Enhancing Transparency in Reporting

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Agenda

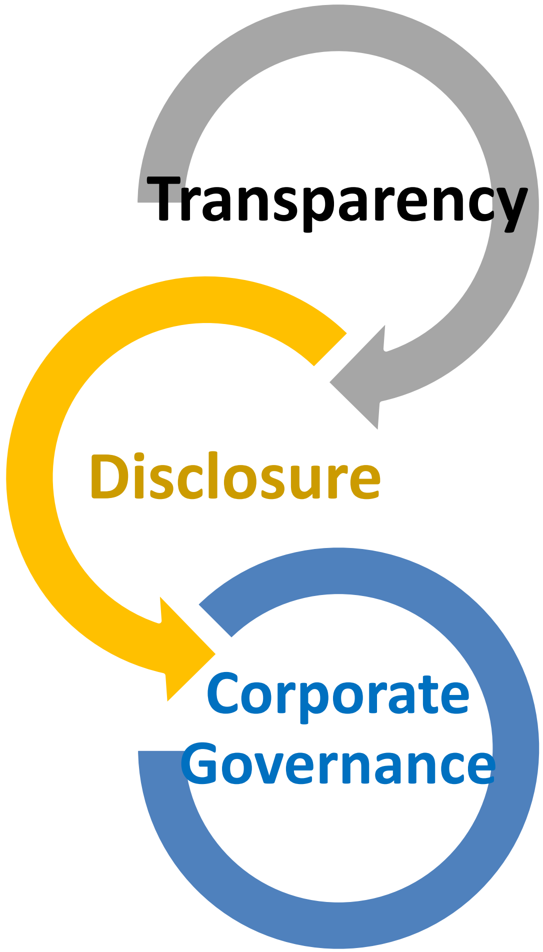
1. Transparency & Disclosure
2. Firm-Level Inspections
3. Case studies
   - Identifying and assessing significant risks
   - Use of Substantive Analytical Procedures (“SAP”)
   - Construction Contracts
   - Group Audits
4. Root Cause Analysis
5. Key Messages

Transparency & Disclosure

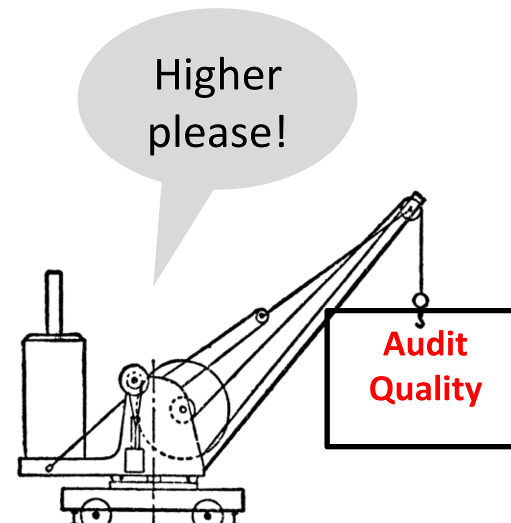
Transparency & Disclosure

- Users of audited financial statements:
  i) Investors,
  ii) Shareholders,
  iii) Other stakeholders

- Users require **more information that are reliable** and provided on a **timely** basis



