AUDIT PRACTICE BULLETIN NO 1 OF 2009

AUDIT CONSIDERATIONS IN THE CURRENT ECONOMIC ENVIRONMENT

16 MARCH 2009

1. The Audit Practice Bulletin is issued by the Accounting and Corporate Regulatory Authority to highlight current or emerging issues that may have a bearing on the conduct of audits by the Public Accountants.

2. This issue of the Audit Practice Bulletin highlights areas of concern in the audit of financial statements in the current economic environment. This bulletin does not establish any new requirements but serves to draw emphasis on areas which have become more significant in the current economic environment.

3. The audit profession should continue to exercise vigilance and rigor under the current economic climate. A vigilant and robust audit profession is an essential pillar in the overall corporate governance regime of Singapore.

4. The current downturn in the economic environment has a wide-ranging impact on businesses and provides particular challenges to all involved in financial reporting. The current market conditions have been characterised by significant trading difficulties compounded by a reduction in liquidity. These bring about greater uncertainties and audit risks such as in the areas of going concern especially for entities dependent on financing for their operations, valuation of financial instruments held at fair value in the absence of an active market and impairment of assets such as trade receivables and stocks as customers may not be able to pay their debts when due and significant decrease in customer demand may lead to stocks obsolescence.

5. Public accountants should continue to give careful consideration to areas that are especially susceptible to heightened risk in the current climate in planning and executing their audits.

6. These areas include, but are not limited to, the following:
   - Planning and fraud considerations;
   - Cash at banks;
   - Going concern;
   - Valuation of financial instruments held at fair value;
   - Impairment of assets;
   - Deferred tax asset recognition;
   - Provision for onerous contracts and restructuring
   - Disclosure in the financial statements and off-balance sheet items; and
   - Communication with those charged with governance.

The details are provided in the Annexure to this Audit Practice Bulletin.

Note: Please note that the contents of the Audit Practice Bulletin are not rules of the Accounting and Corporate Regulatory Authority and are not intended to serve as a substitute for the relevant auditing standards. The Public Accountants are to observe, maintain and apply the prescribed professional standards, methods, procedures and other requirements in carrying out the audits of financial statements.

ANNEXURE

AREAS	AUDIT CONSIDERATIONS AND RELEVANT STANDARDS AND PRACTICES
1. Planning considerations	▪ The current economic conditions may present credit, liquidity and financial reporting challenges for many entities which may not have experienced such challenges previously. ▪ SSA 300 requires the auditor to consider, among other things, the significant business and industry developments affecting the entity in planning the audit. As part of the planning and risk assessment process of the entity, the auditor should determine how and to what extent the current market conditions have affected the entityỏs business and activities and exposed the entity to going concern issues and risks of material misstatement of the financial statements. In the same light, the auditor should also consider if and how the current economic climate has affected the adequacy and effectiveness of internal controls of the entities in the audit planning process. ▪ In developing the audit strategy, the auditor should consider the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters. (Ref: SSA300.10)
2. Fraud considerations	▪ The current economic environment may result in a greater risk of fraudulent financial reporting by management due to increased pressures or incentives to meet market expectations; requirements of third parties e.g. covenant requirements, analystsỏ expectations; and requirements under performance-based compensation etc as well as risk of employee fraud arising from incentive or pressure to commit fraud or a perceived opportunity to do so. ▪ The increased pressure to meet revenue targets and analysts expectations may cause companies to change business practices such as rights of return, change in payment terms, bill-and-hold and consignment arrangements. These have an effect on revenue recognition and necessary audit procedures should be incorporated to test the amount and timing of revenue recognition. ▪ SSA240.3 requires the auditor to consider the risks of material misstatements in the financial statements due to fraud in planning and performing the audit to reduce audit risk to an acceptably low level. ▪ The appendices in SSA240 provide useful examples of fraud risk

