



# **PRACTICE MONITORING PROGRAMME**

## **SEVENTH PUBLIC REPORT**

**August 2013**

The Accounting and Corporate Regulatory Authority (“ACRA”) is the national regulator of business entities and public accountants in Singapore. ACRA also plays the role of a facilitator for the development of business entities and the public accountancy profession. The mission of ACRA is to provide a responsive and trusted regulatory environment for businesses and public accountants.

#### Scope/Disclaimer

ACRA’s oversight of the profession has been stringent and its inspection methodologies have evolved to be more rigorous but also more targeted and risk based. Therefore the observations in this report, while raising some concerns, reflect a rigorous approach and a high benchmark reflecting the need to maintain a high degree of confidence in the financial information that underpins Singapore’s markets.

In presenting the specific findings in this report, efforts have been made to provide as much of the context as possible under which these findings arose in the PMP. The findings should not be read in isolation or regarded as creating mandatory rules in addition to the auditing standards. Public accountants should read and assess the applicability and severity of each of the findings in the broader context of upholding the profession’s standards and in careful consideration of the uniqueness of individual audit engagements.

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#### Acronyms

AARG	ASEAN Audit Regulators Group	FRS	Financial Reporting Standards
IFIAR	International Forum of Independent Audit Regulators	PAOC	Public Accountants Oversight Committee
PIE	Public Interest Entity	PMP	Practice Monitoring Programme
SSA	Singapore Standard on Auditing	SSQC 1	Singapore Standard on Quality Control 1

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# 1 EXECUTIVE SUMMARY

## Strengthening the Financial Reporting Value Chain – A Collective Responsibility

- 1.1 The Southeast Asia region is increasingly seen as a major economic growth force in Asia. In a recent speech by the Minister for Trade and Industry in June 2013, Mr Lim Hng Kiang cited a 2013 Global Manufacturing Competitiveness Index report<sup>1</sup> which predicted that five of the top fifteen manufacturing locations in the world will be in ASEAN<sup>2</sup> by 2018. One of Singapore's competitive advantages is its reputation as a **trusted financial and business hub**. Hence, Singapore has to maintain a healthy and trusted financial eco-system to seize growth opportunities as they arise.
- 1.2 As the financial and business landscape rapidly evolves, fast-paced developments in the accounting, auditing and financial reporting framework are also taking place. For example, in responding to investors' calls for greater transparency of financial information and auditor insights into significant audit issues and judgements, the International Auditing and Assurance Standards Board ("IAASB") is currently exploring changes to the auditor reporting standards<sup>3</sup>. Essentially, the primary objective underlying these developments remains unchanged, that is to enhance **trust and public confidence in the integrity of financial information**.
- 1.3 **High quality financial reports** are essentially a **collective responsibility**, predicated on the joint and inter-dependent efforts of all stakeholders in the financial reporting eco-system such as the **preparers, directors, auditors, audit committees, and regulators**. ACRA believes each stakeholder has an equally important role to play. Directors and preparers need to take responsibility for coming up with a good set of financial statements and auditors have to carry out their audits diligently. Similarly, audit committees have to oversee the financial reporting and audit process, including the selection of auditors. Lastly, regulators must exercise robust oversight by monitoring and enforcing non-

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<sup>1</sup> The 2013 Global Manufacturing Competitiveness Index report published by Deloitte Touche Tohmatsu can be accessed at [http://www.deloitte.com/view/en\\_GX/global/industries/manufacturing/global-competitiveness/index.htm](http://www.deloitte.com/view/en_GX/global/industries/manufacturing/global-competitiveness/index.htm)

<sup>2</sup> The 5 ASEAN countries are Singapore, Vietnam, Indonesia, Malaysia and Thailand.

<sup>3</sup> In July 2013, the IAASB issued an exposure draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* to seek views from stakeholders in relation to its proposals to enhance auditor reporting globally. The proposals are build upon the indicative direction set out in its 2012 consultation document titled *Invitation to Comment: Improving the Auditor's Report*.

compliance, thereby maintaining the integrity and quality of the financial reporting value chain.

- 1.4 Recognising the inter-dependency amongst the various stakeholders in producing reliable financial reports, ACRA adopts a **holistic regulatory approach** that encompasses three key functions of the financial reporting value chain; namely the **preparation, audit** and **filing** of financial statements. In carrying out its regulatory and engagement initiatives, ACRA will continue its efforts to ensure an effective and responsive regulatory environment to enhance the standing of Singapore as a trusted financial and business hub.

## ACRA and the Public Accountancy Profession

- 1.5 Within the financial reporting value chain, the public accountancy profession assumes the role of a guardian overseeing the integrity of financial reports. This is achieved through the performance of quality audits by the profession. As an independent auditor regulatory authority, ACRA conducts the PMP<sup>4</sup> inspection as well as other regulatory activities to ensure audit work performed by the profession is up to the required standards.
- 1.6 In May 2013, ACRA, together with the independent audit regulators from Malaysia and Thailand, held a periodical dialogue with the regional leaderships of the Big-Four audit firms<sup>5</sup>. This meeting was also attended by leaders from the global audit firms. Two key issues discussed were the state of audit talent in the ASEAN region and the need to raise audit quality of financial reporting amongst ASEAN companies. This periodical dialogue will continue as audit regulators and audit firms work together towards addressing common audit quality challenges.
- 1.7 The key findings arising from the PMP are reported under two broad segments of ACRA's inspection activities; inspection of audits of public interest entities<sup>6</sup> ("PIEs") and non-PIEs. Besides findings on engagement inspections in both segments, information in the PIE segment includes **sharing of good practices** noted from ACRA's review of firms' quality control policies and procedures

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<sup>4</sup> Further information about the PMP, its scope and activities can be found in Section 2 of this Report.

<sup>5</sup> Comprising Deloitte & Touche LLP, EY LLP, KPMG LLP and PwC LLP.

<sup>6</sup> The current definition of PIEs include companies listed on the Singapore Exchange or are in the process of issuing debt or equity instruments for trading on the Singapore Exchange, entities in regulated financial industries (such as banks, insurance companies, funds, fund managers and securities/brokers/dealers), and other entities which raise funds from the public (such as charities, Institutions of a Public Character and religious organisations).

against the Singapore Standard on Quality Control 1<sup>7</sup> (“SSQC 1”) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.

### *Firm-level Reviews in the PIE Segment*

- 1.8 Having completed two cycles of the PIE segment firm-level reviews since 2007, ACRA has seen **commendable improvements** made by firms in implementing and enhancing their systems of quality control over time. Notwithstanding this, each firm is progressing at a separate pace, with some showing greater improvement than others. Additionally, areas of strengths and weaknesses amongst each SSQC 1 element differ amongst firms. ACRA noted that better performing audit firms analyse the results of reviews to determine root causes and implement effective actions.
- 1.9 This year’s report provides insights into the practical policies and procedures which have proven effective in shaping the right behaviours and driving the execution of quality audits amongst firms. Some notable ones include:
- **Clearer linkage of partner compensation schemes to audit quality;**
  - Dedication of **appropriate resources** to support the firm’s **quality control functions**; and
  - Implementation of **review programmes** which allow for more **timely monitoring of audit quality**.

### *Engagement Inspections in the PIE segment*

- 1.10 In this year’s report, ACRA focused on deficiencies arising from the two most prevalent areas of inspections over the last twelve months, namely:
- *Audits of Cash Flow Forecasts*  
In this complex and judgmental area, deficiencies often arise from the **lack of challenge and assessment** by public accountants on **management’s key assumptions** made in cash flow projections such as growth rate forecasts, cost structures and discount rates. Many of these findings reflect the engagement team’s lack of understanding and appreciation of the requirements of the financial reporting and auditing standards.

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<sup>7</sup> The SSQC 1 is based on the equivalent of the International Standard on Quality Control 1 issued by the IAASB.

- *Audits of Inventories*

Increased complexity of product offerings, sourcing and manufacturing demands have bearings on how inventories are accounted for and hence audited. Failure to adequately consider these implications has resulted in findings in the area of **inventory valuation**, for example, in respect of product bundling arrangements, and **inventory existence**, particularly for inventories held at third party locations.

Given the recurrent nature of these deficiencies, ACRA urges public accountants to place greater emphasis towards identifying their root causes and implementing appropriate and sustainable action plans to resolve these root causes.