- Corporate governance strengthened through high quality audits



Transparency & Disclosure

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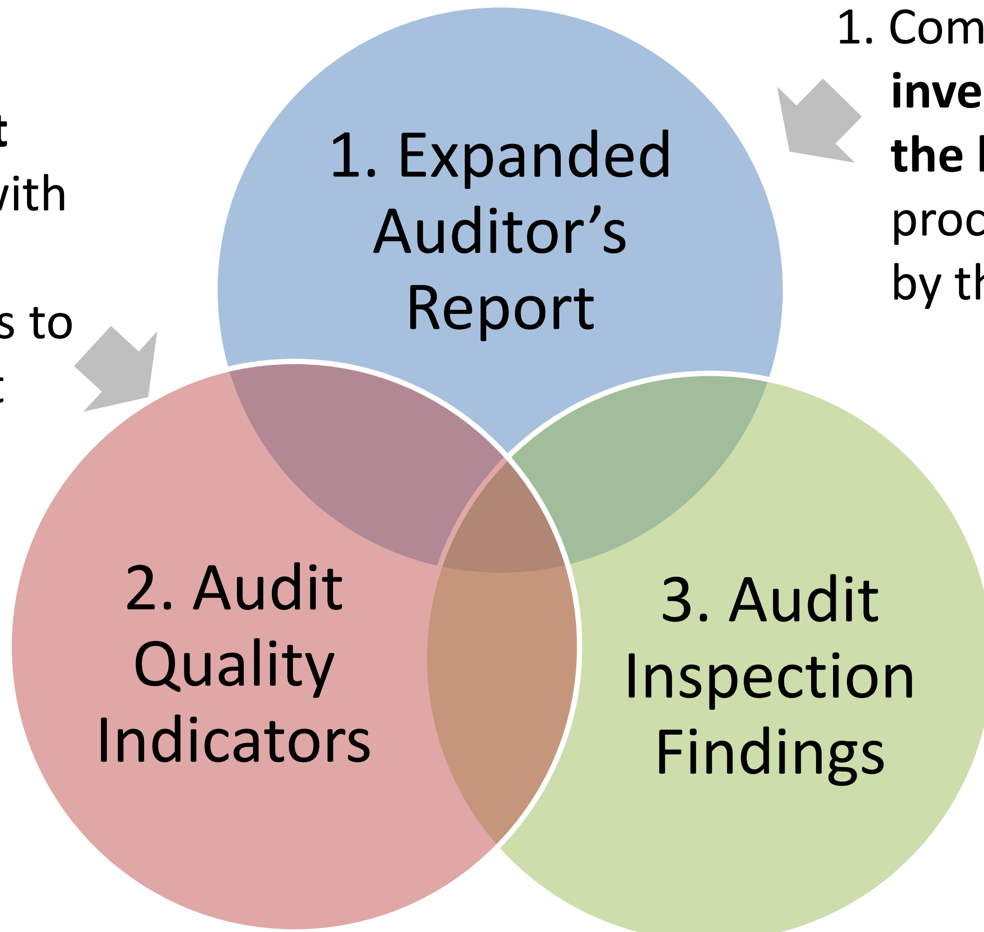
2. Provides **Audit Committees** with a portfolio of measurements to measure audit quality

1. Communicates to **investors insights on the key audit risks** and processes undertaken by the auditor



3. Allow **users** of audited financial statements to **know the potential risks**

Firm-Level Inspections

Tone From The Top

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- Room for improvement – the need to strengthen the linkage between audit quality and partner performance

- **Greater accountability** on the Engagement Partner and EQCR Partner for findings noted in internal / external inspections; and
- **Strengthening the linkage** between **Audit Quality** and **partner compensation**

Ethics and Independence

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- Failure or untimely reporting of non prohibited financial interests in accordance with the firm's policies
- ACRA has increased the inspection scope to include compliance with Ethics Pronouncement ("EP") 200