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	indicators, circumstances that indicate the possibility of fraud and the possible audit procedures to address the assessed risk of material misstatement due to fraud for the auditor's consideration.
3. Cash at bank	▪ Fraud risk relating to misstatements in the financial statements arising from misappropriation of assets, cash being most susceptible, may become more significant in the current economic environment. ▪ Misappropriation of assets involves the theft of an entity's assets often perpetrated by employees but can also involve management who are more able to conceal misappropriations in ways that are difficult to detect. (Ref: SSA240.11) ▪ External confirmation of bank balances and other information is commonly used to provide reliable and relevant audit evidence regarding the existence of outstanding bank balances and transactions existing at balance sheet date. In this connection, consideration should be given if the circumstances would require the auditors to go beyond customary authenticating procedures to physically witnessing the authentication as necessary. ▪ SSA505 provides guidance on the auditor's use of external confirmations as a means of obtaining audit evidence. Key audit considerations include the following: • In assessing the reliability of confirmations and determining the appropriate authenticating process, the auditor considers the characteristics of the respondents such as the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed and objectivity. The legislative framework and regulatory environment in which the respondents (in this case, banks and financial institutions) operate may be relevant in making this assessment. • As the external confirmation does not ordinarily provide all the necessary audit evidence relating the valuation assertion of an account balance, the exposure to credit risk of deposits placed with banks and financial institutions will still need to be assessed as appropriate, taking into account factors such as the credit ratings of these institutions. • The auditor should consider sending confirmation requests to all banks with which the entity maintains an account even if the records show nil bank balance to detect unrecorded transactions such as financial derivatives entered into or financial guarantees given by the entity etc. In addition to obtaining management's written representation to confirm

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	the completeness of the list of bank accounts maintained, other additional procedures such as obtaining corroborative evidence from the review of Board minutes and resolutions should be considered. • When performing confirmation procedures, the auditor should maintain control over the process, particularly over the sending of confirmation requests and receipt of responses to those requests. This minimises the possibility of interception and alteration of requests or responses. • Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response or perform alternative procedures to provide audit evidence of the existence, accuracy and completeness assertion of outstanding bank balances and transactions as at balance sheet date. • The auditor considers whether there is any indication that external confirmation received may not be reliable and considers authenticating the response through validating the sources of replies received by post or in electronic format.
4. Going concern	▪ The global recession and uncertainties have created many challenges for the companies as they cope with declining revenues with failing consumer confidence and consequential fall in spending which may result in operating losses if overheads cannot be covered; higher working capital needs with slower inventory movement, delayed customer payment and pressure from suppliers for payment; potential breaches of terms or covenants associated with credit arrangement or bank loan and difficulty in securing financing or refinancing of existing debts from banks with the credit crunch. Going concern issues can arise if the company is unable to generate sufficient cashflows to meet its payment obligations. ▪ The going concern assumption is a fundamental principle in the preparation of financial statements. (Ref: SSA570.3) Financial statements shall be prepared on a going concern unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. (Ref: FRS1.23) ▪ When preparing financial statements, management shall make an assessment of an entityȏs ability to continue as a going concern. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date. (Ref: FRS1.23 &

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	24). ▪ When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of managementôs use of the going concern assumption in the preparation of the financial statements. (Ref: SSA570.2) ▪ SSA570.8 provides some examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption. ▪ The auditor should evaluate managementôs assessment of the entityôs ability to continue as a going concern. (Ref: SSA570.17)
5. Valuation of financial instruments held at fair value	▪ Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an armôs length transaction. ▪ The current economic conditions may make valuation of financial instruments difficult as active market may no longer exist, requiring the use of a valuation model to estimate fair value. Particular difficulties arise when inputs to a model are not based on observable market inputs but rather are based on the entityôs own data or assumptions. ▪ The auditor should obtain an understanding of the entityôs process for determining fair value measurements and disclosures to identify and assess the risks of material misstatement at the assertion level related to the fair value measurements and disclosures in the financial statements to determine the nature, timing and extent of the further audit procedures. (Ref: SSA545.14) ▪ The auditor should determine the need to use the work of an expert (Ref: SSA545.29) and when planning to use the work of an expert, the auditor should evaluate the professional competence and objectivity of the expert. (Ref: SSA620.8 & 9)
6. Impairment of assets	▪ Market conditions during an economic downturn may result in impairment of assets, such as, arising from a significant and prolonged decline in fair value of quoted investments; reduction in liquidity and heightened risk of non-collection of receivables; and decline in consumer spending resulting in excess or obsolete inventory or inventory with carrying amounts in excess of net realisable values. ▪ In estimating provision for slow-moving or surplus stocks or allowances to reduce accounts receivable to their estimated