### *Engagement Inspections in the Non-PIE Segment*

1.11 Inspections on firms in the non-PIE segment are carried out with the assistance of the Institute of Singapore Chartered Accountants (“ISCA”)<sup>8</sup> with oversight by ACRA. As in previous years, our inspections continue to reveal **recurring and common weaknesses** in the areas of inventory, income statement items such as purchases and sales cut-off tests, construction work-in progress and trade receivables. As such, ACRA finds it **unacceptable** that such lapses continue to recur year after year.

1.12 In this year’s report, ACRA also discusses the gravity of firms operating in a high workload volume practice model and how this systemic threat affects audit quality. ACRA has observed the tendency for public accountants to fail the PMP in instances where public accountants are faced with significant client loads or have unreasonably high concentration of clients with the same financial year-end. Firms are urged to deliver quality audits to showcase the value it brings and charge fees which commensurate with the true value of their work.

### **Initiatives Available to Help the Profession**

1.13 Accountancy professional bodies play an essential role in supporting their members and the profession at large in upholding professional standards in their work. As such, ACRA encourages the accountancy professional bodies to continue their efforts to help public accountants improve and remediate audit deficiencies identified in the PMP inspections.

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<sup>8</sup> ISCA was previously known as the Institute of Certified Public Accountants of Singapore (ICPAS).

## 2 OVERVIEW OF THE PMP

- 2.1 Ensuring **high quality audits** is a key area of focus for ACRA. To safeguard public interests in the work of the public accountancy profession in Singapore, ACRA conducts robust regulatory oversight activities on the profession, through the PMP. Under this programme, ACRA carries out inspections on the audit work performed by public accountants with the aim of promoting high quality audits.

### Objectives of the Annual PMP Public Report

- 2.2 The publication of the Annual PMP Public Report aims to communicate ACRA's assessment of the state of the public accountancy profession in Singapore. Via the report, ACRA hopes to provide greater transparency on its inspection activities and findings with the objective of helping to ensure that the work of the public accountants meet professional standards.
- 2.3 This public report, now into its seventh edition, reports on key findings and observations gathered from the PMP inspections during the period from 1 April 2012 to 31 March 2013. Similar to prior years' reports, this report does not constitute a comprehensive list of all the findings identified during our inspections. Instead, it highlights the observations that ACRA deems important to be communicated and findings requiring particular attention from the profession.

### Summary of PMP Inspection Activities

- 2.4 The PMP covers all public accountants providing public accountancy services in Singapore. However, **inspection activities** are carefully **calibrated** to reflect the **different level of public interest risks** of audits conducted by firms in two broad segments:
- i) Firms that perform audits of PIEs; and
  - ii) Firms that perform audits of non-PIEs.
- 2.5 Firms in the **PIE segment** are inspected directly by ACRA and the **scope** covers a **review of the firm's quality control policies and procedures** ("firm-level reviews") and **individual engagement inspections of selected audit engagements**. ACRA's approach in performing inspections of individual engagements for firms in this segment comprise a mixture of:

- Detailed engagement inspections of public accountants to assess whether the public accountants’ work has been conducted in compliance with the Singapore Standard on Auditing<sup>9</sup> (“SSAs”). The Public Accountants Oversight Committee (“PAOC”) is the deciding authority on the outcome of these inspections; and
- Conducting engagement reviews in the course of firm-level reviews to assess the firm’s compliance with the requirements of the SSQC 1 in the area of ‘engagement performance’.

2.6 For firms in the **non-PIE segment**, the **scope** of inspection on these firms focuses only on **detailed engagement inspections**. Due to the size and operations of firms in the non-PIE segment, this is viewed as a more practical method of monitoring audit quality. Inspections on these firms are carried out with the assistance of ISCA with oversight by ACRA.

2.7 Based on ACRA’s registration statistics as at 31 December 2012, the number of public accounting firms and public accountants in the respective segments are as follows:

*Figure 1: Number of Public Accountants and Public Accounting Entities*

As at 31 Dec 2012	PIE segment	Non-PIE segment	Total
Number of public accounting entities	18	611	629
Number of public accountants	295	674	969

### *PIE Segment*

2.8 Audits in this segment are largely dominated by listed entity audits. The Big-Four audit firms play a significant role in this market as collectively, they audit approximately 62% of entities listed on the Singapore Exchange, comprising 88% of market capitalisation as at 31 December 2012. Given the high level of public interest, the Big-Four firms are subjected to a shorter cycle of biennial inspections. The remaining firms in the PIE segment with proportionately lower concentration of PIE audits are typically inspected once every three years.

<sup>9</sup> The SSAs are based on the equivalent International Standards on Auditing issued by the IAASB, with necessary modifications for local statutory reporting requirements.

2.9 During the period covered in this report, ACRA conducted inspections on eight firms<sup>10</sup> in the PIE segment. In total, 47 individual engagements were inspected by ACRA during the period. Out of these, 31 audit engagements signed-off by 19 public accountants<sup>11</sup> were subjected to detailed engagement inspections. The remaining 16 engagements were subjected to firm-level engagement reviews.

### *Non-PIE Segment*

2.10 The majority of Singapore's public accountants are in the non-PIE segment. Amongst this majority, most conduct their operations as sole proprietorships, hence explaining the correspondingly high number of firms in this segment. These small practices audit mostly small and medium private companies. During the period from 1 April 2012 to 31 March 2013, 128 public accountants covering 384 audit engagements in the non-PIE segment were inspected.

## **International Activities**

### *International Forum of Independent Audit Regulators ("IFIAR")<sup>12</sup>*

2.11 ACRA plays an active role in IFIAR as part of its efforts to promote global development of independent audit oversight. In the most recent IFIAR plenary meeting in Noordwijk, Netherlands in April 2013, **ACRA was elected as a member of the IFIAR Advisory Council** for a four-year term. Joining six of the most established audit regulators<sup>13</sup> from around the world, ACRA is honoured by the opportunity to bring a Southeast Asian voice to the Advisory Council and to contribute towards charting the future direction of IFIAR. This is ACRA's second term on the council, having previously served from October 2008 to April 2011.

2.12 In addition, **ACRA is a member in three out of the six working groups set up within IFIAR**, namely the Global Public Policy Committee ("GPPC") Working Group, the International Co-operation Working Group and the Standards

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<sup>10</sup> The firms inspected were EY LLP, KPMG LLP, Lo Hock Ling & Co, Mazars LLP, Nexia TS Public Accounting Corporation, Ng, Lee & Associates, RSM Chio Lim LLP and UHY Lee Seng Chan & Co.

<sup>11</sup> A public accountant may have more than one file selected for inspection.

<sup>12</sup> IFIAR is an organisation comprising audit regulators (Members) from around the world that are independent from the audit profession and has 46 members as of April 2013. IFIAR focuses on:

- i) Sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;
- ii) Promoting collaboration and consistency in regulatory activity;
- iii) Providing a platform for dialogue with other international organisations that have an interest in audit quality.

<sup>13</sup> The other Advisory Council members are from Abu Dhabi, Australia, Canada, France, United Kingdom and Sri Lanka.

Coordination Working Group<sup>14</sup>. ACRA also actively contributes to the initiatives of other Working Groups in IFIAR. For instance, ACRA presents at the inspection workshops organised by IFIAR’s Inspection Working Group.

- 2.13 One of IFIAR’s key developments in 2012 was the publication of the first global survey<sup>15</sup> of audit inspection findings, bringing together common inspection issues identified by IFIAR members. The survey revealed considerable commonality in the findings raised by audit regulators around the world. The survey results are further discussed in paragraphs 3.52 to 3.55 of this report.

### *ASEAN Audit Regulators Group*

- 2.14 In moving towards capital markets integration in the ASEAN region, the role of independent audit oversight is essential for increasing corporate governance and investor confidence. With this vision in mind, ACRA, together with the independent audit regulators of Malaysia and Thailand formed an informal cooperation group known as the ASEAN Audit Regulators Group (“AARG”) in 2011 to foster closer collaboration among audit regulators to promote audit quality in the ASEAN region.

- 2.15 **The AARG holds periodical dialogues with the regional leaderships of the Big-Four audit firms** to discuss audit quality matters. Its most recent meeting was held in Singapore in May 2013. For the first time, this meeting was also **attended by leaders from the global audit firms** comprising members of the Regulatory Working Group of the GPPC<sup>16</sup> who were present to provide an international perspective on the regional issues discussed during the meeting.