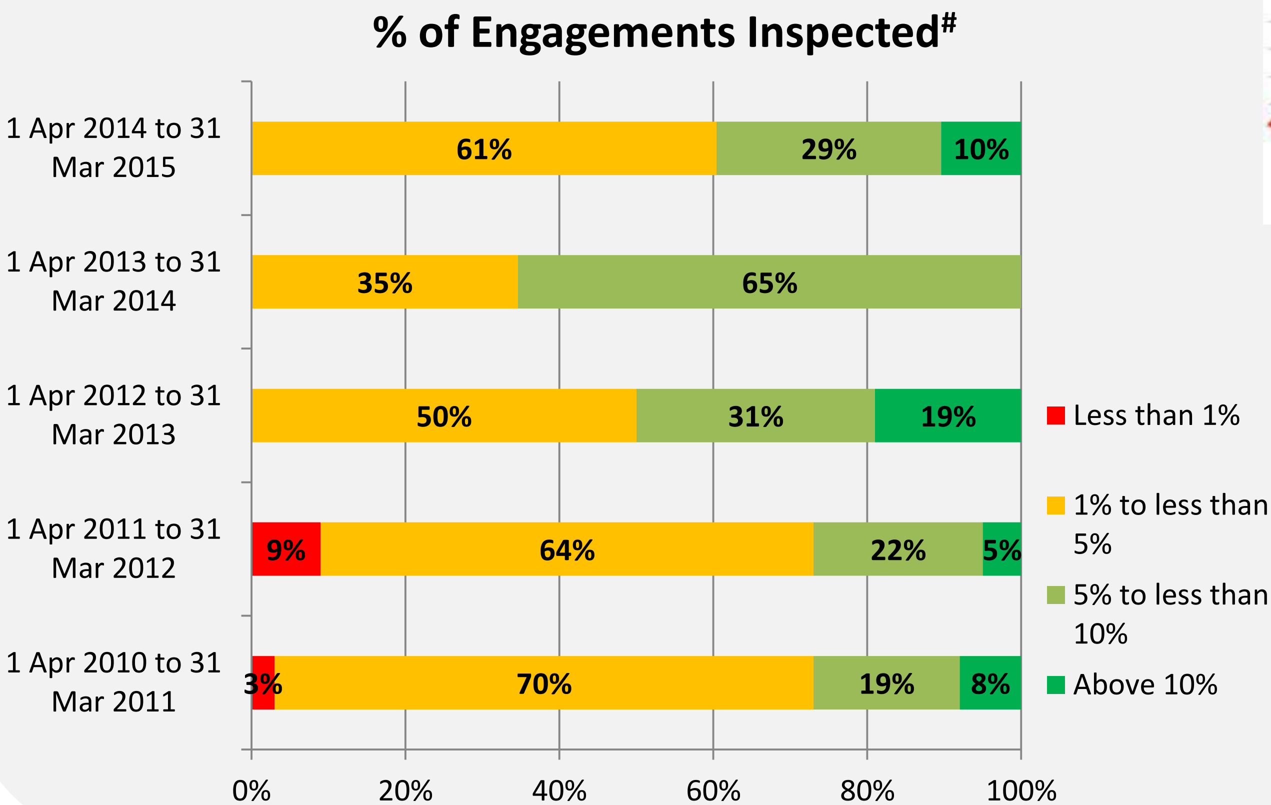
EP 200

Anti-Money Laundering and Countering the Financing of Terrorism

- Requirements for firms to have a robust process on "knowing your clients"
- Greater awareness on obligation to report suspicious transactions
- Extent and progress of implementation differs
- Staff training required

Involvement of EP

Engagement Partner (EP) involvement



- EPs have been spending more time on the audits, but improvement was not sustained

This chart shows the time spent by the EP as a proportion of the total engagement hours in the engagements inspected by ACRA

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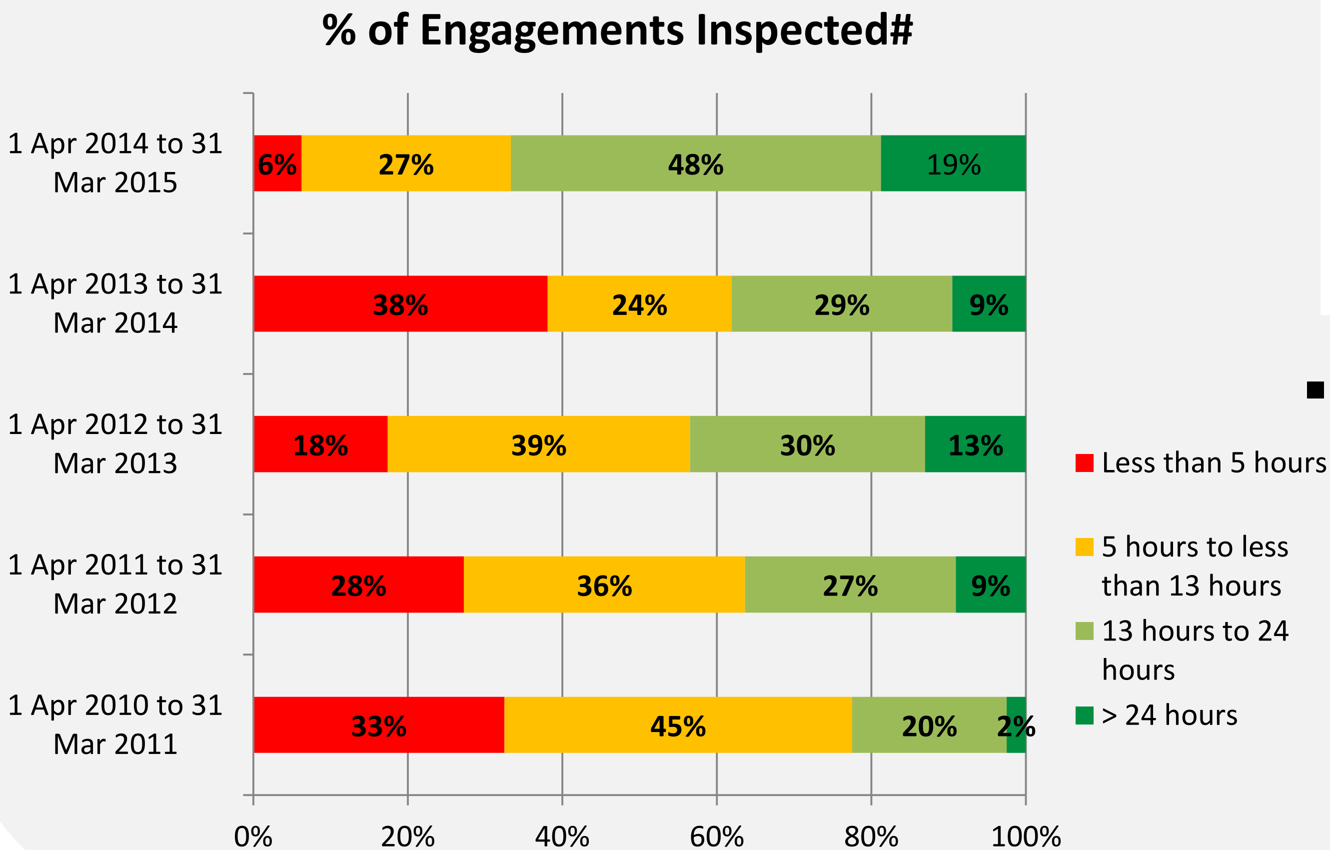
Involvement of EQCR Partner