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	realisable value, management may use a formula based on experience to account for these estimates. SSA540.8 requires the auditor to design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entityÕs accounting estimates are reasonable in the circumstances. The auditor should also review the continuing appropriateness of formulae used by management in the preparation of accounting the estimates. (Ref: SSA540.18) ▪ <u>Financial assets</u> A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a Ôloss eventÕ) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. (Ref: FRS39.59) Examples of such events are provided in FRS39.59 to 61. ▪ <u>Non-financial assets</u> FRS36.9 requires an entity to assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. Goodwill acquired in a business combination and certain intangible assets are subject to annual impairment testing irrespective of whether there is any indication of impairment. (Ref: FRS36.10) Additional impairment testing is required if new indicators of impairment arise subsequent to the annual testing. Adverse changes in business environment brought about by the current economic conditions may lead to circumstances such as operating losses, net cash outflows, and plans to discontinue or restructure the operation to which an asset belongs or dispose of an asset, which are considered indicators of impairment. An impairment loss is recognised when the recoverable amount of a non-financial asset is lower than its carrying amount. The recoverable amount of an asset or a cash generating unit is the higher of its fair value less costs to sell and value in use. (Ref: FRS36.6 & 104) ▪ Impairment testing is an area requiring significant judgement as it involves the assessment of reasonableness of managementÕs assumptions and estimates of the entityÕs projected cashflows and growth rate and the discount rates used in calculating the

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	value in use of an asset. ▪ SSA540.8 states that the auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.
7. Deferred tax asset recognition	▪ FRS12.34 states that a deferred tax asset should be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. ▪ The entity would need to assess whether it is probable that sufficient future taxable profits will be generated to offset the tax losses for the recognition of deferred tax asset in light of current economic crisis and declining profitability of companies. This involves management's estimates of expected availability of future profits which should be updated to take into account the current expectations of future conditions. ▪ SSA540.8 requires the auditor to design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.
8. Provision for onerous contracts and restructuring	▪ A contract is onerous if the unavoidable costs of meeting the obligations exceed the economic benefits to be received in the future. Onerous contracts can arise from purchase commitments which are entered into at high prices for which a provision is required for the potential loss due to declining selling prices under current tough trading conditions. ▪ The difficult economic conditions may cause companies to restructure such as closure of factories or retrenchment to reduce cost, giving rise to the need to provide for onerous contracts which may arise from unavoidable rental payments under non-cancellable lease or restructuring costs. ▪ Auditors should consider the risks of material misstatement relating to the recording of restructuring costs. ▪ The recognition, measurement and disclosure of provision for restructuring are set out in FRS37.
9. Disclosures in the financial statements and off-balance sheet	▪ FRS1.122 and 125 require the disclosure of information about significant areas of judgements, estimates and assumptions made by management in applying accounting policies that have the most significant effect on the amount recognised in the financial

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items	statements. ▪ The current economic conditions can be expected to give rise to a greater number of disclosures on judgements, estimates and assumptions such as in explaining going concern conclusion and accounting for valuation of financial assets etc. ▪ In reviewing the presentation of the disclosures, the auditor considers whether the notes to the financial statements taken together with the primary financial statements present a true and fair view. ▪ All off-balance sheet items should be properly accounted for, assessed and presented clearly in the financial statements.
10. Communication with those charged with governance	▪ The auditor is required to communicate to those charged with governance matters of governance interest identified during the audit of financial statements. Such matters that arise from current market conditions may include: • Items that have a significant impact on the financial statements, for example, the selection of new or changes to accounting policies; estimates, judgements and uncertainties used and unusual transactions noted; • Material weaknesses in the internal controls; • Significant related party transactions; • Disagreements with management; • Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entityôs financial statements; and • Expected modifications to the auditorsô report.