- 2.16 Two key issues discussed at the meeting were the **state of audit talent in the ASEAN region** and the **need to raise the quality of financial reporting amongst ASEAN companies**. As part of the discussion on audit talent, participants were also presented with the results of a series of comprehensive surveys<sup>17</sup> of audit staff conducted by the Association of Chartered Certified Accountants (“ACCA”) with the AARG members in Singapore, Malaysia and Thailand.

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<sup>14</sup> Further information on IFIAR’s Working Groups can be accessed at [www.ifiar.org](http://www.ifiar.org).

<sup>15</sup> The survey can be accessed at [www.ifiar.org/IFIAR-Global-Survey-Media-Coverage.aspx](http://www.ifiar.org/IFIAR-Global-Survey-Media-Coverage.aspx).

<sup>16</sup> The GPPC comprise the six largest international audit firm networks (BDO, Deloitte Touche Tohmatsu, EY, Grant Thornton, KPMG and PwC).

<sup>17</sup> These surveys conducted by ACCA in the respective countries can be accessed at the following links:

Singapore: [www2.accaglobal.com/documents/talent\\_attraction.pdf](http://www2.accaglobal.com/documents/talent_attraction.pdf)

Malaysia: [www2.accaglobal.com/documents/optimising-talent.pdf](http://www2.accaglobal.com/documents/optimising-talent.pdf)

Thailand: [www.sec.or.th/infocenter/th/accountant/talent\\_attraction\\_report.pdf](http://www.sec.or.th/infocenter/th/accountant/talent_attraction_report.pdf).

2.17 The series of surveys, conducted between 2012 and 2013 provided several insights into key attraction and retention factors for audit staff in the three jurisdictions. The findings from the surveys revealed that the three jurisdictions shared common challenges in that:

- Audit is a highly attractive career because of its excellent training and unique exposure to different industries;
- Despite its attractiveness, several factors strongly affected employee satisfaction, including the high workloads compared to the rewards; and
- In all three jurisdictions, many believed that their high workload was connected to the need for clients to improve the quality of management accounts and to pay fees reflecting the true value of an audit.

2.18 During the May 2013 meeting, the AARG also held separate discussions with each firm to address common issues identified during the AARG's respective audit inspections and the firm's own internal quality reviews. Whilst noting progress amongst these firms in institutionalising stronger internal quality review programmes, the AARG would like to encourage firms to place greater efforts towards identifying and addressing the root causes of the more common findings. The AARG looks forward to **continued periodical dialogue** with the firms in working together to address common audit quality challenges faced in the region.

### 3 AUDITS OF PUBLIC INTEREST ENTITIES

#### Key Observations: Firm-Level Reviews in the PIE Segment

- 3.1 Firm-level quality controls are akin to internal controls of a company. In a financial reporting environment, effective internal controls play a significant part in ensuring there is consistency and appropriate safeguards in the preparation of the financial statements, and hence quality in the final output produced. Similarly for an audit firm, having good quality controls that are in line with the SSQC 1 requirements would provide safeguards to ensure **consistent execution of quality audits** on all engagements.
- 3.2 The increased focus on firm-level quality controls has been brought about by changes to the operating and auditing environment over the years. These changes include increased scrutiny on audit quality both locally and internationally, increased financial reporting standards and requirements, greater complexity of accounting matters, and heightened fraud risk. At the same time, the profession is faced with cost pressures and talent crunch issues. These developments have led firms to appreciate the importance of having a strong system of quality controls to sustain audit quality.
- 3.3 Having completed two cycles of firm-level reviews since 2007, ACRA has seen **commendable improvements** made by firms in implementing and enhancing their system of quality controls. The firms are progressing at separate pace though, with some showing greater improvement than others. Further, with globalisation becoming more commonplace, some network firms have even formed regional clusters and increased inter-office co-operation efforts to drive consistency and improvement in audit quality across the region.
- 3.4 This year's report highlights **areas of strength** and **good practices put in place by firms** in respect of each SSQC 1 element. The measures described below have contributed towards higher audit quality for firms which have implemented them. Hence, ACRA hopes this sharing would be useful for firms. Ultimately in considering whether to adopt these measures, firms would need to assess the suitability and adaptability of these measures in their own setting.

## Leadership Responsibilities for Quality within the Firm

3.5 Leadership is critical as it sets the tone at the top. When leaders of the firm set audit quality as one of their key priorities and demonstrate their commitment, it would have a profound influence on the behaviour and work ethics of staff to focus on the similar. In respect of this area, ACRA has seen the following commendable observations:

### *Linking Quality and Partner Compensation to Audit Quality*

3.6 ACRA commends firms which have taken a bold move forward from a 'seniority-based only' partner compensation system to a performance-based system which links quality to partner compensation. This move, particularly evident in most of the Big-Four firms, incorporates **clear and sufficient weighting of audit quality indicators into the partners' appraisal process**.

3.7 Examples of audit quality indicators considered in the partner appraisal process are:

- Requiring the consideration of feedback obtained from the firm's quality control functions on partner's performance;
- Imposing more effective sanctions on independence and/or ethical violations to promote proper behaviour;
- Limiting the upside to the performance grade achievable by partners with lapses in audit quality, based on internal and/or external quality reviews conducted; and
- Institutionalising the evaluation of contributions made by partners assigned with quality control functional responsibilities, with appropriate weightings allocated for these responsibilities.

3.8 ACRA also believes more can be done to recognise the role of the EQCR in upholding audit quality in engagements. To achieve this, an effective appraisal system could be put in place to assess the involvement and quality of the work performed by the EQCR. Linking the results of engagements to the corresponding EQCR's compensation could serve as an effective tool to promote accountability and enhance the contribution of the EQCR in engagements.

### *Reviewing Partner Workload to Enable Quality Work*

3.9 To ensure that engagement partners and EQCRs have sufficient time to perform their roles effectively, some firms have adopted appropriate **quantitative guidelines in the allocation of engagement partner portfolio**, such as:

- Setting an upper limit on the total audit fees an engagement partner should be managing, and the maximum number of listed clients with the same financial year-end to be handled by each partner;
- Proportionately reducing the client portfolio of partners assigned with other functional responsibilities within the firm so that they have sufficient time to perform their management and oversight roles in addition to their day-to-day client engagement activities; and
- Allocating notional fees to partners assigned with EQCR roles so as to reflect the EQCR's time involvement and work commitment for the audits.

### *Investing Right Resources in Quality Control Functions*

3.10 Quality control functions commonly found amongst firms are technical, risk management, training and internal review (monitoring) departments. As firms increasingly recognise the importance of these functions in driving the conduct and consistency of audit quality, ACRA has noted a corresponding **increase in the amount of resources allocated to these functions** over the last couple of years. This trend is particularly evident for resources involved in internal review and monitoring functions of the firms, where new work streams and programmes have been introduced to monitor the quality of engagement files (e.g. internal pre and post issuance engagement reviews and SSQC 1 assessment reviews).

3.11 In some firms, ACRA is heartened to note that senior partners or experienced full time resources are being assigned to lead these functions. Clear and appropriate lines of reporting are also established to avoid conflict of interest situations and decisions on audit quality matters from being glossed over by commercial considerations.

## **Independence and Ethical Requirements**

3.12 Independence and ethical behaviour are fundamental traits of the accountancy profession. Therefore, it is important that audit firms have a robust system of policies and procedures in place for the firm and its staff to comply with relevant independence and ethical requirements. This section highlights some good

practices established by firms in the area of independence and ethical requirements.

### *Independent Monitoring Mechanism in Relation to Fees*

- 3.13 Effective internal monitoring and reporting mechanisms become increasingly important as a firm's service offerings grow in size and complexity. Over the years, ACRA noted that more firms have initiated independent monitoring mechanisms for **tracking compliance with independence requirements** in relation to relative fee sizes and overdue fees. For instance, some firms have designated staff to monitor long outstanding fees to ensure that audits for the following year do not commence prior to settlement of overdue fees. To facilitate compliance monitoring, ACRA also noted firms leveraging on their existing practice management systems to automate data extraction and to generate ad-hoc or customised internal compliance reports.
- 3.14 In light of the enhanced requirements in the upcoming revised Code of Ethics and Professional Conduct<sup>18</sup>, firms should also consider **centralised monitoring of fees** to allow greater independent and timely oversight over the monitoring process. ACRA further suggests that status updates relating to independence and ethical matters be communicated and discussed at management meetings on a regular basis. This formal reporting requirement will help keep management cognisant of such matters so as to set appropriate behaviour and direction from the "tone at the top".