EQCR Partner Involvement

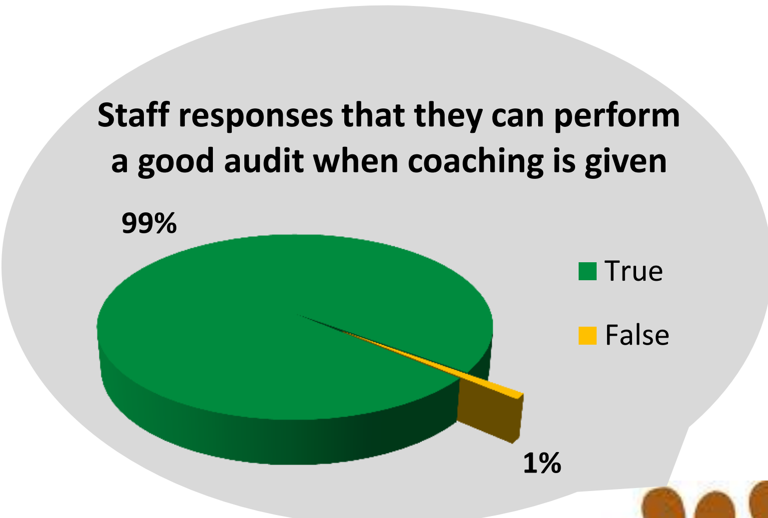


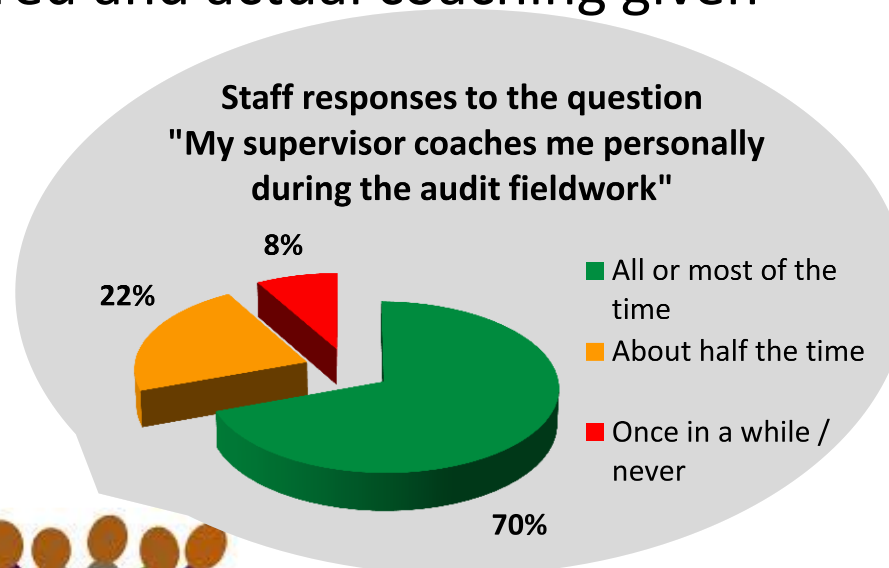
- Proportion of engagements with EQCR partner hours > 13 hours has increased

This chart shows the amount of time spent by the EQCR Partner in the engagements inspected by ACRA

Extent of coaching

- Partners and managers do not provide sufficient coaching
- Expectation gap between desired and actual coaching given





