

AUDIT PRACTICE BULLETIN NO. 1 OF 2016

IDENTIFYING, ASSESSING AND RESPONDING TO RISKS OF MATERIAL MISSTATEMENT IN THE FINANCIAL STATEMENTS

INTRODUCTION

1. A risk assessment to identify the risks of material misstatement in the financial statements provides the foundation for the entire audit. Having determined the risks, the public accountant would then design and implement the appropriate audit procedures to respond to these risks. Singapore Standards of Auditing (“SSA”) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and SSA 330 *The Auditor’s Responses to Assessed Risks* set out the responsibilities of the public accountant when identifying, assessing and responding to risks.
2. Since ACRA’s adoption of a risk-based inspection methodology in 2014, audit inspections under the Practice Monitoring Programme (PMP) have focused on the work performed by public accountants in significant risk areas. However, ACRA observed that public accountants were unable to identify the appropriate significant risks in the first place due to the lack of a robust risk assessment process. Consequently, inappropriate and/or inadequate audit procedures were performed which did not address the underlying risks.
3. Hence the purpose of this Audit Practice Bulletin is to **provide guidance on performing the required risk assessment to identify the significant risks in an audit engagement before carrying out the necessary audit procedures to address such risks**, as well as to **emphasise the importance for public accountants to exercise a certain level of rigour and professional scepticism in the risk assessment process with illustrative examples**.

RISK ASSESSMENT PROCESS

4. A risk assessment process typically involves considering a number of factors, such as the nature of the risks, the entity’s relevant internal controls and the required level of audit evidence. SSA 315.6 specifies the risk assessment procedures to be performed to provide the public accountant with the basis for identifying and assessing risks of material misstatement. The result of the assessment effectively categorises the risks identified into:
 - a) Significant risks that require special audit consideration and responses; and
 - b) Normal risks.
5. Having identified and assessed the risks, the public accountant will design appropriate audit responses to those risks in order to obtain sufficient appropriate audit evidence on which to base his audit opinion. The risk assessment **continues throughout the audit** and the audit plan and/or procedures are revised whenever necessary.
6. In summary, the risk assessment process is broken down into three key steps:
 - a) Understanding the entity and its environment, including the entity’s internal controls;
 - b) Identifying and assessing the risks; and
 - c) Responding to identified risks.

A) STEP 1: UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

7. As part of the risk assessment process, a public accountant must gain an understanding of the entity and its environment, including the entity's internal controls. The purpose of this procedure is to enable him to identify and assess the risks of material misstatement arising from the entity's facts and circumstances [SSA 315.11], such as:
 - The nature of the entity's business;
 - The industry in which the entity operates;
 - The level of competition within that industry;
 - The entity's customers and suppliers; and
 - The regulatory environment in which the entity operates.
8. Obtaining a proper understanding of the entity and its environment is particularly important for a new audit engagement. ACRA noted instances where the public accountant simply concluded that there were no significant risks in the current year on the basis that a clean audit opinion was issued by the predecessor auditor. Public accountants should note that having **an in-depth understanding in the initial year of undertaking the audit is essential** to carry out an effective audit. It will also facilitate subsequent audits as the public accountant can incrementally build onto the robust understanding that has been established.
9. Understanding of an entity can be obtained through various means: inquiry of relevant persons, observation and inspection of processes and documentation, and performing analytical procedures on key financial and non-financial information. [SSA 315.6]
10. In most instances, ACRA noted that audit deficiencies occurred due to **a lack of understanding of the entity and its environment at the onset during audit planning stage**. The public accountants had either relied on his/her general knowledge of the industry, or on prior years' audit working papers and assumed the *status quo* for the current year's audit. As a result, **there were no significant risks identified** and audit procedures in the standard audit programmes were performed without consideration of whether any of the risks applicable to the audit engagement were significant risks.
11. In some instances, public accountants did not even meet or discuss with the entity's directors or management to corroborate their understanding of the entity before commencing the audit. ACRA noted that in these instances, the audit usually commenced after receipt of a draft set of management accounts and after an overall analytical review was performed by the audit team. However, the public accountant was not involved upfront in understanding the reasons for the fluctuations in the analytical review and did not understand the audit risks associated with the changes in the entity until the audit was completed.
12. In general, when obtaining an understanding of the entity and its environment, public accountants should at least:
 - a) **Communicate** with management and those charged with governance to understand the events and conditions of the business environment and whether changes have occurred since the previous audit that may affect the current audit, for purposes of updating the risk assessment of the entity.