### *Practice Aids for Monitoring of Fees*

- 3.15 In addition to having independent monitoring mechanisms, ACRA also noted instances where firms have developed practice aids to assist engagement teams in **documenting their self-assessment of independence and ethical threats** arising from audit and non-audit fees earned from their clients. This is particularly useful for group audits where there could be significant non-audit engagements performed by component auditors who are part of an audit firm's network.

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<sup>18</sup> ACRA is currently considering adopting the amendments from the revised IFAC Code of Ethics into ACRA's Code of Ethics and Professional Conduct. The resulting revisions are likely to come into force in 2014.

### *Comprehensive Independence Compliance Testing*

- 3.16 In respect of independence compliance testing, ACRA noted that the testing process in some audit firms is performed or overseen by senior personnel with good knowledge of ethical and independence requirements. A **comprehensive work program** is also used to ensure uniformity in the application and quality of the testing methodology.
- 3.17 In addition, ACRA observed that some audit firms perform independence compliance testing on a regular basis (at least once annually) and include a sample of all grades of staff, including both professional and administrative staff, with a testing bias towards senior management. This helps reinforce the message that all staff should adhere to the independence policies at all times.

### *Robust Independence Training*

- 3.18 ACRA commends firms that are proactive in ensuring that their staff are kept up to date with existing and new developments on independence and ethical requirements. For instance, **staff awareness** in respect of ACRA's and the firm's own independence policies and considerations are heightened and **refreshed through annual trainings** and **upon new staff joining the firm**. Firms should also consider incorporating relevant case studies and scenarios to give greater depth and widen the knowledge as well as awareness of staff on these matters.

### *Complete and Timely Updates to the Restricted Entity Listing*

- 3.19 Most audit firms maintain a restricted entity listing, containing a list of entities, typically listed audit clients, for which a firm's staff are not allowed to have any financial interest in. ACRA noted that some firms are more diligent than others in ensuring that the **listing is updated and communicated to staff in a timely manner**. In addition, as independence requirements extend beyond just interests in listed audit clients, it is equally important that staff are provided with means or access to perform self-independence checks for all of the firm's audit clients, where necessary. This would include its non-listed clients, related entities of its listed audit clients<sup>19</sup>, as well as global clients of the audit firm's network.

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<sup>19</sup> Section 290.34 of the Code states that “*in the case of a financial statement audit client that is a listed entity or public company, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities.*”

## Client Acceptance and Continuance

3.20 Most firms in this segment would already have devised an appropriate framework of policies and procedures to perform client acceptance and continuance assessment. However, having a framework of policies and procedures alone is insufficient. Robust execution and assessment of the risks associated with accepting or retaining clients are also important contributors to a strong quality assurance structure as discussed below.

### *Diligence in Addressing Procedural Lapses*

3.21 From ACRA's reviews, procedural lapses commonly occur in the form of:

- lack of quality and retention of relevant documentation to support the client risk-ratings and client acceptance and continuance assessments; and
- accepting engagements or commencing audit fieldwork before the detailed engagement risk assessment was carried out and documented.

3.22 It is encouraging to observe firms taking these findings seriously and putting in place processes to address the lapses found. For instance, some firms have **invested in tools or subscribed to relevant data service providers to perform a more rigorous background search on potential clients**. Others have upgraded their client management systems to allow better support and improve the quality of documentation by engagement teams performing such assessment. ACRA has noted that these enhancements reduce incidences of non-compliance relating to client acceptance and continuance procedures as compared to its previous reviews.

### *Robust Risk Analysis Process*

3.23 To sufficiently distinguish between risk levels of different clients and to reflect risks specific to audits performed in the region, some firms have **improved the granularity of their risk rating systems**. This includes both a detailed evaluation of as many risk factors under consideration (such as country or industry specific risks) and clearer distinction of risk ratings. Formal guidance on the definitions of each category of risk rating is also set out to improve the consistency of application of risk rating across engagements within the firm.

### *Linking Risk Ratings to the Nature, Timing and Extent of Audit Procedures*

3.24 An important element within the client acceptance and continuance assessment process is to have **linkages established between the various risk categories to**

**the nature, timing and extent of audit procedures carried out.** This is crucial to ensure all risks identified are adequately addressed.

- 3.25 In promoting this mindset, firms could provide guidance to distinguish the audit procedures required to be performed in respond to different levels of risk identified. This would help improve audit productivity by providing clarity to engagement teams on the right amount of efforts required to address the risks identified. In instances where such linkages are weak or non-existent, ACRA observed that this increases the likelihood of ‘over-auditing’ and the unnecessary performance of ineffective audit procedures.

## **Human Resources**

- 3.26 This area remains a **perennial challenge** for the public accountancy profession. In a 2012 survey on talent attraction and retention conducted by ACCA (“ACCA Talent Survey”)<sup>17</sup> in Singapore, it is noted that only 38% of audit staff surveyed were satisfied with their current career choice in audit, with 65% of the respondents indicating their intention to leave their existing firms within 3 years. Against this backdrop, firms are faced with an uphill task of creating conducive work environment and practices to attract and retain high quality talent within the profession. Notwithstanding this, ACRA has observed some positive initiatives in recent years that are highlighted in the following paragraphs.

### *Greater Transparency on Career Progression*

- 3.27 The new generation of workforce places great emphasis on increased clarity on their career development path. Despite the abundance of career advancement opportunities, staff often express dissatisfaction over the lack of transparency in the career progression process. As echoed in the ACCA Talent Survey, a source of contention amongst respondents to the survey was that they felt their efforts have not been adequately recognised by senior management in the firms.
- 3.28 Hence, performance evaluations play a crucial role as they form the basis to monitor and accordingly recognise the performance and quality of staff. We have noted some firms setting out **clear, structured and objective measures for assessing staff performance** in their engagement feedback and staff performance evaluation forms. For these evaluations to be comprehensive and objective, certain firms have even implemented tighter monitoring mechanisms such as mandating the completion of engagement feedback forms for all

engagements undertaken by staff meeting certain criteria or establishing and enforcing strict timelines for submissions.

- 3.29 For staff evaluation to be effective, further **clarity and feedback** needs to be given to staff **on the level of competence required to be demonstrated in order to progress to the next level**. This would help enhance transparency of the staff's career progression path and allow under-performing staff to understand their shortcomings and take steps to improve as necessary.

### *Linking Performance Evaluation and Audit Quality*

- 3.30 Besides transparency on career progression, the criteria used for evaluating staff performance also have to be appropriate in order to inculcate the right behaviour towards audit quality. Similar to partner performance, staff performance evaluation, compensation and promotion procedures should give **due recognition and reward to the achievement of audit quality indicators** such as the quality of engagements performed, development and maintenance of staff competence and commitment to ethical principles.
- 3.31 ACRA commends firms that have taken the results of quality reviews into consideration when assessing the performance and compensation of audit staff and partners. We see distinct differentiations in the recognition and remuneration scheme of staff and partners as key motivators to drive the right behaviour towards audit quality in a firm. Whilst punitive measures are more commonly adopted, a better alternative would be to reward staff and partners who have performed well in the firm's monitoring reviews and in their overall engagements.

### *Greater Staff Engagement and Communication*

- 3.32 In addressing human resource issues that have impact to audit quality such as staff turnover, some firms conduct **comprehensive annual staff surveys** to gauge staff morale and **seek feedback on areas of improvement**. While this form of engagement helps identify issues at the ground, it is the post survey responses and follow-up actions that determine the effectiveness of the staff engagement process.
- 3.33 It is encouraging to see firms taking the results of the survey seriously and implementing appropriate actions in response to results of the survey. For instance, responding to feedback received from audit staff that they are spending significant amounts of time performing administrative duties such as billings,

collections and portfolio allocation, one firm hired additional support staff and re-designated some of these duties to these staff, thus allowing its audit staff to concentrate on audit work.

- 3.34 In areas where staff feedback cannot be addressed immediately, the engagement process is also useful to indicate the firm's willingness to consider staff views, the deliberation process undertaken and its outcome. In some firms, the survey results are disclosed to staff to promote open communication.

