



**Guidance to Audit Committees**

**on**

**Evaluation of Quality of Work  
Performed by External Auditors**

**July 2010**

## **Foreword**

Good corporate governance is an essential tenet of protecting shareholders' interest. Whilst those charged with governance i.e. directors (including Audit Committees) and management of the company play a pivotal role in corporate governance, external auditors also play a key fiduciary role through the provision of audit reports and other assurance services. The achievement of high corporate governance standards will depend on the interplay between the different elements of the corporate governance eco-system.

This Guidance has been prepared with a focus on the function of the external auditor in the corporate governance eco-system. The effective interaction between Audit Committees and external auditors can make a key contribution to the delivery of a quality audit outcome. Quality audit work, in turn, is inextricably linked to the external auditor's ability to deliver value to the company's shareholders.

The Guidance focuses on four important indicators of audit quality observed through ACRA's Practice Monitoring Programme (PMP) and also contains a set of sample guidance questions which are directly relevant to the identified indicators of audit quality. The guidance questions would also provide useful assistance to Audit Committees in performing their statutory and fiduciary duties.

As regulators of the public accountancy profession and publicly listed companies in Singapore, ACRA and SGX are pleased to collaborate on this Guidance. We believe that both the public accountancy profession and the users of financial information have a role to play in enhancing audit quality in Singapore. An environment where high audit quality is expected of the profession and valued by users would strengthen investors' confidence in Singapore's capital markets.

We are pleased to launch the publication "*Guidance to Audit Committees on Evaluation of Quality of Work Performed by External Auditors*".

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## Introduction

An environment of high quality financial reporting supported by a robust audit framework are key factors for promoting confidence in the effective functioning of our capital markets.

Overseeing the external audit function in an effective manner is an important element of a high quality corporate governance framework. This responsibility is normally delegated by a company's Board of Directors to its Audit Committee ("AC"). The AC plays an essential role within a company's governance framework under the Companies Act as well as the Code of Corporate Governance. The composition of the AC should be sufficiently balanced in terms of its skills, relevant experience and industry knowledge to enhance the effectiveness of the external audit process.

The primary role of the AC is to assist the Board of Directors in overseeing the quality and integrity of the company's financial information. To do this, the AC must also play a diligent oversight role with respect to the company's management, the effectiveness of the company's internal controls over financial reporting, the qualifications and performance of the internal audit function and the qualifications, performance and independence of the external auditor. Depending on the company's governance framework, the AC may also have oversight responsibilities with respect to the company's compliance and risk management practices.

It follows that ensuring a high standard of audit quality is a vital part of the AC's role, not only because the AC has oversight responsibilities over the work of the external auditors but because the work of the external auditors can assist the AC in carrying out its regulatory oversight responsibilities<sup>1</sup>.

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<sup>1</sup> Companies Act, Cap. 50 section 201B(5) stipulates that "*The functions of an audit committee shall be —*

(a) *to review —*

(i) *with the auditor, the audit plan;*

(ii) *with the auditor, his evaluation of the system of internal accounting controls;*

(iii) *with the auditor, his audit report;*

(iv) *the assistance given by the company's officers to the auditor;*

(v) *the scope and results of the internal audit procedures; and*

(vi) *the balance-sheet and profit and loss account of the company and, if it is a holding company, the consolidated balance-sheet and profit and loss account, submitted to it by the company or the holding company, and thereafter to submit them to the directors of the company or the holding company; and*

## *Purpose of this Guidance*

This Guidance is intended to enhance audit quality in Singapore by encouraging ACs to evaluate their external auditors, especially during the appointment, reappointment and rotation of statutory auditors, based on key indicators of audit quality which we have found to be important when evaluating public accountants and firms in the course of ACRA's PMP<sup>2</sup>.

Amongst the many factors which impact the quality of audit, we have found four to be of particular importance and ACs can evaluate their external auditors using the **E-A-S-E** indicators as follows:

- **E**mphasis on quality by the audit engagement partner and the audit firm;
- **A**llocation of adequate and appropriate human resources;
- **S**ubstantial involvement of the audit engagement partner; and
- **E**xercise of professional scepticism.

ACs may wish to use the sample questions set out in the Annex in carrying out their evaluation.

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*(b) to nominate a person or persons as auditor, notwithstanding anything contained in the articles or under section 205,*

*together with such other functions as may be agreed to by the audit committee and the board of directors."*

<sup>2</sup> In its capacity as an independent audit regulator, ACRA monitors the audit quality of public accountants through its Practice Monitoring Programme ("PMP"). In the course of its work, ACRA has been able to assess the quality of work performed by the public accountancy profession based on standards adopted from international standards issued by the International Federation of Accountants, which are the same standards used by most of ACRA's international counterparts in regulating external auditors.