300 staff surveyed

Illustrative Audited Entity 1

Illustrative Entity 1

Company	Principal activities
Company H (Holding company)	**Principal activities of Company H** ▪ Manufactures and sells commercial fans and turbines ▪ Owns large warehouse and leases excess warehouse space to customers for short-term storage of goods
Company S (100% owned subsidiary)	**Principal activities of Company S** ▪ Manufactures and sells household fans

Other information on Company H and S:

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

Company H prepares consolidated accounts

Case Study 1

Identifying and Assessing Significant Risks

Case Facts:

PA is into his 5th year of the audit, and at the planning stage in March 2015…

1 Reviewed the YTD Dec 2014 management accounts

Observed:

Total revenue increased by **$13mil (or 52%)** from $25 mil in 2013 to $38 mil in 2014

2 Inquired with management on the increase in revenue

Understood:

- Company H had commenced provision of systems solutions services that integrated fans and turbines
- 2014 revenue was $10 mil
- Project duration ranged from 3 to 6 months

Note: Revenue is recognised when invoices are raised

Case Study 1

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Identifying and Assessing Significant Risks

Work Performed

- Identified **sales and purchases cut-off** as **significant risks**
- Performed sales cut-off test:
  - ➢ 5 samples before year-end
  - ➢ 5 samples after year-end

Audit working papers:

✓ Checked to acknowledgement slip signed by customer

Comments by engagement team – *"**Progress bills** were attached for samples #2 and #5 where **values were higher than other invoices**"*

Work Not Performed

Failed to appropriately identify significant risks on revenue

Engagement team had not:

- Identified **progress bills** billed for systems solutions services (i.e. Project Revenue – new during the year);
- Assessed the appropriateness of revenue recognition; and
- Designed specific audit procedures to address risks in Project Revenue

Case Study 2

Identifying and Assessing Significant Risks

Case Facts:

Planning discussion was held with the Finance Director in March 2015:

Company H
(Holding company)

- Nov 2014 – Completed delivery of systems solutions to Customer P
- Systems delivered was incompatible
- Project was stopped due to dispute
- $2 mil receivables balance outstanding from Customer P (20% of Company H's receivables)

Company S
(100% owned company)

- March 2014 – New range of fans was launched; $8 mil revenue recognised in 2014
- October 2014 – customers had returned fans
- Possible fault in fan motors; 2 years warranty

Case Study 2

Identifying and Assessing Significant Risks

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Work Performed

- Documented the minutes of meeting with the Finance Director
- Except for sales and purchases cut-off, no additional significant risks were identified

Work Not Performed

1. **Failed to appropriately identify significant risks arising from developments during the year**

+

2. **Failed to design audit procedures to address these risks**

- How had the dispute impacted revenue and receivables recognised?
- What was a reasonable estimate for the provision for return of fans?
- Would warranty provision be required?

Case Study 2

Identifying and Assessing Significant Risks

- Significant risks – form part of the Key Audit Matters ("KAM") in an audit engagement
- Failure to identify KAM leads to inappropriate disclosure in the Expanded Auditor's Report (SSA 701)

"Let's make sure we catch all the **Key Audit Matters**"!

Case Study 3

Use of SAP to test revenue

Case Facts:

- Company H's warehouse space was leased to various customers for short-term storage ranging from 1 week to 3 months
- Group policy – recognised rental income on a straight-line basis over the period of the lease agreement

Audit working papers documented the following:

"As expectations of rental income can be developed with reasonable precision, SAPs in accordance with SSA 520 Analytical Procedures would be used to test reasonableness of rental income"

Case Study 3

Use of SAP to test revenue

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Work Performed

Audit working papers:

Rental income	S$
2014	$8 mil
2013	$5.5mil
Increase	$3.5 mil of 64%

Reasons for increase in revenue:

1. Increase in floor area leased out from 8,000 sq ft (2013) to 9,500 sq ft (2014)
2. Increase in warehouse occupancy rates from 60% to 75% (system extract)

Work Not Performed

Fluctuation Analysis ≠ Substantive Analytical Procedures

No independent expectation of rental income

No determination of threshold of differences

Reliance placed on occupancy rates without testing the reliability of the system and data

Case Study 3

Use of SAP to test revenue

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What the engagement team should have performed:

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

Rental income	$
Warehouse lot A1	$93,500
Warehouse lot A2 to … Z10	$7.4065 mil
Total	$7.5 mil
Actual rental	$8 mil
Difference	$500k

To perform for ALL warehouses

Example for warehouse lot A1:

