# AUDIT PRACTICE BULLETIN NO. 2 OF 2016

# THE ENHANCED AUDITOR REPORTING STANDARDS: COMMUNICATING KEY AUDIT MATTERS AND ADDRESSING GOING CONCERN IN "CLOSE-CALL" SITUATIONS

## INTRODUCTION

1. In July 2015, the enhanced auditor reporting standards[1] were issued in Singapore and will be effective for audits of financial statements for periods ending on or after 15 December 2016.

2. The most significant change is the introduction of a new Singapore Standard on Auditing (SSA) 701, *Communicating Key Audit Matters in the Independent Auditor's Report,* which requires auditors of listed entities to communicate key audit matters (KAMs) in the auditor's reports on the listed entities' financial statements.

3. In complying with the requirements of SSA 701, public accountants may face challenges as the **determination and communication of KAMs** involve the exercise of significant professional judgement. Hence, the purpose of this Audit Practice Bulletin is to **provide guidance on the decision-making process public accountants may apply when determining KAMs and ACRA's expectations with respect to the documentation requirements in SSA 701**.

4. Another key change in the enhanced standards is an added responsibility imposed on public accountants to ensure that the entity has made adequate disclosures in its financial statements regarding **going concern in "close-call" situations**. Hence, this Audit Practice Bulletin also seeks to **provide guidance on how public accountants may address this requirement as set out in the revised SSA 570 *Going Concern*.**

## SECTION A: KEY AUDIT MATTERS – MANDATORY FOR AUDITS OF LISTED ENTITIES[2]

5. KAMs are defined as those matters that, in the **auditor's professional judgement**, were of **most significance in the audit of the financial statements of the current period**.

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[1] The enhanced auditor reporting standards comprise the following new and revised Singapore Standards on Auditing (SSAs):
(a) SSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements;*
(b) SSA 701 (New), *Communicating Key Audit Matters in the Independent Auditor's Report;*
(c) SSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report;*
(d) SSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report;*
(e) SSA 570 (Revised), *Going Concern;*
(f) SSA 260 (Revised), *Communication with Those Charged with Governance;* and
(g) Conforming Amendments to Other SSAs.

[2] A listed entity is defined in the SSA Glossary of Terms as "An entity whose **shares, stock or debt** are quoted or listed on a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body."

6. SSA 701 pins a common starting point for the determination of KAMs by requiring KAMs to be **selected from matters communicated with those charged with governance (TCWG)**. Such matters are set out in paragraphs 14 to 17 of SSA 260 *Communication with Those Charged with Governance.* To enhance the starting point, SSA 260 will now require the public accountant to communicate **all significant risks identified** to TCWG as part of the planned scope and timing of the audit.

7. In the context of Singapore listed entities, these matters are typically included in the Planning Memorandum and the Summary Memorandum that are presented by the public accountant at the Audit Committee meetings.

8. After determining KAMs, the public accountant is required to communicate the KAMs with TCWG. **ACRA strongly encourages the public accountant to kick-start the process early** and communicate his preliminary views about KAMs **when presenting the 2016 audit plan to TCWG.** The public accountant may do so by determining a **preliminary list of KAMs** using prior year's audit as a basis (for a recurring engagement), updating the list for current year's developments and **drafting a description for each KAM**. This is greatly beneficial as it will:

   a) Enable TCWG to be made aware of the KAMs that the public accountant intends to communicate upfront and help them visualise how the final auditor's report will look like;

   b) Facilitate a robust two-way communication between the public accountant and TCWG where the public accountant can hear the views of TCWG and seek clarification where necessary, whilst also allowing TCWG to understand the basis for the public accountant's decisions; and