- b) **Exercise a level of professional scepticism** over management's representation and corroborate the information.

B) STEP 2: IDENTIFYING AND ASSESSING THE RISKS

13. How does an auditor go about identifying and assessing the risks of material misstatement associated with an audit?
14. First, the public accountant must **identify risks** of material misstatements relevant and specific to the entity's audit, **based on** the understanding he had obtained in Step 1 and the conditions and events identified that may indicate the existence of risks of material misstatement [SSA 315 Appendix 2]. **Anchoring the risk identification process to the public accountant's understanding of the entity is critical to support the public accountant's risk assessment.**
15. Thereafter, the public accountant must **assess the identified risks** which would be broadly classified into two buckets:
 - (a) **Financial statement level** risks that relate pervasively to the financial statements as a whole and potentially affect many assertions; and
 - (b) **Assertion level** risks for classes of transactions, account balances and disclosures.
16. **Financial statement level risks** typically represent circumstances that may increase the risks of material misstatement due to fraud, for example, through management override of internal controls, which explains the importance of the understanding and assessment of the entity's management and control environment in Step 1.
17. For **risks of material misstatement at the assertion level** for classes of transactions, account balances, and disclosures, consideration of these risks has a direct bearing on the nature, timing, and extent of further audit procedures to be performed at the assertion level so as to obtain sufficient and appropriate audit evidence. As part of the assessment, the public accountant may, in some instances, conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions. [SSA 315.25]
18. Identifying such risks requires the public accountant to exercise considerable professional judgement and skills and more importantly, **the ability to relate how these risks potentially impact the recognition, measurement, presentation and disclosure in the financial statements**, such as the assertions on completeness, existence, accuracy (including cut-off), valuation, occurrence, or rights and obligations, and presentation. [SSA 315.26 and 27]
19. After assessing the financial statement level and assertion level risks, the public accountant must **further determine whether any of the identified risks are significant risks**. In exercising judgement on **which risks are significant risks**, the public accountant shall at least consider [SSA 315.28]:
 - a) whether the risk is a fraud risk;
 - b) whether the risk is related to recent significant economic, accounting or other developments and therefore requires specific attention;
 - c) the complexity of transactions;
 - d) whether the risk involves significant transactions with related parties;

- e) the degree of subjectivity in the measurement of financial information related to the risk; and
 - f) whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.
20. For example, in assessing the significance of the risk in the valuation assertion of a long-lived asset (such as investment in a subsidiary with indicators of impairment), the public accountant should consider that ascertaining the recoverable amount involves the use of fair values or discounted cash flow projections which are susceptible to management estimates due to assumptions used. Hence, this poses a significant risk of material misstatement to the financial statements.
21. As part of the risk assessment process, public accountants should note that a material balance need not necessarily translate to a significant risk. Likewise, a significant risk need not be associated with a material balance. For example, there may not be a significant risk related to the accuracy assertion of a material property, plant and equipment (PPE) balance because ascertaining the accuracy of PPE is neither complex nor subjective. On the contrary, the year-end accruals balance may not be material, but the completeness assertion for accruals may be a significant risk due to a high staff turnover in the accounting payables department.
22. Whilst the identification and assessment of significant risks requires the exercise of professional judgement, public accountants should not go under this guise and assert that a particular area and/or assertion is not a significant risk without any reasonable basis. In deciding whether a public accountant's assessment is appropriate, ACRA would ordinarily adopt the test of whether a group of reasonably experienced public accountants would also agree on the same basis to reach the same professional judgement on the significance of the risks.