Rental income	Daily rental rate	Period of lease	Expected revenue
Customer A	$300	60 days	$18,000
Customer …to D	$425	90 days	$38,250
Expected rental income for warehouse lot A1			**$93,500**

Illustrative Audited Entity 2

Illustrative Entity 2

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Build-A-Ship Limited (the "Group")

- Principal activities:
  - i. Investment holding
  - ii. Ship building
  - iii. Ship repairs
- Operates in South East Asia ("SEA")
- The Group has 3 shipyards (one in Singapore and two in Thailand)
- Financial year-end : 31 Dec 2014
- Group audit opinion: Unqualified on 7 April 2015
- Group results are profitable with positive net assets

Audit considerations:

The engagement team had appropriately identified the following:

- Significant components of the Group

Companies	Country of incorporation	Principal activities	Significant component?
Holding company	Singapore	Investment holding	N.A
Subsidiary A	Singapore	Ship building	Yes
Subsidiary B	Thailand	Ship building	Yes

- Significant risks of the Group
  - i. Revenue recognition
  - ii. Impairment of ships and provision for liquidated damages
  - iii. Impairment of shipyard
  - iv. Group reporting from component auditors

Case Study 4

Existence and Accuracy of Contract Revenue

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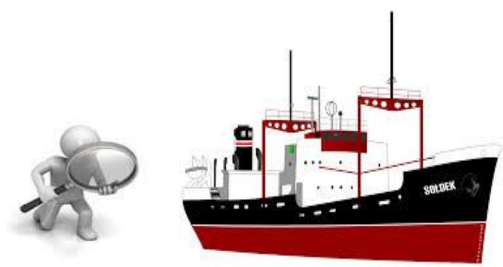
Case Facts:

Group policy: Stage of completion is measured by reference to **physical surveys of construction work completed**

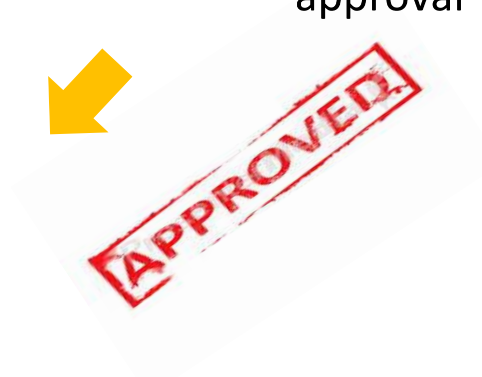
Contract cycle in Subsidiary A:



1. Subsidiary A's experts value physical extent of completion of ships

2. Valuation sent to customers for approval

3. **Certificate of Billing raised** upon approval



4. **Progress bill** raised to customer

Revenue recognised based on Sub A's expert valuation

Case Study 4

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Existence and Accuracy of Contract Revenue

Work Performed

- Obtained the most recent valuation from **Subsidiary A's experts**
- Agreed value of construction work to revenue in the Profit and Loss ("P/L")
- Agreed value of contracts and variation orders to contracts
- Reviewed key contractual terms and milestones

Work Not Performed

1. Subsidiary A's expert valuation (an internal document) **had not been agreed with the customer**

+

2. Had not assessed the competence and capability of Subsidiary A's experts

Any differences between valuation by Subsidiary A's experts and Certificate of Billing?

Case Study 5

Completeness of Contract Revenue and Costs

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Case Facts:

Consistent with the Group's policy, valuation of Sub A's experts are recognised as revenue

Contract values and valuation for the 3 largest ships at year-end:

Ship name	Valuation in 2014: Date when valn was last performed by Sub A's experts (A)	Valuation in 2014: Valuation by Sub A's experts (B)	Valuation in 2015: Date when valn was first performed by Sub A's experts (C)	Valuation in 2015: Valuation by Sub A's experts (D)	Total contract value, inclusive of VOs (E)	Stage of completion computed by mgmt in 2014 (F) = (B)/(E)
Agony	10 Dec 14	$60 mil	12 Jan 15	$100 mil	$250 mil	24%
Behman	12 Dec 14	$160 mil	31 Jan 15	$200 mil	$450 mil	36%
Cenron	22 Nov 14	$200 mil	5 Jan 15	$280 mil	$500 mil	40%

Contract costs in P/L = **Stage of completion (%)** x total estimated contract costs

Case Study 5

Completeness of Contract Revenue and Costs

Work Performed

- Agreed the contract revenue recognised in the P/L to the **most recent valuation report** by Subsidiary A's experts performed in November / December 2014

Work Not Performed

1 **Completeness** of revenue till the year-end had not been addressed, leading to under-recognition of contract revenue in the P/L