### ***Who should use this Guidance***

Whilst this Guidance is expected to be used predominantly by ACs, it is also relevant for company directors and other persons involved in corporate governance activities and financial reporting, as well as regulators and external auditors.

This Guidance does not impose additional compliance requirements or supersede existing requirements to which ACs might already be subject.

In developing this Guidance, we have had regard to existing guides such as the Code of Corporate Governance and the Audit Committee Guidance Committee's Guidebook for Audit Committees in Singapore ("ACGC Guidebook"). This Guidance has also been informed by the extensive literature written on audit quality which includes the United Kingdom Financial Reporting Council's Audit Quality Framework as well as the Australian Financial Reporting Council's Strategic Review on Audit Quality in Australia. Therefore users should not read this Guidance in isolation but should also refer to other guidance materials available.

As this Guidance is not designed to be exhaustive or comprehensive, there may be specific circumstances to be taken into account by ACs when applying this Guidance in a manner appropriate to their companies.

An AC may also wish to discuss matters raised in this Guidance with the management of the company.

## **Enhancing the Value of Audit**

In issuing the audit report, the external auditor plays a key role in preserving and strengthening confidence in Singapore's business and financial markets. However, the audit report is only one element of the value derived from an audit. For example, a good audit will normally uncover issues and learning points that are useful for a company, including, for example, the improvement of risk management, strengthening of corporate governance and challenging of underlying business assumptions.

Globally, there has been intense debate about changes which could be made to the form of the audit report, in order to make it more meaningful for its intended users as well as to bridge the "audit expectation gap". Even if the result of this debate is an enhanced audit report, it will remain a minimum requirement, underpinned and limited by statutory provisions and professional standards. For auditors to play a role in preserving and strengthening confidence in Singapore's financial reporting and business and financial markets, it is important that they be encouraged to go beyond the minimum and to reach the highest standards of audit quality. In this context, there is an important role for all users of financial information, including Boards of Directors and Audit Committees, in setting higher expectations of auditors and the quality of work that they deliver.

In 2009, ACRA commissioned the Singapore Management University to carry out "*A Survey on the Oversight of External Auditors through the Lenses of Audit Committee Chairmen*". The survey interviewed AC Chairmen on the key factors for consideration when deciding on the appointment, reappointment and change of external auditors. One recurring theme emerging from the survey was that open and effective communication between the AC and the audit engagement partner was a key element in promoting audit quality, and that regular interaction between the AC and the audit team was one of the key factors in preventing the external audit function from turning into a mechanical process.

In 2010, to follow-up on the first survey, ACRA commissioned the Association of Chartered Certified Accountants (ACCA) to carry out a survey of Audit Committee Chairmen on the value of audit, what it meant to the AC Chairmen and how the external auditor can meet the AC's expectations with respect to value.

The results of this year's survey showed that AC Chairmen continue to place great importance on the involvement of and engagement with the audit engagement partner and believe the value of audit to be enhanced when:

- The audit engagement partner engages the AC on a timely basis on significant audit issues, which may arise due to changes in the business, industry and operating environment, changes in accounting standards and other regulatory requirements or findings emerging from the audit itself;
- The audit engagement partner is able to use his personal experience or his firm's collective experience to offer useful precedents and suggestions to assist management in resolving difficult accounting and reporting issues; and
- The audit engagement partner shares his personal experience or his firm's collective experience of his client's industry and facilitates the benchmarking of the company to best practices in financial reporting.

The AC may consider the auditor to be one of its "lines of defence" in overseeing the quality and integrity of the company's financial information, after management, the internal audit function and the risk management function (if this falls within the ACs responsibilities).

In connection with the value of audit, ACs have a responsibility to manage costs and should consider cost-effectiveness when approving a level of audit fees sufficient to enable auditors to properly perform their statutory function of issuing a true and fair opinion on the financial statements. However, this responsibility must be exercised with due regard to the indicators of audit quality in order to ensure that audit quality is not compromised by an excessive focus on audit costs. The AC Chairmen surveyed commented that auditors who are able to create and add to the value of audit should be fairly remunerated for the value delivered.

In summary, the value of audit is enhanced when the auditor is able to engage the AC effectively on all audit and related matters and when the audit report is substantiated by underlying audit work of high quality. Both the AC and the external auditor should thus take an interest in the indicators of audit quality, including the four key areas that will be discussed in this Guidance.