C) STEP 3: RESPONDING TO IDENTIFIED RISKS

23. After identifying and assessing the risks of material misstatements, the public accountant is required to design and implement appropriate audit procedures in response to the identified risks to obtain sufficient appropriate audit evidence on which to base his opinion on the financial statements.
24. In general, to address a significant risk, the public accountant must perform substantive procedures that are **specifically responsive** to that risk. Such procedures are usually customised according to the unique circumstances. This typically means that the public accountant has to be involved right at the start of the audit. ACRA noted that this was often not the case for public accountants that audit non-public interest entities and that resulted in downstream issues as the audit team were not adequately supervised to perform the appropriate audit procedures.

AN ILLUSTRATIVE EXAMPLE OF THE THREE-STEP APPROACH TO RISK ASSESSMENT

25. Table 1 presents an example which demonstrates how the **three-step approach in the risk assessment process** (mentioned in paragraph 6 above) can be applied to allow better appreciation of the importance of identifying and assessing the risks of material misstatements in an audit.
26. The example would also illustrate how an inappropriate identification and assessment of significant risks would have a cascading impact on the work performed and how further specific audit procedures may be designed to address the identified significant risks so that sufficient appropriate audit evidence would be obtained to base the opinion on the financial statements.

Table 1: Illustrative example of the three-step approach in the risk assessment process

Case Facts:

Principal activities

Trader of natural gas, gas turbine engine and supplier of main line steel pipelines for oil and gas projects

Background information

- 1) Company A had no office in Singapore and all the accounting records were maintained in Country R (a country which is low on the Transparency International Corruption Index)
- 2) Revenue in FY2014 was derived solely from the sales of gas turbine engines whereas FY2015 included a new stream of revenue – sale of natural gas
- 3) Sale of natural gas made up 85% of FY2015 revenue
- 4) Natural gas was sold on a back-to-back basis i.e. Company A would purchase the natural gas only upon the receipt of a sales order from customers. In FY2015, natural gas was supplied by Company A's sole supplier and sold to its sole natural gas customer. Both the supplier and the customer were operating in Country R
- 5) Cash from the sale of natural gas was maintained outside of Singapore and that receipts, payments and active bank accounts were not maintained in Country R but in two eastern European countries, Countries N and P
- 6) No inventory was maintained by Company A as the natural gas was shipped directly from the supplier to the customer
- 7) Margins for gas sales varied between 8.9% to 12.2%

Financial information

	FY2015	FY2014
	US\$'000	US\$'000
Revenue	495,200	3,500
Cost of goods sold	(447,661)	(3,395)
Gross profit	47,539	105
Gross profit margin (%)	9.6%	3%
Net profit	12,044	23

	What was performed	What should have been performed
<p>Step 1: Understanding the entity and its environment</p>	<ul style="list-style-type: none"> • Brought forward a document prepared in FY2011 which stated that the entity was in the business of trading of gas pipes • Brought forward from FY2014 a document on the review of design of controls over: <ul style="list-style-type: none"> - sales – the process of receiving customer’s purchase orders for raising a sales invoice - purchases – the process of raising purchase orders upon receipt of customer’s orders and supplier’s invoice being matched with purchase order • Noted that there was a new revenue stream that was back-to-back in nature. Did not obtain further in-depth understanding 	<ul style="list-style-type: none"> • Perform an analytical review to obtain an understanding on the huge increase in revenue in FY2015 • For the new revenue stream identified, to understand <ul style="list-style-type: none"> - the business rationale and strategy e.g. reasons for buying and selling through the Company (based in Singapore) when both the sole supplier and customer are operating in Country R - if supplier and customer are related parties - the revenue recognition policy e.g. type of source documents used to recognise and record the transactions - the controls in place over the new revenue stream e.g. how the natural gas was physically transported and how prices were determined
<p>Step 2: Identifying and assessing the risks</p>	<ul style="list-style-type: none"> • For the sale of natural gas (new revenue stream), rebutted the presumption that revenue recognition was a significant risk due to fraud on the basis that transactions were carried out on a back-to-back basis <p><u>Key deficiency in Step 1 and cascading effect on Step 2:</u></p> <ul style="list-style-type: none"> • Failure to obtain an appropriate and sufficient understanding of the sale of natural gas resulted in an inability to recognise the significance of the risks associated with this new revenue stream • Led to an inappropriate rebuttal of the presumed significant risk of revenue recognition due to fraud 	<ul style="list-style-type: none"> • Should not rebut the presumption that revenue recognition for natural gas was a significant risk due to fraud • Instead, occurrence and cut-off of revenue recognition for natural gas should be identified as significant risks <u>due to the complexity in the purchase, sale and accounting for the transactions</u>, including: <ul style="list-style-type: none"> - Cash being held in Countries N and P - No physical inventories maintained with Company - Transactions and accounting records in Country R