### *Comprehensive Staff Training*

- 3.35 An important aspect of quality relating to staff training is its effectiveness. Firms which are stronger in this area are often more **responsive in identifying and fulfilling training needs of staff**. The ability to react may come from results of internal or external quality reviews or informal feedback from engagement teams gathered on a periodic basis. Instead of merely reiterating auditing and financial reporting requirements, quality training materials by firms would also include simulation questions, real-life case studies or practical application issues to enable staff to better understand the subject.

- 3.36 Besides the effectiveness of the training curriculum, mechanisms put in place to monitor the timeliness of staff training and attendance are equally important. New recruits to the firm should be given basic and adequate training, at the very least on the firm's audit manual and methodology, prior to being deployed to audit assignments.

- 3.37 Most firms would have effective mechanisms in tracking staff attendance. However, the better ones would impose stricter measures to ensure attendance, such as requiring the need to seek replacements and obtain various levels of mandatory approval to be excused from training. In the event of non-attendance, stringent follow-up measures are also implemented such as requiring the staff to self-study the training materials and subsequently be subjected to comprehension tests. These measures would ensure all staff receive the right amount of training as required by the firm.

### **Engagement Performance**

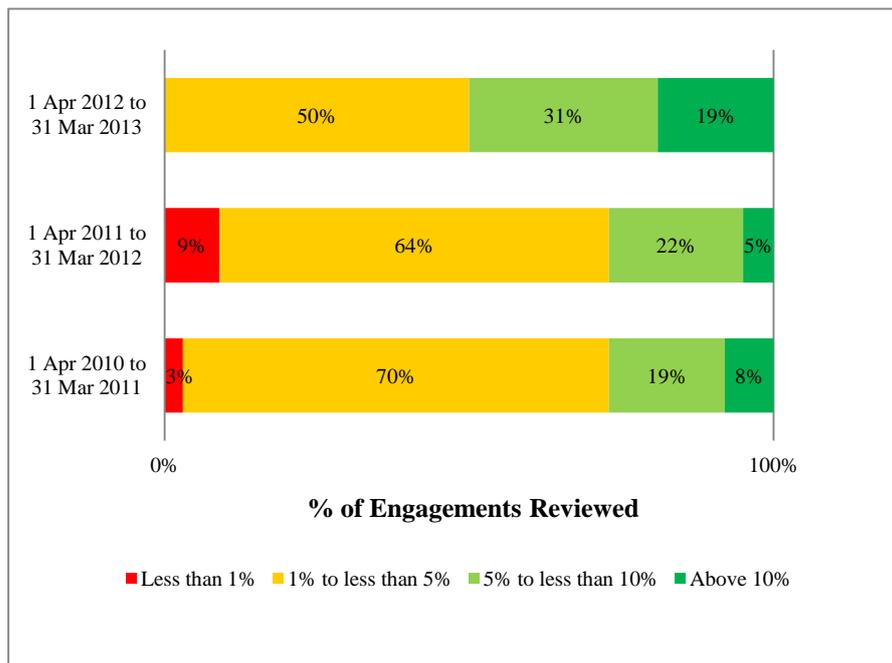
- 3.38 ACRA's firm-level review includes a review of compliance by engagement teams with relevant auditing and financial reporting standards, and the firm's policies and methodology when performing their audit. Audit firms that have

performed well in this area typically display the attributes that are discussed below.

### *Involvement of Senior Staff on Engagements*

3.39 An analysis of the time recorded by engagement partners and EQCR on sample engagements reviewed by ACRA for firms in the PIE segment are as presented in **Figures 2** and **3** below<sup>20</sup>:

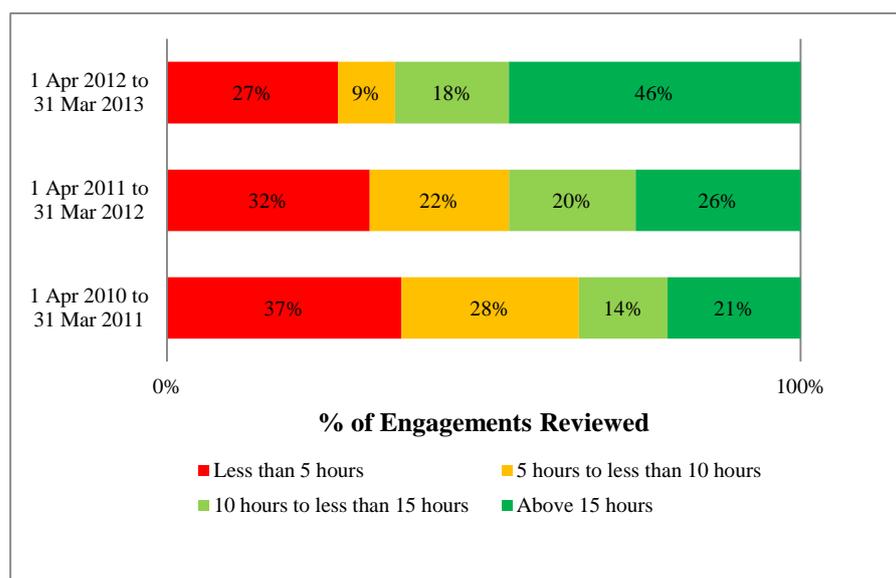
**Figure 2: Time Recorded by Engagement Partners<sup>21</sup>**



<sup>20</sup> Based on engagements reviewed as part of firm-level inspections.

<sup>21</sup> As a % of total hours for each engagement inspected.

**Figure 3: Time recorded by EQCR**



3.40 Whilst ACRA has not set a minimum standard for an acceptable level of engagement partner and EQCR involvement, ACRA regards 5% of total engagement time for a low risk engagement and up to 10% of total engagement time for higher risk engagement to be appropriate starting points. Similarly, in looking at procedures that an EQCR would have to carry out on a listed entity audit, ACRA estimates that an EQCR should be spending at least 13 to 24 hours<sup>22</sup>.

3.41 Although ACRA noted engagements with higher engagement partner and EQCR hours have increased over the past three years, their overall level of involvement in audits are still predominantly low. The number of engagements at the lower bands (below 5% for engagement partner hours and below 10 hours for EQCR) clearly suggests that there is **further room for improvement in providing the necessary levels of supervision in engagements.**

3.42 Adequate levels of supervision by senior and experienced members of the engagement team are important as we have observed close linkages between their involvement in engagements and the resultant quality of audit work. In this respect, ACRA has noted instances where deficiencies detected in basic areas could have been avoided had a more diligent review been carried out by both the engagement partner and EQCR.

<sup>22</sup> This is estimated based on activities expected to be performed by the EQCR as discussed in ACRA's Audit Practice Bulletin No. 1 of 2011: Engagement Quality Control Review, accessible at <https://www.acra.gov.sg/training-and-resources/publications/bulletins-and-guidance/audit-practice-bulletin>.

### *Consultations Database*

3.43 Some firms adopt the well encouraged practice of **documenting consultations raised** and **maintaining a central database** for these consultations. The type of consultations documented and retained typically include technical matters on audit and accounting issues as well as queries related to the firm's independence and ethical matters, audit process and methodology. A centralised database acts as a safeguard against the proliferation of inconsistent views by different engagement teams on similar matters. This database would also reduce duplicate analysis and research work on similar issues.

### *Allocation of Additional/ Dedicated Resources to Technical Quality Control Functions*

3.44 In recent years, many audit firms have allocated **additional or dedicated resources to the technical quality control function**. Staff in this function are typically tasked to perform technical consultations, review the firm's audit methodology, issue guidance on technical related matters and conduct trainings.

3.45 To complement their technical versatility, some firms arrange for their technical quality control staff to hold a small audit portfolio or be involved in audit work periodically. This is to ensure that they are adequately exposed to practical issues and challenges faced during an audit. Similarly, in promoting a culture of technical competence amongst audit staff, firms may also consider short-term secondment programmes of audit staff to this function as a pre-requisite for further career advancement and in assuming greater leadership roles within the firm.

### *Timely Issuance of Audit Guidance*

3.46 Audit guidance serves as useful reference materials and is typically the most often consulted publication by staff of the firm. Recognising this, some firms **proactively monitor issues** that are recurring or pervasive and **provide timely and appropriate guidance** to address them. Such guidance may be in the form of e-mails, periodical publications or directly communicated to staff during their training.