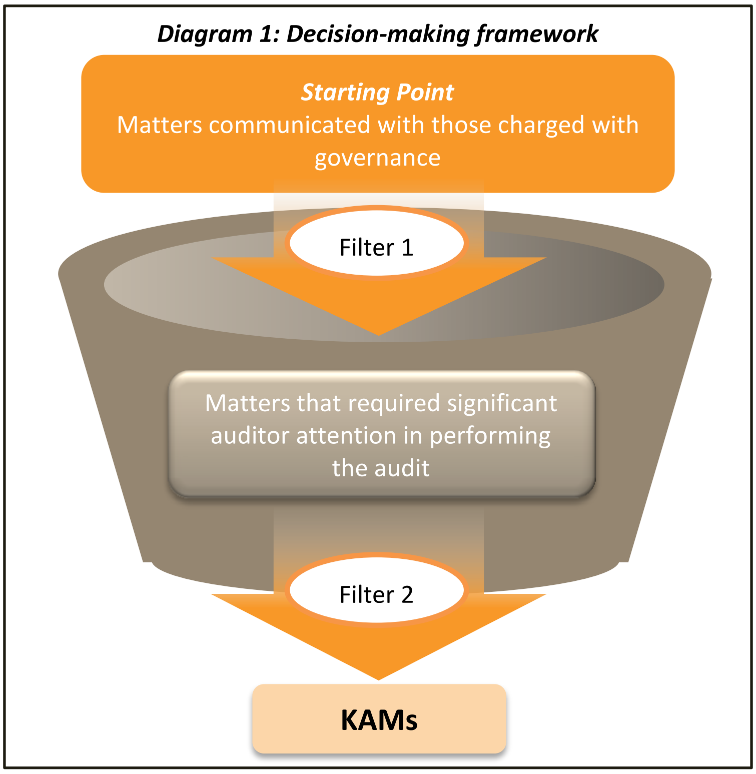
   c) Minimise any last minute surprises or timeline pressures which may occur if communication is left to the end of the 2016 audit.

9. As KAMs are to be determined **based on the actual results of the audit and audit evidence obtained**, the public accountant must take note to update the preliminary list and **present a final list of KAMs** and the descriptions to TCWG at the conclusion of the audit. He should also ensure that the **audit documentation is properly updated** to reflect changes in the KAMs determined and the reasons for those changes.

## DETERMINING KAMS – APPLYING THE DECISION-MAKING FRAMEWORK

10. SSA 701 sets out requirements to address the public accountant's professional judgement in determining KAMs. Whilst there is a certain level of prescription to achieve some consistency across reports, SSA 701 guides public accountants towards identifying KAMs that are as **entity-specific and relevant** as possible so as to enhance the communicative value of the auditor's reports.

11. ACRA has summarised the requirements of SSA 701 into a **decision-making framework** in <u>Diagram 1</u> to aid public accountants when applying professional judgement in determining KAMs.




### *Filter 1*

12. From the starting point i.e. matters communicated with TCWG, the public accountant will shortlist those matters that **required a significant amount of his attention in performing the audit**. In carrying out this first filtering exercise, SSA 701 requires the public accountant to **explicitly consider** the following:

    a) Areas of **higher assessed risk of material misstatement**, or **significant risks** identified. Public accountants should refer to SSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ACRA's Audit Practice Bulletin No. 1 of 2016[3] which set out further guidance relating to the identification of significant risks;

    b) **Significant auditor judgments** relating to areas in the financial statements that involved **significant management judgment**, including accounting estimates that have been identified as having high estimation uncertainty; and

    c) The effect on the audit of **significant events or transactions** that occurred during the period.

13. Matters of significance requiring auditor attention often relate to areas of complexity and significant management judgement that would in turn require the public accountant to make difficult or complex auditor judgement. Auditing such areas typically result in the deployment of more resources and greater work effort and involvement by senior audit team members. However, a matter need not necessarily be shortlisted simply based on

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[3] ACRA's Audit Practice Bulletin No. 1 of 2016 can be located here: https://www.acra.gov.sg/docs/default-source/default-document-library/training-and-resources/publications/audit-practice-bulletin/apbno-1of2016

the high number of audit hours incurred, which may have arisen due to non-complex factors such as geographical diversity of the group, high volume of routine transactions or large size of normal operations.

14. Having determined the matters that required significant auditor attention, the public accountant must **include these shortlisted matters in the audit documentation**.