22 Nov 14 - Last valuation performed

1 **Under-recognition of rev**

31 Oct 14 **30 Nov 14** **31 Dec 2014** **31 Jan 15**

Case Study 5

Completeness of Contract Revenue and Costs

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Work Not Performed

2

Stage of completion of ships was inaccurate as: Valuation by Sub A's experts (numerator in POC formula) was incomplete

Contract costs in the P/L = **Stage of completion (%)** x total estimated contract costs

3

Correspondingly, contract costs recognised in the P/L was inaccurate

Case Study 5

Completeness of Contract Revenue and Costs

What the engagement team should have performed:

1. Used January 2015 valuation report as a **proxy** to measure the **stage of completion** as at **31 December 2014**

2. Computed the **stage of completion** based on the **costs method as a means of sanity check**

Stage of completion (%) = Contract costs incurred to-date/Total estimated contract costs

Stage of completion (%)

Stage of completion (%)

Comparison to be made to identify any significant differences

Case Study 6

Testing the Accuracy of Estimated CTC*

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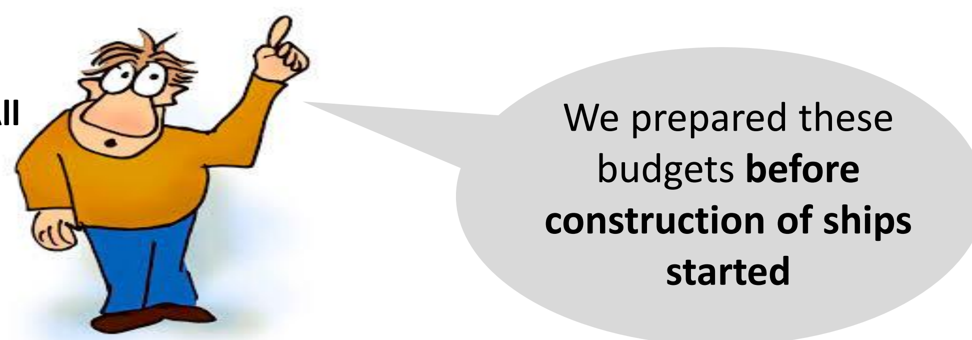
Case Facts:

Contract costs of uncompleted ships at 31 December 2014:

Ship name	Total contract value	Date the contract was awarded	Total estimated contract costs	Total contract costs incurred to-date	Estimated CTC*	Estimated profit margin
Agony	$250 mil	31 Oct 13	$232.5 mil	$80 mil	$152.5 mil	7%
Behman	$450 mil	24 July 13	$396 mil	$140 mil	$256 mil	12%
Cenron	$500 mil	18 Sept 13	$460 mil	$220 mil	$240 mil	8%

CEO
Mr Know-All



*Costs-To-Complete

Case Study 6

Testing the Accuracy of Estimated CTC*

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Case Facts:

Information on completed ships in 2013 and 2014:

From management's initial budgets

Completed ships	Estimated margin	Actual profit margin
2013		
Desco	18%	10%
Eyco	12%	5%
2014		
Falcon	15%	11%
Gladiator	10%	8.5%

- Actual profit margins of completed ships extracted from project completion sheets
- Actual profit margins have historically been **at least 5%**

Case Study 6

Testing the Accuracy of Estimated CTC

Work Performed

Contract Costs in the P/L

- Selected 25 samples and verified to source docs
- Sent confirmations to subcon with no exceptions
- Re-computed estimated CTC = Total estimated costs – total contract costs incurred to-date

Work Not Performed

Failed to test the **accuracy** of total estimated CTC

- Failed to note that budgets were outdated (i.e. **actual** profit margins of completed ships were **consistently below** the **estimated** profit margins)
- Re-computation of the estimated CTC **would not be sufficient**

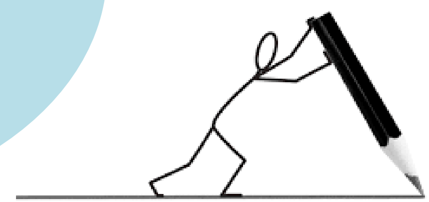
Case Study 6

Testing the Accuracy of Estimated CTC

What the engagement team should have performed:

Senior 1 : Did you notice that the Company's actual profit margins were always **below budget**?

Assistant Manager: Yes! I noticed that when flipping through the completion documents! **Let us discuss further with management**



Agenda for discussion with management:

- Reasons for lower margins – cost overruns?
- What are the **progress** and/or **status** of on-going projects?
- Will estimated costs-to-complete be impacted?