## **Monitoring**

3.47 The monitoring element of SSQC 1 emphasises the need for checks and balances within a firm's system of quality control. Timely evaluation of the firm's system of quality control is necessary to ensure they stay relevant and

effective. Firms which have performed well in this element often demonstrated the qualities that are discussed below.

### *Comprehensive Review and Monitoring Framework*

3.48 In recent years, ACRA has seen enhanced initiatives carried out by firms to better monitor the quality of audit work. Some of these initiatives involve real-time efforts prior to completion of an audit engagement, such as **pre-issuance engagement or financial statements reviews**. Others are performed once the engagement is completed such as **post-issuance engagement and SSQC 1 assessment reviews**.

3.49 Having a right balance of review and monitoring mechanisms is useful in ensuring that potential risk areas are appropriately mitigated and dealt with. However, ACRA would like to point out that these reviews should not act as substitutes for engagement partner and EQCR involvement in engagements.

### *Well Organised and Conducted Review Programmes*

3.50 For the monitoring process to be effective, **a proper programme governing the conduct of the monitoring reviews** has to be set out from the start. This includes having the scope, objective, and timelines clearly defined prior to the commencement of each review. Due discipline also needs to be exercised in ensuring that reviews are carried out as planned and in particular, with strict adherence to the timelines set for the reviews. Firms with well established review programmes also often encounter lesser interruptions to their day-to-day audit operations.

### *Proper Follow-up on Monitoring Review Findings*

3.51 Monitoring programmes would not be effective without **proper follow-up on the review findings**. To minimise the occurrence of repeated findings in future engagements, root causes ought to be identified and communicated to staff on a timely manner. In some firms, separate training sessions are conducted whilst others issue guidance to educate staff on the procedures that should have been carried out.

## Key Observations: Engagement Inspections in the PIE Segment

### Inspection Findings – A Global Perspective

- 3.52 In December 2012, IFIAR published its first global survey<sup>15</sup> of audit inspection findings, summarising common issues identified by audit regulators on inspections of listed company audits.
- 3.53 The survey results indicated that audit regulators were reporting findings in numerous common areas across different jurisdictions, with the top five highest number of inspection findings in decreasing order of frequency being in the following areas:
- Fair value measurement
  - Internal controls testing
  - Engagement quality control reviews
  - Adequacy of review and supervision
  - Adequacy of financial statements and disclosures
- 3.54 ACRA takes a great interest in the results of the survey given that findings in many of the top most common areas also persistently feature in ACRA's inspections. For example, as elaborated in paragraphs 3.39 to 3.42 of this report, lack of engagement partner and EQCR supervision and review leading to inadequacies in audit work remains a major concern area in Singapore. Audits of accounting estimates used in fair value measurements have also been consistently identified as the most common and significant area of finding from ACRA's inspections over the past few years.
- 3.55 ACRA believes the publication of the survey results by IFIAR represents an important step towards communicating the value of independent audit inspections to audit firms and stakeholders alike. By giving an indication of common inspection findings globally, the results serve as a useful reference on areas where audit firms should focus their attention on. Further, given the commonality of findings in major areas of concern, these issues may be more effectively addressed and resolved via global initiatives, especially for firms with established international networks.
- 3.56 In this year's report, we will focus on the two most prevalent deficiencies arising from our inspections over the last twelve months; **audits of cash flow forecasts** and **audits of inventories**. ACRA finds it **unacceptable that there has been a**

**lack of improvement in these two areas** over the years, despite their deficiencies being consistently communicated to public accountants, privately via inspections and publicly through reporting channels such as ACRA's Audit Practice Bulletins and the annual PMP public reports. This clearly suggests that previous remediation efforts implemented have not been effective in addressing the findings raised.

## **Audits of Cash Flow Forecasts**

3.57 In the complex and judgmental area of fair value and accounting estimates, ACRA's main concern lies on the level of challenge and assessment by public accountants on the key assumptions used to support management's cash flow projections for purposes of determining value-in-use calculations. Examples of audit deficiencies found are discussed below.

### ***Failure to Assess the Appropriateness of the Growth Rates Applied to Revenue***

3.58 In the course of ACRA's inspections, we have encountered instances where public accountants **fail to adequately challenge the growth rates adopted by management**. Often, management's business plan and growth rates were accepted as reasonable by relying on management's self-assessment and representation of increasing future revenue due to reasons such as planned expansions into new markets, product or service innovations or synergies achieved from mergers and acquisitions.

3.59 As prescribed under SSA 540.13 *Audits of Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures*, the auditor is required to test how management made the accounting estimate and the data on which it is based. Hence, in meeting the requirements of the standard, public accountants would need to critically assess whether the business plan and revenue growth prospects are reasonable and supported, giving due consideration to the various factors such as historical growth trends, changes in market conditions and business environment, reactions of competitors and actions of customers.

### ***Failure to Assess the Appropriateness of Costs Structure Used***

3.60 In this area, ACRA commonly found public accountants either readily accepted:

- forecasted expenses growing in tandem with revenue without adequately challenging whether the assumption is reasonable; or

- management’s representation that margins can be improved through cost cutting measures without corroborating how these can be achieved.

3.61 In some instances, future capital expenditure may be warranted to cater for increases in revenue due to asset enhancement and replacement exercises or the need for expansion due to the company achieving full operating capacity. Hence, in assessing the appropriateness of cost structures used in cash flow forecasts, the public accountant should also consider the existing capacity at which the company is operating and **be skeptical of any additional capital expenditures being omitted from the cash outflows.**

*Failure to Consider More Appropriate Sources or Factors Relevant to the Forecast*

3.62 When auditing cash flow forecasts, the public accountant’s efforts are invariably focused on understanding and validating the assumptions made by management. In doing so, attention is sometimes focused only on the information provided and the public accountant may lose sight of the big picture.

3.63 We have encountered engagements where public accountants had failed to take into consideration significant factors that come into play and serve as useful corroborative evidence such as whether:

- **the level of development reflected in the forecasts are in line with management’s plans** as detailed in minutes of meetings or correspondences;
- **the cash flow projections are consistent with the budgets presented** to management or its board of directors; or
- **more appropriate and relevant sources may be available** in estimating or in testing the assumptions used in the cash flow forecast.

3.64 For instance, in one engagement, more than one source was available as a proxy to estimate the level of gross profit margin achievable by an entity’s newly set-up subsidiary; the first being average industry estimates and the second being the actual gross profit margin achieved by an entity belonging to the same client group which had commenced similar operations a year ago. Use of either basis would yield significantly different cash flow forecasts and ultimately impact the results of its impairment assessment. The public accountant however failed to make use of available proxies to test the reasonableness of management’s estimates.

### *Failure to Consider the Appropriateness of the Methods Used*

- 3.65 ACRA has observed the **use of profit-before-tax as a proxy for the projected cash flows in support of value-in-use calculations**. However, this method would only be appropriate in instances where there are no significant non-cash flow items included in profit-before-tax. Otherwise, consideration should be given to exclude items such as depreciation, provisions and unrealised foreign exchange gains and losses from the profit-before-tax figures.
- 3.66 In one exception, ACRA noted the **use of post-tax cash flows and discount rates in deriving the value-in-use**. This is contrary to the requirements set out in FRS 36.50 *Impairment of Assets* for estimates of future cash flows to exclude income tax receipts or payments and FRS 36.55 for discount rates to be determined based on pre-tax rates.

### *Failure to Adequately Assess the Reasonableness of Discount Rates Used*

- 3.67 This is one of the most common deficiencies in this area. Public accountants often fail to exercise sufficient rigour in challenging the discount rates used by management to determine the present value of cash flows from future use of its assets.
- 3.68 A common fallacy noted is to **merely adopt and accept the use of unadjusted current costs of borrowing as a proxy for the discount rates**. Whilst this might be a starting point, it may not be appropriate as consideration also needs to be given to specific risks premiums associated with the entity and the business environment it operates in (e.g. country risk, currency risk, price risk, etc).
- 3.69 In instances where current cost of borrowings appears to have been adjusted by management, we often noted that the reasonableness of these risks premium and how they have been adjusted were not appropriately or adequately assessed by public accountants. In performing such assessment, public accountants are also reminded to document the evaluation process and conclusions reached as evidence of work performed.