15. Whilst SSA 701 does not require the public accountant to document his rationale as to whether each of those matters communicated with TCWG is a matter that required significant auditor attention, ACRA **strongly recommends** the public accountant to at least document his rationale for the following: **A matter communicated with TCWG that falls under one of the categories in paragraph 12 AND has not been determined to be a matter that required significant auditor attention**. Such documentation is beneficial as it will:

    a) Clearly demonstrate that the public accountant has fulfilled the requirement in SSA 701 to take into account the considerations in paragraph 12;

    b) Provide a basis for the public accountant's professional judgement especially when required to explain to the audit committee or during internal/external inspections; and

    c) Help future audit teams understand the public accountant's rationale and better assess if those rationale still apply in future audits.

***Filter 2***

16. From the shortlisted matters (i.e. those that required significant auditor attention in performing the audit), the public accountant will determine which of those matters were **of most significance in the audit of the financial statements of the current period and therefore the KAMs.**

17. Carrying out this step involves the public accountant making a **judgement about the relative significance** of the matters that have been shortlisted. Essentially, this means that the public accountant needs to **assess and compare the importance** of each matter, relative to the others, so as to identify those of most significance. In assessing the relative significance, the public accountant should bear in mind the key principle of **determining matters specific to the audit**.

18. From a documentation perspective, the public accountant is required to **include his rationale for determining whether or not each of the matters that required significant audit attention is a KAM.** In documenting the rationale, the public accountant may consider using the factors set out in SSA 701:A29 to support his judgement, including:

    a) Importance of the matter to intended users' understanding of the financial statements;

    b) Complexity or subjectivity involved in management's selection of an appropriate accounting policy compared to other entities within its industry; and

    c) Nature and extent of audit effort needed to address the matter.

19. Finally, the public accountant may use the number of KAMs identified to perform an **overall sense check**. As a general rule of thumb, the greater the number of matters initially determined to be KAMs, the more the public accountant may need to **reconsider** whether each of those matters meets the definition of a KAM. In the United Kingdom (UK), the average number of reported risks ranged from 3.1 to 4.4 with the highest number not exceeding 8[4]. It is not ACRA's intention to prescribe the number of KAMs that should be reported but reference can be drawn from the UK experience, in that auditors appear to have landed on a certain number of KAMs in a balance between utility and transparency.

## COMMUNICATING KAMS IN THE AUDITOR'S REPORT

20. For each KAM, SSA 701 requires the public accountant to describe:

    a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM;

    b) How the matter was addressed in the audit; and

    c) The reference to the related disclosures in the financial statements, if any.

21. In meeting the requirements in paragraph 20, it is imperative for the public accountant to ensure that the **descriptions are supported by the audit documentation.** For example,

    a) The description of why the matter was considered to be one of most significance in the audit **should be in line with the public accountant's rationale** when determining this matter to be a KAM from amongst those matters that required significant auditor attention; and

    b) The description of how the matter was addressed in the audit should **factually reflect the underlying audit procedures performed** and not the planned procedures or "model" procedures extracted from standard audit programs.

       For example, in auditing the existence of receivables, circularisation of audit confirmations would typically be performed and stated as one of the procedures in standard audit programs. However, there may be instances where this step was not carried out and the auditor performed other procedures instead such as checking against source contracts and subsequent receipts. In such circumstances, the public accountant must take note to describe the actual audit procedures performed.

22. More importantly, public accountants should be mindful that the communication of KAMs does not change the scope of an audit. Hence, **KAM reporting does not absolve public accountants of their responsibility if the underlying audit procedures performed were deficient in the first place.**

[4] Extracted from the UK Financial Reporting Council's publication on "Extended auditor's reports – A further review of experience."

23. Although not prescribed in the standards, ACRA also expects public accountants to bear in mind the following when describing KAMs so as to **enhance the communicative value** of the auditor's report to the end users of the financial statements i.e. the investors:

a) Avoid boilerplate and generic language – KAMs should be entity-specific

b) Explain the significance of the matter – KAMs and not KAPs (key audit procedures)

c) Use simple and less technical terms – KAMs should be concise and understandable

24. To complement KAM reporting by the auditor and provide further insights to investors, ACRA has also been **strongly encouraging TCWG to communicate its views on the significant financial reporting issues** of the listed entity and how those issues have been addressed. Such transparency enables investors to hear directly from TCWG and deepen their trust that TCWG have appropriately discharged their oversight responsibilities.