Case Study 7

Assessing Foreseeable Losses

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Case Facts:

Audit report date – 7 April 2015

1 — 1 Feb 14 – Construction commenced

2 — June 14 - Construction disrupted as subcontractor was bankrupt

3 — Oct 14 – Construction resumed with new subcon and letter sent to customer on revised delivery date (July 16)

- New subcon quoted an **additional $5 mil to complete the construction**
- Estimated margin revised from **7% to 5%**

4 — 4 Feb 15 – legal claim of $15 mil (assessed to be remote)

1 — Dec 15 - Initial delivery date

3 — July 16 – Revised delivery date

Ship: Agony

Case Study 7

Assessing Foreseeable Losses

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Work Performed

- Agreed the $5 mil additional costs to the new subcontractor agreement
- Reviewed January 2015 management accounts and noted no unusual activities
- Discussed revised profit margin from 7% to **5%** with management

5% was within the acceptable range of completed ships (see slide 31)

Documented in the audit working papers :

"based on discussions with management, the construction of Agony would still be profitable.

Reliance can be placed on management's experience and expertise due to the history of strong profits made by the group in the prior years.

Therefore, no foreseeable losses were expected"

Case Study 7

Assessing Foreseeable Losses

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Work Not Performed

1. Placed reliance on management's representation → Hence, omitted to assess if the **triggering event**[1] would cause a lower than the revised profit margin of 5%

+

2. Had not performed a robust post balance sheet review → Hence, omitted to identify and test the probability of the legal claim of $5 mil

+

3. Had not assessed if provision for liquidated damages was legitimate → Hence, failure to recognise a provision for liquidated damages of $2.5 mil in 2014

[1] **The new subcontractor agreement with higher construction costs after the bankruptcy of the initial subcontractor**

Case Study 8

Group Audits – Sufficiency of Audit Evidence

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Case Facts:

- Subsidiary B in Thailand had been suffering losses for the past 2 years
- Company's revenue was derived solely from **ship repairs.** The Company was unable to secure any shipbuilding contracts
- **Impairment of shipyard** had been set as a significant risk since prior year

Work done by the component auditor

- Followed up on the impairment of shipyard raised in the prior year. No exception was noted
- No details of procedures performed were provided in the 2014 reporting deliverables from the component team

Case Study 8

Group Audits – Sufficiency of Audit Evidence

Work Performed

- Obtained the SRM from the component auditors in Thailand and reviewed Thailand's awp

<u>Summary Review Memorandum:</u>
"Based on the work performed, no exceptions noted. No impairment on the shipyard was necessary"

<u>Audit working papers:</u>
"We have reviewed the component auditor's audit working papers and concurred with the conclusion reached by the team"

Work Not Performed

Inadequate audit evidence to support the conclusion that the shipyard was not impaired

- What were the factors and circumstances in Subsidiary A that led to the conclusion of **no impairment?**
- Were the changes in factors and circumstances **reasonable** and **sustainable**?

Root Cause Analysis

Root Cause Analysis

The importance of performing a RCA

Findings → **Root causes** → Remediation plans → Monitoring

- Root Cause Analysis (“RCA”) identifies the **underlying problems** to the findings rather than the **symptoms**

- Helps firms and public accountants focus their limited resources on addressing the right things

I wonder why we missed out testing the assumptions in the discounted cash flow?

Root Cause Analysis

Remediation plans addressing the root causes

Excessive workload

Excessive delegation with **no accountability**

High staff turnover

Lack of **technical knowledge**

Strengthening linkage between audit quality and partners performance

Reallocation of partners' portfolio

- Staff training
- Mandatory consultation on complex issues

Re-assessment of staff retention policies

Note : There could be a single or multiple root causes for each finding

Root Cause Analysis

Challenges in Performing a RCA

- Lack of ownership of the RCA process and unwillingness to own up to the actual root cause
- Attributing the root cause to convenient factors such as poor quality clients, lack of staff or low audit fees
- Disagreement on the finding
- Inability to deep dive to identify root causes

HR partner: The senior resigned because you gave him a hard time during the audit!

Partner: We omitted to test impairment assumptions as the senior resigned during the audit

Key Messages

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Key Messages

Engagement teams must ensure significant risks are appropriately identified and adequate work is performed to address these risk areas

Firms should ensure processes are in place to embrace additional disclosures required in the Expanded Auditor’s Report

ACRA will monitor the effectiveness of the firm’s remediation plans as part of the inspection process

Thank You