## Emphasis on Quality by the Audit Engagement Partner and the Audit Firm

**The emphasis on providing quality audit work to the client must be driven by the audit engagement partner and the culture of the firm must reflect the importance it places on audit quality.**

- The culture within an audit firm is a key driver of audit quality. The emphasis placed by the firm’s leadership on audit quality should be demonstrated by the creation of an environment with a clear and consistent “tone at the top” approach oriented towards achieving high quality audit. The overriding importance attached to high quality audit by the firm’s leadership should pervade throughout the firm, and that the firm’s internal governance structure, professional ethics, policies and quality control processes are designed to support audit quality.
- Auditing standards in Singapore require an audit firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that audit reports issued by the firm or engagement partners are appropriate in the circumstances. **To get a sense of the firm’s commitment to quality, the AC could ask for a presentation on or description of the audit firm’s system of quality control and how this satisfies the relevant auditing standard.**
- **With respect to a firm’s system of quality control, the AC should be interested in the priority placed by the firm’s leadership on ensuring the robustness and effectiveness of these controls.** Some firms are subjected to independent monitoring of their systems of quality control, including the quality of work in specific audit engagements, as a result of their membership in an international network of audit firms. Other firms may conduct internal peer reviews of audit quality. The frequency and scope of such reviews as well as the calibre and independence of the people who carry them out, are indicators of the firm’s emphasis on maintaining a strong system of quality control.

- In its interaction with the audit engagement partner and other communications (e.g. technical bulletins) with the audit firm, the AC should be able to assess the degree of emphasis given by the firm's leadership to ensuring audit quality, including whether the firm is proactive in alerting the company to emerging issues and changes to accounting standards which may impact the company's financial reporting. **The AC should consider the quality of thought leadership provided by the audit engagement partner and audit firm in areas of relevance to the company.**
- Audit firms may allocate resources to support areas of audit quality through dedicated functions such as technical consultation on audit and accounting issues, risk management, quality reviews and training (including audit methodology development and industry specific expertise). By asking firms to demonstrate the availability of such resources, either within the firm or within its international network of firms, ACs would be able to further assess the extent of the firm's commitment to audit quality.
- One of the most important interactions between the AC and the Audit team is the review and discussion of the audit plan. In addition to allowing the AC to understand and approve the scope of the audit, it will provide an important insight into the audit team's audit approach and understanding of the company's business and business risks. **ACs should require audit plan(s) to be presented, discussed and approved at an early stage of the audit cycle. Subsequent changes to audit plans and the rationale for the changes should be reported back to the AC on a timely basis.** The audit plans should include the auditor's assessment of audit risks and planned procedures to address those risks as well as information on the resources dedicated and timelines to complete the audit.

## Allocation of Adequate and Appropriate Human Resources

**Whilst the system of quality control in an audit firm can provide the infrastructure and a conducive environment for quality work, audit quality is very much driven by the individuals performing the audit. The AC should give due consideration to the skills and qualities of key members of the audit team.**

- The audit engagement partner is the pillar of the audit team and hence the most important contributor to audit quality. **The AC should assess whether the audit engagement partner has sufficient experience to understand the company's business so as to be able to advise the AC of risk areas on a timely basis, of audit and accounting issues arising from changes in the business, industry and operating environments as well as changes in accounting standards and regulatory requirements.** A partner with sufficient experience should be able to engage management and the AC in the process of resolving such issues at an early stage.
- The team supporting the partner also plays a key role in determining the quality of the audit. Firms are expected to recruit and retain appropriately qualified personnel and provide them with adequate training, including training on the firm's audit methodology, before considering them to be ready to perform an audit. **Each year, when it meets with the audit engagement partner to review and approve the audit plan, the AC should ask for a list of all audit team members, including information on their seniority, industry experience, technical knowledge, language skills (where the company has foreign operations), understanding of the company's operations and reporting systems, and expected role in the forthcoming audit.** The AC, assisted by the company's management, should pay particular attention to the qualifications of senior members of the audit team, especially the senior manager and managers, and to the number of years each team member has served on the company's audit. **The AC should also ask the audit engagement partner to confirm the independence of each team member.** This should enable the AC to assess whether the firm has provided

an appropriate team for the audit, taking into account the size, nature and complexities of the company's operations.