	What was performed	What should have been performed
<p>Step 3: Responding to identified risks</p>	<ul style="list-style-type: none"> • Performed sales transaction test <ol style="list-style-type: none"> 1. Traced 30 sales invoices to the bill of lading 2. Traced posting to receivables' ledger, sales ledger and inventory ledger 3. Traced receipts posting to receivables' ledger and cash book account • Performed purchases transaction test <ol style="list-style-type: none"> 1. Traced 30 purchases to source documents (duly acknowledged Railway/Airway bills) and ensured that they were properly authorised 2. Traced to suppliers' invoices and checked mathematical accuracy 3. Traced posting to payables' ledger and cash book ledger 4. Traced quantities to inventory ledger for goods received in store • Performed sales cut-off test on all streams of revenue by selecting the last five transactions before year end and the first five transactions after year end. However, none of the samples selected were for the sale of natural gas <p><u>Work performed was ineffective as risks associated with the new revenue stream were not addressed</u></p> <ul style="list-style-type: none"> • The audit procedures appeared generic • It seemed strange that natural gas was transported via rail or air • Also, since purchases were sent directly to the customer, it was questionable how the engagement team was able to verify the receipt of natural gas into store. 	<ul style="list-style-type: none"> • Assess the appropriateness of the revenue recognition policy in accordance with requirements in FRS 18 <i>Revenue</i> by reviewing the respective contracts between the Company and the supplier and customer. E.g. ascertain the risks and rewards the Company bore in the purchase and sales transactions to determine if revenue should be recognised at gross or net • Determine if the customer and supplier are related parties by performing background checks. Such checks also serves to corroborate management's representation • For test of details, ensure that procedures are designed to be specifically responsive to the significant risks identified e.g. <ul style="list-style-type: none"> - Trace the quantities sold in the sales invoice to the supplier's invoice to ensure that transactions were indeed carried out on a back-to-back basis - Review the flow of payment made to the supplier and the flow of payment received from the customer for the purchases and sales respectively. - Check names of parties payments were made to, and the same for parties whose receipts were from - Ensure cut-off test include the sale of natural gas

REVISION OF RISK ASSESSMENT

- 27. In addition, during the course of audit, if the public accountant obtains audit evidence or additional information which is inconsistent with the original audit evidence used to perform an earlier risk assessment, the public accountant should re-assess the risks of material misstatement at the assertion level [SSA 315.31].
- 28. The re-assessment may lead to the identification of conditions and events that may indicate a significant risk of material misstatement. In the event this happens, the public accountant should re-assess and consider upgrading the risk from a normal risk to a significant risk as illustrated *in Tables 2 and 3*.

Table 2: Illustrative example on the re-assessment of risks based on new evidence or information obtained during the course of audit – revenue recognition (cut-off)	
<p>Case Facts:</p> <ul style="list-style-type: none"> • Entity was engaged in mining activities. Noted that mining activities were usually slow or shut down in the months of July, August and December due to weather conditions. In addition, mining outputs were expected to be low in the last quarter (October to December) of the year based on historical trends • Based on understanding above, the occurrence of revenue was identified as a significant risk due to fraud during the planning stage <p><u>New Information</u></p> <ul style="list-style-type: none"> • Upon receipt of the full-year revenue transactions, noted that actual sales for the single month of December 2015 were much higher than the average quarterly sales 	
Work performed	What should have been performed
<ul style="list-style-type: none"> • Despite the unusually high sales volume in the month of December 2015, the public accountant did not consider that the new information was inconsistent with his original understanding used to perform the earlier risk assessment • Accordingly, no re-assessment of risks was performed and cut-off of revenue recognition remained as normal risk 	<ul style="list-style-type: none"> • Understand the reasons for the unusually high sales volume in the month of December 2015 • Re-assess the risk of an inappropriate revenue cut-off, taking into consideration the low level of mining activities prior to December 2015 • Elevate the risk relating to the cut-off of revenue recognition from normal to significant, <u>given that there is a potential fraud risk associated with revenue recognition</u>