### *Incorrect Comparison of Recoverable Amount against Goodwill Only*

- 3.70 Common errors made by public accountants when performing goodwill impairment assessment include the following:

- The **value-in-use (recoverable) amount was compared only to the goodwill balance instead of the summation of goodwill and carrying amount of the asset**, as required under FRS 36.90; and
- The carrying amount of goodwill for a non-wholly-owned cash generating unit (“CGU”) was not grossed up to 100% before it is compared against the recoverable value of the CGU, as prescribed under FRS 36.C4.

3.71 In ACRA’s view, these practices which are clearly non-compliant with the requirements set out in FRS 36 should not have occurred. Having continuously noted these observations across various firms over the years, ACRA finds this trend to be particularly worrying as it reflects a lack of professional skepticism in ensuring a proper comparison of two amounts.

## **Audits of Inventories**

3.72 Inventory is typically a key focus of inspection work due to the significance and risks associated with this account balance, particularly for entities involved in trading and manufacturing of products. Increasingly, accounting for inventories is becoming more complex due to innovations in product offerings, complicated sourcing and supply chains, advancements in manufacturing processes and demands to maximise product delivery and efficiencies. Similarly, auditors need to ensure that their audit procedures are updated to stay ahead of the curve. However, from the engagements inspected, ACRA noted this was not the case in numerous instances, as evidenced by poorly executed audit procedures as discussed below.

### ***Inventory Valuation and Product Bundling***

3.73 To capture consumer sentiments, products are increasingly sold in bundles or packages. With the new international accounting standards on revenue recognition which requires the assessment of each performance obligation in a contract, it is ever more important that public accountants understand how an entity’s products are being sold, so as to develop necessary audit procedures and select appropriate samples to test the net realisable value (“NRV”) of inventories. We have noted instances where public accountants fail to take into account the sale of these products in their current bundled form, resulting in incorrect comparison of costs against selling price of inventories.

3.74 In such cases, public accountants often **mistakenly compare the costs of an individual inventory item selected to the selling price of the bundled**

**product.** This comparison will fail to appropriately indicate whether the individual inventory item selected for testing is indeed impaired as the total selling price of a bundled product offering would by reasonable standards exceed the cost of any one particular item in the bundled offering.

3.75 Public accountants should also seek to understand the reasons for the bundled product arrangements offered and its composition to determine whether specific products within the bundle may be more susceptible to write-downs than others. This is particularly relevant where a slow moving inventory item is strategically offered together with a more successful item to improve sales of the former. Careful consideration of these products' costs vis-à-vis the pricing mechanism adopted would be required in such instances.

3.76 Besides the above, other common findings noted in the area of inventory valuation include:

- Assessment on reasonableness of inventory obsolescence performed only for the list of inventories written down by management without considering the overall inventory listing and ageing records, resulting in potential under-provision of inventory obsolescence allowances;
- Instead of critically assessing the appropriateness of the provision made, audit procedures performed were limited to mere inquiries with management on the inventory provisioning policy and re-computation of the allowance made by management; and
- Vouching to incorrect documents such as the entity's master selling price listing instead of transacted sales invoices when performing net realisable value tests.

### *Costing of Inventories*

3.77 Two important aspects in the costing of inventories are:

- the cost components of the product; and
- the costing method used.

3.78 Findings were noted in both aspects during ACRA's inspections. These findings though less systemic in nature, reveal areas of pitfalls which may be committed by public accountants in basic and least expected areas. For example, ACRA noted instances where **work had not been performed to test the completeness and accuracy of material cost components** such as labour and overhead costs in the costing of "work-in-progress" and finished goods.

- 3.79 Where standard costing is adopted, public accountants should also assess the accuracy of and the reasons for variances identified between standard and actual cost of each significant inventory component such as raw materials, labour and other overhead costs. In reviewing the variances computed by management, public accountants need to consider whether these are permanent or temporary in nature; the former requiring an update to the entity's standard costing set.
- 3.80 Several findings relates to **ineffective audit procedures employed in testing an entity's inventory costing method**. Most commonly, in testing the weighted average cost of inventories, the public accountants have only vouched to the most recent suppliers' invoices for the samples selected and did not verify the weighted average costing computation in the inventory system.

### *Inventories Held at Third-Party Locations*

- 3.81 With greater accessibility to worldwide markets and wider distribution networks, more inventories are held at third party locations. If inventories held overseas are material to an entity, it is important that the public accountant sufficiently weigh the risk factors when deciding between obtaining audit evidence via physical attendance at the overseas warehouse as opposed to obtaining a third party confirmation.
- 3.82 Where audit confirmations were sent and received, ACRA noted that **inadequate work was performed to test the reconciliation of differences** between the confirmation replies and management's inventory listing. For example, ACRA had observed instances where the nature and appropriateness of long outstanding reconciling items were not investigated and appropriately resolved. Work performed was also typically limited to verifying the reconciling items to supplier and sales invoices, without considering the relevant shipping terms and delivery dates to ascertain existence and appropriate ownership of inventories at year end.
- 3.83 Where third party confirmations were sent but not received, ACRA had found instances where no follow-up or alternative procedures were performed by the public accountants as required under SSA 505.12 *External Confirmations*. **Inventories held at third party locations or goods-in-transit were sometimes omitted** when selecting items for testing, even though that they were material to the overall inventory balance.

## Analysing the Root Causes

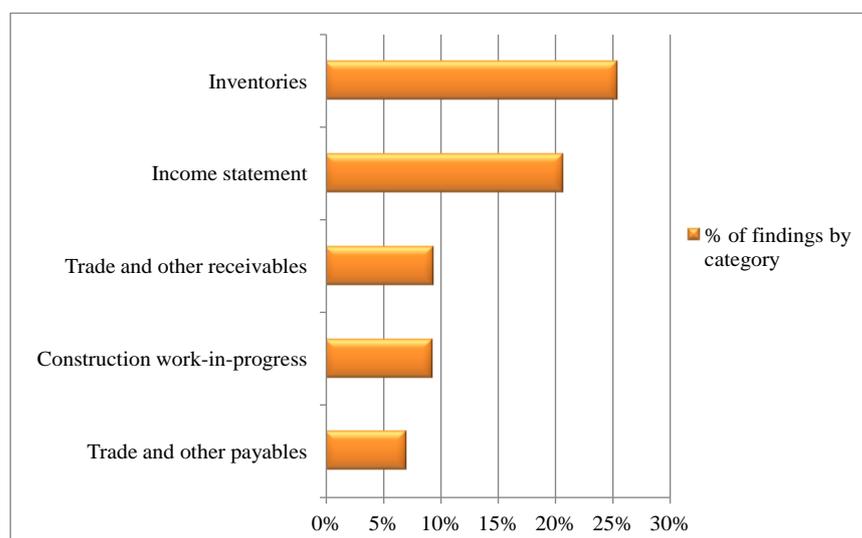
- 3.84 Despite efforts put in by firms, improvements in these areas have been slow, as evident from the repetition of similar findings year after year. To address these deficiencies, **ACRA urges public accountants to carefully re-examine the root causes and implement effective action plans to resolve the underlying root causes.**
- 3.85 In ACRA's opinion, some of the root causes of these deficiencies stem from the combination of one or more of the following:
- Insufficient understanding of the entity's business and financial reporting or auditing standards' requirements, resulting in gaps and ineffectiveness in the procedures performed and the audit assertions it aims to satisfy;
  - Work on complex and judgmental areas being delegated to inexperienced or junior staff, coupled with inadequate levels of supervision and review by senior members of the engagement team;
  - Insufficient resources allocated to engagements, due to staff shortage or turnover, resulting in procedures being compromised to meet deadline pressures;
  - Lack of willingness to challenge management representations and demonstrate appropriate levels of professional skepticism, especially in audits of accounting estimates; and
  - Unwillingness to seek appropriate assistance and opinions from external experts or independent third parties due to cost reasons.
- 3.86 ACRA acknowledges that there are no simple and straight forward solutions to the issues highlighted above. Some of these issues such as resource and deadline pressures may also be intricately linked to poor quality financial information prepared and management's incorrect perception or attitude towards financial reporting and the role of auditors.
- 3.87 Appropriate and adequate support from other stakeholders in the financial reporting value chain is hence equally important for auditors to perform their roles effectively. With this in mind, in addressing the root causes and ultimately the audit deficiencies found, we encourage firms to think out of the box for sustainable long term solutions. Initiatives need not only be confined within the firm or the profession, but could also involve collaboration efforts with relevant stakeholders such as the firms' audit clients comprising its management, staff and audit committee as necessary to achieve better quality audits.