25. With greater insights provided by KAMs in the auditor's reports, public accountants should also be prepared to verbally explain KAMs and answer queries from stakeholders such as investors during the listed entities' annual general meetings.

## AN ILLUSTRATIVE EXAMPLE[5] ON DETERMINING AND COMMUNICATING KAMS

26. The following example illustrates how the decision-making framework can be applied in determining KAMs as well as how the public accountants may document the professional judgements exercised throughout the process. The example will also provide guidance on how KAMs may be described and communicated in the auditor's report.

<table>
<tr><th colspan="3">DETERMINING KAMS</th></tr>
<tr><td colspan="3"><u>Background:</u><br>The entity is in the business of property development. It also owns and invests in properties locally and overseas, predominantly in Countries X, Y and Z. Before the year- end, the entity entered into a joint venture arrangement with a third party in Country X to jointly develop a residential property. The entity also changed its group-wide accounting system during the year to improve information flows and enhance the financial statements preparation process.</td></tr>
<tr><td rowspan="3">Starting Point</td><td colspan="2">Identify matters communicated with TCWG</td></tr>
<tr><td>1. Revenue recognition from projects<br>2. Provision for foreseeable losses<br>3. Valuation of investment properties<br>4. Management override of control</td><td>→ Significant risks</td></tr>
<tr><td>5. New joint venture in Country X<br>6. Realisable value of properties held for sale<br>7. Implementation of new accounting system</td><td>→ Other focus areas</td></tr>
</table>

5 This illustrative example has been developed by ACRA to provide guidance ahead of the effective date of SSA 701. ACRA will endeavor to provide further guidance after the 2017 inspections in this area.

| **Filter 1** | **Shortlist matters that required significant auditor attention** | | | |
|---|---|---|---|---|
| | ***Shall take into account considerations in paragraph 12*** | ***Significant risks*** | ***Significant auditor/ management judgements*** | ***Significant events/ transactions*** |
| | *1. Revenue recognition from projects* | ✓ | ✓ | |
| | *2. Provision for foreseeable losses* | ✓ | ✓ | |
| | *3. Valuation of investment properties* | ✓ | ✓ | |
| | *4. Management override of control* | ✓ | | |
| | *5. New joint venture in Country X* | | ✓ | ✓ |
| | *6. Realisable value of properties held for sale* | | ✓ | |
| | *7. Implementation of new accounting system* | *Whilst not falling within considerations in paragraph 12, the audit team expended significant effort understanding the new system and the information flows that may impact the financial statements.* | | |

| | ***Matter(s) <u>NOT</u> shortlisted*** | ***Rationale***<br>*(strongly recommended to document in working papers)* |
|---|---|---|
| | *Realisable value of properties held for sale* | • *These properties were from past completed projects and brought forward from prior years i.e. no new properties added in the current year.*<br>• *During the year, the entity managed to sell off most of the properties due to successful marketing strategies, with the remaining value of unsold properties at year-end being immaterial (comprising less than 5% of materiality).*<br>• *These remaining properties have also been written down to realisable values based on comparable actual sales transactions close to the year-end.*<br>• *The audit of this matter therefore did not require significant auditor attention during the year.* |

| **Filter 2** | **Determine KAMs i.e. matters of most significance in the audit of the financial statements of the current period** | | |
|---|---|---|---|
| | ***Make a judgement about the relative significance of matters shortlisted*** | ***KAM?*** | ***Rationale***<br>*(<u>must</u> document whether or not <u>each</u> matter that required significant audit attention is a KAM)* |
| | *Revenue recognition from projects* | *Yes* | *For illustration purpose that this is a KAM only, the documentation example is not provided.* |
| | *Provision for foreseeable losses* | *Yes* | *For illustration purpose that this is a KAM only, the documentation example is not provided.* |
| | *Valuation of investment properties* | *Yes* | ***<u>Example of documenting the rationale for a KAM:</u>***<br>• *This was a significant risk of the entity. As at year-end, the investment properties contributed more than 40% of the group's total assets.*<br>• *During the year, the entity changed its property* |