- **In assessing the appropriateness of the audit team, the AC may also want to enquire specifically about issues which are relevant to the company's business such as specialist expertise in certain areas** e.g. valuation of financial instruments and knowledge of business and tax regulations pertaining to foreign operations. Where such specialist expertise is critical, the AC should enquire if it will reside within the audit team or accessible within the audit firm in Singapore or within the audit firm's global network.
- Another factor to be taken into account in assessing the appropriateness of the proposed audit team is whether the size and experience of the team are likely to be sufficient to ensure that the audit firm will be able to manage the various stages of the audit, complete the audit within the agreed timelines and enable the company to meet its statutory filing deadlines. **In assessing the sufficiency of audit resources assigned to the company, the AC should ask for a detailed plan outlining each member of the audit team's involvement/ area of responsibility and the areas of work to be completed within the stipulated audit periods.** Such a plan will also facilitate a smooth working relationship between the audit team and management on a day-to-day basis.

## Substantial Involvement of the Audit Engagement Partner

**The substantial involvement of senior members of the audit team is critical to ensure that all audit issues are identified and resolved quickly and appropriately. In this respect, the AC should give particular attention to the extent of involvement of the audit engagement partner.**

- Being the most experienced person on the audit team, the audit engagement partner is the most qualified person to identify and/or understand the significance of issues which may not be identified or fully understood by less experienced members of the team. However, he can only fulfill this responsibility if he is substantially involved throughout the audit process. **When discussing the audit plan and other key areas required under the Companies Act with the audit engagement partner and his team, the AC should have a frank conversation about the extent of the audit engagement partner’s involvement in the audit and that of senior team members.** This should include a discussion of hours to be spent by each member of the engagement team, and the nature and timing of the partner’s involvement<sup>3</sup>. The AC should also enquire if the audit firm has a proper channel to facilitate the prompt escalation of significant accounting and audit issues to the attention of the audit engagement partner.
- ACs are encouraged to engage the audit engagement partner/team as frequently as possible to discuss audit matters throughout the financial year to ensure “no surprises” at the year-end audit, so that there is adequate time to deliberate and resolve critical issues before the financial results are released publicly. **To facilitate the timely involvement of the audit engagement partner/team, ACs may wish to consider the merits of involving their auditors in reviewing the company’s interim results announcements throughout the financial year.** However, ACs should be aware that reviews of interim financial results do not constitute an audit.

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<sup>3</sup> ACRA has not set a minimum standard for an acceptable level of engagement partner involvement, and is of the view that the extent of involvement should be material and vary according to the complexity and risk of the engagement. However, some firms regard 5% of total engagement time for a low risk engagement as a reasonable target and up to 10% of total engagement time for higher risk engagement and ACRA regards this as an appropriate starting point for discussions with audit firms.

## Exercise of Professional Scepticism

**The qualified and technically competent auditor cannot be effective if he does not exercise an appropriate level of professional scepticism. In engaging with the auditor on various audit issues, the AC should consider whether he has exercised an appropriate level of professional scepticism.**

- Professional scepticism requires an inquisitive mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence without being obsessively suspicious or negative. It must be based on a thoughtful and knowledgeable assessment of what could go wrong in the financial reporting of the company. The auditor, when appropriate, should ask probing questions, critically analyse answers and diligently compare the results of this analysis with other evidence. The auditor should challenge management's judgment on the application, interpretation and presentation of financial statements.
- When auditing areas which are largely based on management estimates and assumptions e.g. valuation of assets, impairment of assets, provisions, going concern assessment etc, the auditor must scrutinise those management estimates and assumptions and ensure they are not inconsistent with the auditor's general understanding of the company's business and other corroborative evidence. **The AC should be alert to indications that the auditor is insufficiently sceptical and too ready to accept management assertions. An auditor's willingness to speak up on key issues and challenge management's assertions contributes to the effectiveness of an audit.** One way in which the AC may be able to assess whether the auditor has exercised sufficient professional scepticism is to require the auditor to clearly articulate and justify the work he has done to satisfy himself that the estimates and assumptions used by management are reasonable and acceptable for the purpose of the audit.

- The auditor also needs to exercise professional scepticism when he intends to rely on the work of experts e.g. valuers of property, valuers of financial statements, lawyers, tax assessors etc. In addition to assessing the expert's independence, qualification and competence, the auditor must scrutinise the expert's estimates and assumptions before he decides that the work of the expert can be relied upon for the audit. **When the auditor intends to rely on the work of an external expert, the AC should query the auditor's approach and understanding of the assumptions and methods adopted by the expert.**
- When an auditor of a group of companies acts as the group auditor, he needs to exercise professional scepticism if he intends to rely on the work of component auditors which may include other member firms of the audit firm's international network outside of Singapore and as well as unaffiliated auditors. The AC should be aware that the group auditor would need to perform certain audit procedures<sup>4</sup> to satisfy himself that the component auditor has performed all the necessary audit work at the component level, if he wanted to rely on the component's auditor's work. **For groups with extensive foreign operations audited by component auditors, the AC should inquire and discuss with the group auditor the audit procedures being carried out in order for him to place reliance on the work of the component auditor.** The AC should also obtain a good understanding of the component auditor including the structure of the audit firm, its governance process, its internal quality review process as well as the professional competence of the component auditor.

