness of the accounting estimate.

¶17-420 Evaluate the data, method and assumptions

In reviewing and testing the process used by management to develop the estimate, the auditor should perform the following:

(a) Evaluate the data and consider the assumptions on which the estimate is based considering:

(1) whether the data on which the estimate is based is accurate, complete and relevant;

(2) the need to seek evidence from sources outside the entity;

(3) whether the data collected is appropriately analysed and projected to form a reasonable basis for determining the accounting estimate;

(4) whether the entity has an appropriate base for the principal assumptions used in the accounting estimate;

(5) whether the assumptions on which the estimate is based, are:

- reasonable in light of actual results in prior periods;
- consistent with those used for other accounting estimates; and
- consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement; and

(6) in the case of complex estimating processes involving specialised techniques, the need to use the work of an expert.

(b) Test the calculations involved in the estimate — The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

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(c) Compare, when possible, of estimates made for prior periods with actual results of those periods; and when possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:

(1) obtaining evidence about the general reliability of the entity's estimating procedures;

(2) considering whether adjustments to estimating formula may be required; and

(3) evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

¶17-430 Test the controls over the estimate process

Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

(a) controls exist for the review and approval of the accounting estimates by appropriate levels of management and those charged with governance; and

(b) the accounting estimate is derived from the routine processing of data by the entity's accounting system.

Such testing is required when:

(a) the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or

(b) substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.

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¶17-440 Develop a point estimate or range

The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

The auditor may develop a point estimate or a range in a number of ways, for example, by:

(a) using a model, for example, one that is commercially available for use in a particular sector or industry, or proprietary or audit-developed model;

(b) further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions;

(c) employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions; or

(d) making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

¶17-450 Review of subsequent events

Events, which occur after period end, up to the date of an auditor's report, may sometimes provide sufficient audit evidence regarding an accounting estimate made by management. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained. In other cases, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the end of the reporting period and therefore may not be relevant to the measurement of the fair value accounting estimate. In these cases, the auditor may be required to undertake other audit procedures.

In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

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¶17-460 Final assessment

The auditor should make a final assessment of the accounting estimate in the financial statements based on the audit evidence and conclude if the accounting estimates are reasonable or materially misstated in the context of the applicable financial reporting framework.

Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Similarly, where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

EVIDENCE AVAILABLE IN SMALLER ENTITIES

¶17-500 Evidence available in smaller entities

The auditor of any entity adapts the audit approach to the circumstances of the entity and the engagement. The audit of a small entity differs from the audit of a large entity as documentation may be less sophisticated and the entity may not have formal established processes. Also, the small entity's business activities are limited and their transactions are ordinarily less complex.

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Some of the areas requiring consideration are as follows:

Concentration of ownership and management

Small business entities ordinarily have few owners; often there is a single proprietor. The owner may employ a manager to run the entity but is, in most cases, directly involved in running the entity on a day-to-day basis and the auditor may focus on inquiries to them accordingly. For instance, the auditor may consider engaging the owners early in the audit process to discuss about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process. As a practical matter, the auditor should also be mindful of the owners' ability to override controls.

Smaller scale of operations

Small entities often have a limited range of products or services and operate from a single or limited number of locations. Such characteristics may make it easier for the auditor to acquire, record, and maintain knowledge of the entity than would be the case with a larger entity. The application of a wide range of audit procedures may be straightforward in such circumstances.

Unsophisticated record-keeping

Small entities need to keep sufficient accounting records to comply with relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed such that:

(a) all the transactions and accounting information that should have been recorded have in fact been recorded;

(b) assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and

(c) fraud or error in processing accounting information will be detected.

Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently, record-keeping may be unsophisticated or poor, resulting in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities out-source some or all of their record-keeping.

Small entities often find it convenient to use off-the shelf accounting software packages designed for use on a personal computer. That said, many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

Limited internal controls

Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor cost effective. Indeed, controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Active supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.

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The owner-manager occupies a dominant position in a small entity. The owner-manager's direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small entities. The exercise of this control can also compensate for otherwise less sophisticated internal control procedures. When the owner-manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager's dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial statements. For example, to ensure that the entity meets its debt covenant requirements, the owner-manager may direct accounting personnel to make certain aggressive accounting estimates that they would otherwise not make under usual circumstances. The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty.

A belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

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