| | | | |
|---|---|---|---|
| | | | *valuer for the group from XX firm to YY firm, resulting in greater audit effort to assess the objectivity, competency and scope of the valuer's work, as well as the appropriateness of the valuation methodologies used.*<br>• *As the entity's properties were largely in overseas locations, substantial amount of work were performed by component auditors who relied on property valuation experts of YY firm's branches in the respective jurisdictions.*<br>• *Consistent with prior years, significant management judgements had been applied in the assumptions and inputs in deriving at the fair values of the investment properties. This in turn required us (i.e. the auditor) to exercise greater professional scepticism and judgement in assessing the appropriateness of management's assumptions and challenging their judgements in some instances.*<br>• *We also engaged our own independent property valuers to assist in jurisdictions X, Y and Z where the significant investment properties are located.*<br>• *Extensive discussions were also held with TCWG and management in the process.*<br>• *The underlying audit documentation of the work performed can be found in sections AA of the file.*<br>• *This matter was therefore one of the most significant in the audit of the current year financial statements.* |
| | *Management override of control* | *No* | ***Example of documenting the judgement made on a matter of significance NOT shortlisted as a KAM:***<br>• *Greater consideration was given to significant risks specifically identified in the context of the entity, rather than those presumed in the auditing standards to be significant risks.*<br>• *In addition, based on prior audit experience and the results of the current year audit:*<br>  - *No instances of management override of control were noted.*<br>  - *No exceptions noted from journal entries testing.*<br>• *The new joint venture in Country X also did not give rise to new significant risks of management override of control as the group has always operated in Country X and the joint venture agreement has been tightly drafted to disallow unilateral control on the part of any one party.*<br>• *We therefore assessed this matter to be of less significance compared to the other shortlisted* |

<table>
<tr><td rowspan="3"></td><td></td><td></td><td>matters.</td></tr>
<tr><td>New joint venture in Country X</td><td>Yes</td><td>For illustration purpose that this is a KAM only, the documentation example is not provided.</td></tr>
<tr><td>Implementation of new accounting system</td><td>No</td><td><u>Example of documenting the judgement made on a matter of significance NOT shortlisted as a KAM:</u><br>• During the year, the entity implemented a new accounting system.<br>• Given that this is a major system that will directly impact the financial statements and its reliability, the audit team spent significant hours to understand the new system and the information flows that may impact the financial statements. Our internal IT specialist was also engaged to assist us.<br>• We noted that the entity engaged a professional external consultant to manage the whole implementation process. Components' management and finance staff were appropriately briefed and trained. This led to a smooth and controlled transition with little implementation issues.<br>• No major control deficiencies were identified based on our testing. There were also no difficulties encountered as the finance teams were familiar with the new system and able to address all audit queries. We compiled a list of improvement points and tabled for management and TCWG's information and consideration.<br>• Based on the above and considering the importance of this matter to the investors' (and other stakeholders') understanding of the financial statements, we assessed that this matter is of less significance compared to the other shortlisted matters.</td></tr>
<tr><td>Final KAMs</td><td colspan="3">The final list of KAMs determined is as follows:<br>1. Revenue recognition from projects<br>2. Provision for foreseeable losses<br>3. Valuation of investment properties<br>4. New joint venture in Country X</td></tr>
<tr><td colspan="4">COMMUNICATING KAMS</td></tr>
<tr><td colspan="4">For illustration purpose, "Valuation of investment properties" is used as an example. The descriptions of other KAMs identified above are not provided.</td></tr>
<tr><td colspan="4"><u>Valuation of Investment Properties</u><br>The valuation of the Group's investment properties was significant to our audit because the carrying value of $yy as at the end of the reporting period was material to the financial statements, representing over 40% of the Group's total assets. In addition, the determination of the fair values<br><br>Why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM</td></tr>
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|---|---|
| *of the investment properties was highly judgmental and required significant management assumptions and inputs, as disclosed in Note bb to the financial statements. Further details of the Group's investment properties were also disclosed in Note zz.* | *Reference to the related disclosures in the financial statements, if any* |
| *Our audit focused on ensuring the appropriateness of the fair values of the investment properties and included the following key procedures, amongst others:*<br>*(a) Assessed the objectivity and competency of the valuation experts, **YY firm, which were newly engaged by management during the year**. We evaluated their terms of appointment, scope of work and valuation methodologies.*<br>*(b) Engaged independent third-party property valuation experts to assist us for **significant investment properties located in Countries X, Y and Z**.*<br>*(c) Compared the key assumptions and inputs made by management against those that we had independently obtained. Where there were differences, we sought management's explanations and checked that the necessary adjustments were made to management's assumptions and inputs.* | *How the matter was addressed in the audit*<br><br>__Notes:__<br>▪ **The description of why the matter was of most significance to the audit is important as it distinguishes a KAM from just a mere description of the audit procedures performed.**<br>▪ **The description of how the matter was addressed should be concise and entity-specific. Avoid listing a laundry list of technically-described audit procedures.** |

