

AUDIT PRACTICE BULLETIN NO 2 OF 2011

AUDIT CONSIDERATIONS IN AN UNCERTAIN ECONOMIC ENVIRONMENT

13 December 2011

1. In light of the current uncertain global economic environment and its potential impact on businesses and financial reporting, it is important that public accountants exercise extra vigilance and rigor, with heightened professional scepticism, when conducting the coming year-end audits.
2. The Audit Practice Bulletin (“APB”) No. 1 of 2009 *Audit Considerations in the Current Economic Environment* issued on 16 March 2009 during the last economic downturn has highlighted several areas of concerns in the audit of financial statements which public accountants should take note of. Public accountants should continue to refer to the APB for guidance. However, it should be noted that APB No. 1 of 2009 was prepared based on the extant Singapore Standards of Auditing (“SSAs”) which has since been replaced by the clarified SSAs applicable for audits of financial statements for periods beginning on or after 15 December 2009. The clarified SSAs have retained most of the provisions referred to in APB No. 1 of 2009 and in some cases, enhanced the requirements. When using APB No. 1 of 2009, public accountants should refer to the requirements of the clarified SSAs.
3. Apart from the areas outlined in APB No. 1 of 2009, there are also other areas which have become more significant when performing audits in difficult or uncertain economic conditions. This bulletin will highlight some of these areas as well as areas which have been covered in past APBs¹ issued by ACRA. These include:
 - Communicating with clients
 - Fraud considerations
 - Impairment of non-financial assets
 - Financial statement disclosures
 - Subsequent events
 - The independent auditor’s report
 - Involvement in the audit

¹ Past APBs can be found at <https://www.acra.gov.sg/training-and-resources/publications/bulletins-and-guidance>

Communicating with Clients

4. In times of economic uncertainty, there is a greater need for regular communication with management and those charged with governance (including directors and audit committees) throughout the audit process in order to resolve issues impacting financial reporting on a timely basis.
5. Some of the matters to be covered in such communication with management and/or those charged with governance include:
 - An understanding of the entity and its environment and how the current economic conditions have affected the entity and how management is responding to these conditions. This enables public accountants to plan the necessary audit procedures to address areas of concern adequately and in a timely manner.
 - Material weaknesses in the design or implementation of internal controls, which the audit engagement team became aware of, that may give rise to possible material misstatement in the financial report or may indicate significant doubt about whether the entity is a going concern. This enables those charged with governance to take timely remedial action to minimise the risks of any material misstatement. Public accountants should also be mindful that paragraph 5 of SSA 265 *Communicating Deficiencies in Internal Control to those Charged with Governance and Management* requires the auditor to communicate appropriately, to those charged with governance and management, deficiencies in internal controls that the auditor has identified during the audit and that, in the auditor's professional judgement, are of sufficient importance to merit their respective attentions.
 - The evaluation of accounting estimates that are material to an entity's financial report. This enables public accountants to obtain reasonable assurance that (a) those charged with governance have been appropriately informed about the financial reporting process adopted by management and (b) consistent information on the accounting estimates are presented to management and those charged with governance.
6. Public accountants should refer to SSA 260 *Communication with Those Charged with Governance* for more guidance on the matters to be communicated to management and to those charged with governance.

Fraud Considerations

7. The pressure on some companies, operating in an uncertain and difficult economic environment, to deliver a set of financial numbers which meet targets and expectations may bring about an increased risk of misstatements resulting from fraudulent financial reporting. Fraudulent financial reporting often involves management override of internal controls which may otherwise be operating effectively. This may include management making inappropriate adjustments to assumptions, changes to judgements used on estimates and adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.
8. Paragraph 12 of SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the auditor to maintain professional scepticism throughout the audit and to recognise the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. Public accountants should adopt a heightened sense of professional scepticism and consider the increased risk associated with the potential increase in pressure on management.
9. A risk of material misstatement due to fraud includes the risk of management override of controls. Paragraph 32 of SSA 240 states that irrespective of the auditor's assessment of the risks of management override of controls, auditors shall design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements; review accounting estimates for biases and evaluate the business rationale of significant or unusual transactions that are outside of the normal course of business.