Table 3: Illustrative example on the re-assessment of risks based on new evidence or information obtained during the course of audit – impairment of plant and equipment and inventories obsolescence

Case Facts:

- Entity is a manufacturing Company. Noted during the audit planning in November 2015 that the Company was profit-making. Hence, revenue recognition and the recoverability of trade receivables were identified as significant risks.

New Information

- During the audit, noted that one major customer would be discontinuing the sale of a product (“Product Z”- which the Company was contracted to manufacture) from January 2016

Work performed	What should have been performed
<ul style="list-style-type: none"> • Despite noting the discontinuation of Product Z by a major customer, the public accountant did not consider that the new information was inconsistent with his original understanding used to perform the earlier risk assessment • Accordingly, no re-assessment of risks was performed and impairment of plant and equipment and inventories obsolescence remained as normal risk <p><u>Impact on audit procedures:</u></p> <ul style="list-style-type: none"> • Did not carry out an impairment assessment on the plant and equipment on the basis that the Company was profitable as at year-end • Based on the Company’s accounting policy, performed a review of obsolete inventories aged 9 months and above. However, did not assess the need to provide for obsolescence on the raw materials used for the production of Product Z 	<ul style="list-style-type: none"> • Consider how the discontinuation of Product Z would potentially result in impairment of the customised plant and equipment and inventory obsolescence for specialised raw materials specifically used for the production of Product Z (which was discontinued). This is notwithstanding that the Company remained profitable as a whole • Elevate the risks of impairment of customised plant and equipment and obsolescence of specialised raw materials (specific to Product Z) from normal to significant <u>given that there would be a high degree of subjectivity associated with the valuation of customised plant and equipment and specialised raw materials</u> <p><u>Impact on audit procedures:</u></p> <ul style="list-style-type: none"> • Perform an impairment assessment of the customised plant and equipment by reviewing the assumptions and estimates used by management to derive the recoverable amount • Perform a review of the specialised raw materials and assess any write-off or write-down to net realisable value

RISK ASSESSMENT IN A GROUP AUDIT SITUATION

29. When acting as a group engagement partner, the public accountant is required to **assess, at group level, the risks of material misstatement of the group financial statements**. Such an assessment should be based on the public accountant’s understanding of the group, its components and their environments, including an understanding of the consolidation process and group-wide controls. In assessing the risks, the public accountant should also consider information obtained from the component auditors. ACRA noted instances where the public accountant only performed risk assessment on the holding company’s stand-alone financial statements and had failed to do so at the group level.
30. If **significant risks** of material misstatement of the group financial statements have been identified, the public accountant must **communicate** the relevant significant risks to the component auditor and **evaluate the appropriateness of the audit procedures** to be performed to respond those risks. Public accountants should then comply with the requirements in SSA 600 *Special Considerations Audits of Group Financial Statements (Including the work of Component Auditors)* and take guidance from ACRA’s Audit Practice Bulletin No 1 of 2015 on Group Audits.
31. **Table 4** shows an example of how public accountants may perform risk assessment in a group audit situation.