## SECTION B: GOING CONCERN IN "CLOSE-CALL" SITUATIONS – __APPLICABLE TO ALL AUDITS__

27. The most significant change in SSA 570 (Revised) relates to the public accountant's responsibility in **"close call" situations**, i.e. situations where events or conditions were identified that may cast significant doubt on the entity's ability to continue as a going concern, but after considering management's plans to deal with these events or conditions, management and the auditor conclude that no material uncertainty exists.

28. SSA 570 (Revised) contains a **__new requirement__** for public accountants, in "close call" situations, **to evaluate whether the financial statements provide adequate disclosures about those events or conditions** in accordance with the financial reporting framework.

29. In the context of Financial Reporting Standards in Singapore (FRSs), **FRS 1:122** requires disclosure of the judgements management has made (in the process of applying the entity's accounting policies) that have the most significant effect on the amounts recognised in the financial statements. This would apply to judgements made by management in "close-call" situations[6].

30. ACRA acknowledges that the primary responsibility for assessing the entity's ability to continue as a going concern as well as the communication of going concern issues lie with

[6] Based on the International Financial Reporting Standards Interpretations Committee (IFRIC)'s agenda decision in July 2014

management and TCWG. Hence, the public accountant's responsibility under SSA 570 *(Revised)* is to **challenge the adequacy and quality of the disclosures in the financial statements.**

31. For example, an entity lost a principal supplier during the year i.e. an event or condition that may cast significant doubt on the entity's ability to continue as a going concern. This was, however, mitigated when the holding company:

    (a) Directed a related company to step in temporarily to provide a different but compatible type of supplies to the entity;

    (b) Negotiated with the major customers to accept changes to the products' specifications as a result of changes to the supplies; and

    (c) Concurrently sourced for another alternative permanent supplier.

    After considering the effectiveness and viability of these mitigating factors, management concluded no material uncertainty existed and the public accountant concurred with management's assessment and conclusion.

32. In such situations, the entity should ensure that there are adequate disclosures in the financial statements to describe the event or condition, the mitigating factors and the judgement management has applied so as to comply with FRS 1:122. If there are no or inadequate disclosures made in the financial statements, the public accountant should consider the implications for the auditor's report, including modifying the audit opinion where necessary.

## CONCLUSION

33. The introduction of the enhanced auditor reporting standards is the most significant development impacting the Singapore public accountancy profession in recent times. In particular, KAM reporting will increase the communicative value of the auditor's report and at the same time, draw greater scrutiny by stakeholders to the public accountant's work. Hence, public accountants should seize this opportunity to demonstrate the value and relevance of audits to the capital markets and strive to make the auditor's reports meaningful and purposeful year-on-year. To ensure proper application of the enhanced auditor reporting standards by public accountants, this area will be a focus for ACRA's practice reviews in 2017.

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|---|---|
| **Note:** | Please note that the contents of the Audit Practice Bulletin are provided for the guidance of public accountant to supplement prescribed professional standards, and include criteria that ACRA considers in evaluating the work of public accountants. They 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 must observe, maintain and apply the prescribed professional standards, methods, procedures and other requirements in carrying out the audits of financial statements. |