Impairment of Non-Financial Assets

10. The economic slowdown may have a negative impact on a company's profitability and its cash flows from non-financial assets and increase the likelihood of assets impairment where the carrying amounts of assets are greater than the present values of expected cash flows from the assets. Management may no longer be able to provide evidence that there has been no indication of impairment and may need to perform detailed impairment testing which could involve the preparation of cash flow projections.
11. When evaluating the assumptions and data used in cash flow projections prepared by management, public accountants are reminded of the need to *critically* assess the assumptions used by management in preparing the forecasts (such as revenue growth

rates, profit margins, terminal values and discount rates) to ascertain if they are reasonable and supportable and consistent with market evidence. Such assessments should be documented in the engagement files to support the audit conclusion reached.

12. The cash flows used for impairment testing should be based on the most recent business plan that reflects the expected impact of the economic slowdown. Public accountants should check that the cash flow projections given by management for impairment purposes are consistent with the budgets that are presented to management and those charged with governance.
13. Public accountants should refer to APB No. 2 of 2010 *Impairment of Non-Financial Assets* which discusses the main findings in the area of impairment testing of nonfinancial assets noted during ACRA's Practice Monitoring Programme reviews.

Financial Statement Disclosures

14. Paragraph 1 of the Singapore Financial Reporting Standards 107 *Financial Instruments: Disclosures* requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks. This includes disclosures regarding risks and uncertainties, concentrations of credit risk and contingent liabilities. The uncertain economic environment may increase the likelihood of incomplete or inaccurate disclosures particularly those which are more qualitative, judgemental or complex in nature.
15. Public accountants should perform audit procedures to assess the adequacy of management's disclosures (both qualitative and quantitative) in the financial statements. Public accountants should provide additional supervision to the engagement team over the audit of disclosures that are qualitative, judgemental or complex.

Subsequent Events

16. The uncertain economic environment can cause financial conditions to change rapidly. Events occurring after the date of the financial statements such as new or changes in commitments, borrowings, credit ratings, increases in capital, issuance of debt instruments, developments regarding contingencies and key risk areas may indicate a

need for management to make adjustments or provide additional disclosures in the financial statements.

17. Paragraph 6 of SSA 560 *Subsequent Events* requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
18. Public accountants should also take note of the requirement provided in SSA 560 in situations when facts become known to the auditor (a) after the date of the auditor's report but before the date the financial statements are issued; or (b) after the financial statements have been issued.

The Independent Auditor's Report

19. The global economic slowdown and uncertainties are likely to present more challenges for businesses and those involved in financial reporting. Circumstances may arise which render the need to issue a modified audit opinion. For example, where the going concern assumptions become inappropriate and the assets and liabilities are not recorded on the basis in which the assets are realised and liabilities discharged or where the material uncertainties about an entity's ability to continue as a going concern are not disclosed in the financial report. Paragraph 28 of SSA 705 *Modifications to the Opinion in the Independent Auditor's Report* states that when the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance, the circumstances that led to the expected modification and the proposed wording of the modification.
20. Para A25 of SSA 705 notes that communicating with those charged with governance enables the auditor to seek concurrence regarding the facts of the matter giving rise to the expected modifications and enables those charged with governance to have an opportunity to provide the auditor with further information and explanations in respect of the matters giving rise to the expected modifications.

Involvement in the Audit

21. ACRA has reminded the profession on many occasions that there needs to be substantive and timely involvement of experienced auditors (engagement partners and engagement quality control reviewers) throughout an audit. Public accountants must be adequately involved in directing, supervising and reviewing the audit work of the engagement team.

22. ACRA has also issued APB No. 1 of 2011 *Engagement Quality Control Review* which sets out guidance on the role of the engagement quality control reviewer. The engagement quality control review serves as a safeguard in ensuring that the audit risks have been appropriately addressed and the audit opinions issued are correct and sufficiently supported. It is important for the engagement quality control reviewer to be involved in the audit engagement in a timely manner so as to provide effective support to the engagement partner in ensuring that significant matters are promptly resolved before the date of the audit report.

Conclusion

23. This bulletin serves to remind the profession of the potentially higher risks of material misstatements in financial reports during uncertain economic times as compared to when economic conditions are more favourable. Public accountants would need to exercise vigilance, professional scepticism and judgement when performing the audit procedures to address the identified risk areas.

Note: Please note that the contents of the Audit Practice Bulletin 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 the Accounting and Corporate Regulatory Authority 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.