Table 4: Illustrative example on risk assessment in a group audit situation

Case Facts:

Principal activities

Company C: Provider of general sub-contractor services in Singapore

Subsidiary X: Trader of plastic moulding machines and spare parts in Malaysia

Background information

- 1) Subsidiary X, a wholly-owned subsidiary of Company C, was audited by the component auditors in Malaysia (“Component Auditor H”)
- 2) Company C provided sub-contracting services to construction companies, and revenue recognised was based on the percentage of completion (“POC”) for each project using the cost-to-cost method. There was only one ongoing project as at the end of FY2015.
- 3) Subsidiary X sold mainly to markets in Malaysia and Singapore. For the year ended 31 December 2015, 76% of the sales were to the Malaysia with the remaining 24% to the local market in Singapore.
- 4) Revenue in FY2015 had declined due to a slowdown in the economy and the manufacturing sector. Subsidiary X also lost several major customers in Malaysia towards the end of the financial year.
- 5) Contribution to FY2015 inventories: Company C (9%) and Subsidiary X (91%)

Consolidated Financial information

	FY2015 US\$’000	FY2014 US\$’000
Revenue	194,800	218,400
Net profit	655	2,300
Inventories	6,500	4,600
Inventory Turnover (in days)	195 days	79 days

Work performed	What should have been performed
<ul style="list-style-type: none"> • Risk assessment performed only at the Company level • No risk of material misstatement on inventories was identified as the company-level inventory balance at year-end was immaterial • There was no consideration of risks of material misstatement of the group financial statements 	<ul style="list-style-type: none"> • Risk assessment should be performed at the group level. Based on the longer inventory turnover days and slow-down in the industry, stocks may be slow-moving or obsolete. Coupled with the loss of several major customers, there may be a significant risk of material misstatement related to the valuation of inventories, <u>as the significant economic deterioration may have material impact on the group which requires specific attention</u> • Given that majority of the group’s inventories are held with Subsidiary X, the public accountant should perform the following work: <ul style="list-style-type: none"> - Communicate the significant risk of inventory valuation with Component Auditor H - Issue group reporting instructions to Component Auditor H to audit and report based on the identified significant risk - Evaluate the appropriateness of the audit procedures to be performed to respond to the risk

DOCUMENTATION

32. Finally, work is deemed not performed if there is no record to show for it. Hence, for each of the three steps highlighted in paragraph 6, the public accountant needs to ensure that there is proper audit documentation as required by SSA 230 *Audit Documentation* to allow an experienced auditor, having no previous connection with the audit, to **understand the basis** of the public accountant’s risk identification and assessment, which should be **supported by the public accountant’s understanding of the entity and its environment, including internal control.**
33. During our inspections, ACRA noted that the various preparatory work on gathering information and risk considerations could be documented in different sections of the audit file. Whilst ACRA does not have a prescribed format of how the risk assessment process should be documented, we encourage engagement teams to prepare **an overall summary** to facilitate the review by the public accountant, which should include the following:
- a) Key points noted after obtaining an understanding of the entity;
 - b) Assessment of what could go wrong, taking into consideration the factors in paragraph 19, and therefore identified as significant risks;
 - c) Specific audits responses to address the significant risks identified; and
 - d) Results of the work performed.

CONCLUSION

34. Risk assessment is an important step to an efficient and effective audit. Due to the complexity of transactions, the high level of professional judgement and scepticism exercised, this assessment process requires the public accountant to be involved right from the start to the completion of the audit. The risk assessment process continues throughout the audit and the audit plan and procedures are revised when a re-assessment is necessary.
35. Through this process, the public accountant would be able to focus the audit on the risks which have the potential to materially affect the financial statements and obtain the appropriate evidence on which to base his opinion.
36. With major changes in the economic environment impacting developments in many of the entities, **a more robust and detailed risk assessment is necessary to ensure that the audits are better focused on risks which matter most**, and that public accountants are responding appropriately to these risks by carrying out the appropriate audit procedures.
37. The introduction of key audit matters in the auditor's report under SSA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, applicable for audits of listed entities for the year ending on or after 15 December 2016, also makes it an imperative that the risk assessment process is performed well as key audit matters are "distilled" from areas of significant risks. ACRA will continue to monitor the deficiencies that arise from a lack of a proper risk assessment.

Note: Please note that the contents of ACRA's Audit Practice Bulletins are provided for the guidance of public accountants to supplement prescribed professional standards, and include criteria that ACRA considers in evaluating the work of public accountants. They are not rules of ACRA and are not intended to serve as a substitute for the relevant auditing standards. Public accountants must observe, maintain and apply the prescribed professional standards, methods, procedures and other requirements in carrying out the audits of financial statements.