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<sup>4</sup> ACs should note that such audit procedures are required under the auditing standards, specifically SSA 600: Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).

- The auditor often relies on external confirmations in the audit of cash and bank balances and borrowings, assets held by custodians, receivables and payables. The auditor needs to exercise professional scepticism when he intends to rely on the confirmations. The auditor needs to maintain full control of the confirmation process so that responses are not invalidated by interception and alteration. The auditor also needs to scrutinise the identity of the confirming party to ascertain whether the confirmation can be relied upon. In certain jurisdictions, the auditor may need to collect the reply from the confirming party directly, where other means of obtaining the confirmation without client involvement are not available. **The AC should discuss with the audit partner and his team their approach to the confirmation process if the auditor intends to rely on external confirmations of cash, assets and liabilities of the company.**
- Groups with complex shareholding structures and extensive foreign operations may be susceptible to fraudulent financial reporting in the area of related parties balances and transactions. Auditors need to exercise a high level of professional scepticism when ensuring the completeness of information on related parties and should not take at face value lists of related parties provided by management, without performing additional procedures e.g. independent profile checks on the related parties' shareholdings in other companies. **The AC should ask the audit engagement partner and his team how they plan to verify the completeness of information on related parties as related parties balances and transactions may be susceptible to fraudulent financial reporting.** In doing so, the AC members should recognise their responsibility to ensure that information on all related parties known to them is communicated to the auditor.

## Annex – Sample Questions

This Annex sets out sample questions that ACs may use in their evaluation of the quality of work performed by their external auditors pertaining to each of the four indicators of audit quality:

<b>Emphasis on Quality by the Audit Engagement Partner and the Audit Firm</b>	
1.	Has your firm fully implemented the systems of quality control required by the auditing standards? If not, when will the firm complete its implementation?
2.	What are the key quality controls of your firm to support audit quality? How much resources have been allocated to maintain your firm's system of quality controls?
3.	How frequently is your firm's system of quality controls subject to self-assessment or assessment by your global firm (if applicable) and regulators for its effectiveness and robustness? What are the major improvement areas identified from such assessments?
4.	What are the latest technical developments that your firm is concerned with? And how will they impact the company's financial reporting?
5.	What are the other resources available for you to draw upon within the firm and within your global network to deal with complex issues of the company?

**Allocation of Adequate and Appropriate Human Resources**

1.	What is your understanding of the company’s business and technical developments arising from changes in professional standards and regulatory requirements which the company should be concerned with?
2.	What are the audit team’s members’ industry experience, technical knowledge, language skills, understanding of the company’s operations and reporting systems and their expected roles in the forthcoming audit?
3.	What are the quality controls your firm has put in place to ensure the independence of members of the audit team?
4.	What are the resources available for you to draw upon to deal with technical areas which would require specialist expertise? Are these resources located within the firm and/or within your global network?
5.	How much resources are your firm allocating at different stages of the audit to ensure that the audit is completed within the agreed timelines?

**Substantial Involvement of the Audit Engagement Partner**

1.	What would be the extent and nature of your involvement at different stages of the audit based on your assessment of the complexity and risk of the audit engagement?
2.	What are the critical areas of the audit you would be most intimately involved in? What are the criteria used for selection of these critical areas?
3.	What are your firm’s policies with regard to the directing, supervising and reviewing of audit work?
4.	What channels are in place to facilitate the audit team’s escalation of key technical issues to you in a prompt manner?
5.	What are your plans to engage the AC on critical issues arising from the audit?

## Exercise of Professional Scepticism

1.	Other than the reliance on corroborative evidence, what additional procedures would be performed to challenge management's assertions on estimates and assumptions?
2.	What is the approach adopted by your firm in assessing the competence and work of an external expert?
3.	What procedures would be performed to satisfy yourself in gaining the appropriate assurance over the audit work of component auditors?
4.	What is the approach adopted by your firm to ensure the integrity of the external confirmation process?
5.	What additional procedures would be performed to verify the completeness of information on related parties balances and transactions?