## 4 AUDITS OF NON-PUBLIC INTEREST ENTITIES

### Key Observations: Engagement Inspections in the Non-PIE Segment

4.1 Due to the size and nature of the entities audited in the non-PIE segment, findings tend to be more basic and fundamental as opposed to areas of accounting estimates or complicated accounting treatments. Additionally, inspection findings spread across a broader spectrum of financial statement captions. However, **more than two thirds of these findings are concentrated in five common areas**. A summary of these top five areas of findings<sup>23</sup> are presented below.

*Figure 4: Top Five Areas of Findings from Engagement Inspections in the Non-PIE Segment*



4.2 As in prior years, our inspections continue to reveal **recurring and common weaknesses** in the area of inventory and income statement items (for example, purchases and sales cut-off tests), followed by trade and other receivables, construction work-in-progress and trade and other payables. **The nature and type of findings in these areas remains largely similar to prior years**. For example, for trade and other receivables and payables, inadequacies in the performance of external confirmation procedures are frequently identified amongst engagements inspected. Similarly, for audits in the construction industry, it is commonly observed that procedures to ascertain total contract costs and foreseeable losses are often lacking.

<sup>23</sup> Based on engagement inspections concluded for the non-PIE segment for the period from 1 April 2012 to 31 March 2013.

4.3 Given the similarity of findings to prior years, many of these areas have been discussed and reported extensively in ACRA’s past Annual PMP public reports. **Figure 5** below provides a summary of when these findings have previously featured in ACRA’s past reports. In addition, audit guidance developed by ACRA, in the form of Audit Practice Bulletins (“APBs”) and ISCA, in the form of Audit Practical Guidance (“APGs”), to assist public accountants when auditing these areas are also indicated in **Figure 5** below.

**Figure 5: Reports of 2012/2013 Top Five Areas of Findings in Past Annual PMP Public Reports and Audit Guidance Available**

Area of Finding	Discussed in <sup>24</sup>	Available Audit Guidance <sup>25</sup>
<b>Inventories</b>	PMP Public Report: 2009, 2010, 2011	APG 1: Inventory Obsolescence (August 2010)  APG 6: Valuation of Inventories (June 2011)
<b>Income statement</b>	PMP Public Report: 2009, 2010, 2011	APG 5: Occurrence of Revenue from Sale of Goods (May 2011)  APG 8: Revenue and Purchases Cut-off on Sale of Goods (July 2011)
<b>Trade and other receivables</b>	PMP Public Report: 2009, 2010, 2011	APB No. 1 of 2010: External Confirmations (May 2010)  APG 7: Existence and Completeness of Accounts Receivable and Accounts Payable through Confirmations (July 2011)
<b>Construction work-in-progress</b>	PMP Public Report: 2009, 2012	APG 11: Audit of Long-Term Construction Contracts (September 2012)
<b>Trade and other payables</b>	PMP Public Report: 2009	APB No. 1 of 2010: External Confirmations (May 2010)  APG 7: Existence and Completeness of Accounts Receivable and Accounts Payable through Confirmations (July 2011)

<sup>24</sup> Past annual PMP Public Reports can be accessed at <https://www.acra.gov.sg/training-and-resources/publications/reports/practice-monitoring-programme-public-reports>.

<sup>25</sup> ACRA’s APBs can be accessed at <https://www.acra.gov.sg/training-and-resources/publications/bulletins-and-guidance/>.

ISCA’s APGs can be accessed at <http://caa.isca.org.sg/publications/practical-guidance-3>.

4.4 Despite repeated reminders and guidance, similar lapses continue to recur year after year. ACRA urges public accountants to step up efforts to reverse this trend and improve in the areas noted above. In this respect, ACRA firmly believes that **adequate involvement by engagement partners is critical in addressing these issues**. As the most senior member of the engagement team, engagement partners are also able to impart the skill sets and drive right behaviour in the conduct of an audit. However, at times, adequate engagement partner involvement is often hampered by the high volume of workload confronted by public accountants in this segment. We discuss this issue in greater depth in this year's report.

## **Partner Workload and Audit Quality**

4.5 To date, Singapore has 611 small and medium sized public accounting entities ("SMPs") in the non-PIE segment. Most of these SMPs are sole proprietorships and small partnerships.

4.6 Operating on a much smaller scale and with lesser resources as compared to firms in the PIE segment, SMPs are confronted with unique challenges of their own. Back in ACRA's 2009 PMP Public Report, we have highlighted the **systemic threat to audit quality** when firms operate on a high workload volume practice model. It appears that this systemic threat continues to exist today and is particularly prevalent for smaller firms.

### ***Workload Volume***

4.7 The high workload volume practice model threatens audit quality as it results in engagement partners not devoting sufficient time to provide adequate levels of supervision on engagements and to staff. Based on the inspections covered in this report, ACRA has observed several **extreme instances of partner workload**, for example, a public accountant was practising in four firms and had a total client portfolio of 381 clients, of which 67 appear to have had substantive operations and had annual turnover of greater than S\$5 million. Such situations pose serious questions about the **ability of a public accountant to cope with the volume of work and still produce quality audits**.

4.8 In handling this amount of workload, ACRA observed that some public accountants relied more heavily on experienced managers or staff to assist in the review of engagements. However, these staff may still be lacking the skills and incisiveness to exercise good judgements that the public accountant has from the

years of experience accumulated. ACRA has noted the tendency for public accountants to fail the PMP in these instances. As set out in SSA 220.7 *Quality Control for an Audit of Financial Statements*, ACRA would also like to remind public accountants that as engagement partners, the public accountant is ultimately the one responsible for the audit engagement and its performance. This role should not and can not be delegated to staff or other engagement team members.

### *Workload Concentration*

- 4.9 Due to norms and demands of the financial reporting market in Singapore, there is often a concentration of December year-end clients in a public accountant's portfolio. The high concentration of audits within a fiscal year-end pose a challenge to public accountants as the firm's resources would be stretched to its limits during this period. Potentially, audit engagements may be understaffed, given the high volume of workload and exacerbated by staff retention issues faced by the industry.
- 4.10 The gravity of partner workload conditions in the non-PIE segment is further manifested in **unreasonably high concentration of clients with 31 December financial year-end**. ACRA has found a number of public accountants auditing high numbers of December fiscal year-end clients in one financial year. In one particular instance, a public accountant even had up to 246 clients whose year-end falls on 31 December.
- 4.11 While it is difficult to pinpoint what is considered an excessively heavy or concentrated partner workload, ACRA would like to remind public accountants to assess workloads against their own capacity limits and staff resources available. Due to time and resource constraints, **excessive workload may result in audit procedures being potentially overlooked and the documentation of audit evidence being lacking** in many respects. This would give rise to higher audit risks to the public accountant.

### *Resolving the High Workload Volume / Concentration Conundrum*

- 4.12 The level of audit fees in Singapore is commonly viewed as a reason why public accountants resort to accepting high volume of work in order to support their audit practice. Being a product of market forces, the profession often espouse that this problem is being compounded by the downward spiral of audit fees in the industry. However, with increasing complexity of financial reporting

standards, higher audit threshold exemptions and investor expectations of quality financial reports, it is unlikely that firms in the non-PIE segment would be able to sustain this practice model in the long run.

- 4.13 There is a need for public accountants to consider the **value of their work** and whether they **commensurate with the levels of fees charged**. As fees are a reflection of the true value of work performed, low levels of audit fees would likely result in compromises being made to how audits are conducted and the resources allocated to perform the work. Audit quality would suffer ultimately as a result.
- 4.14 To free the profession from the high workload volume / concentration conundrum, **greater appreciation for the value of audit** needs to be developed. However, this can only take place when public accountants commit to deliver quality audits which serves to showcase the value it brings. Granted, certain trade-offs are required and firms' profit margins may be eroded in the short term as they invest in the measures necessary to achieve improvements in audit quality. Despite competitive pressures, ACRA hopes to see **audit quality emerge as a greater if not major differentiating factor offered by firms in setting themselves apart from others**.

## 5 INITIATIVES AVAILABLE TO HELP THE PROFESSION

- 5.1 Upholding audit quality and the quality of financial reporting is not the work of ACRA and the accountancy profession alone. The trustworthiness and reliability of financial information are essentially a collective responsibility requiring the support of all stakeholders within the financial reporting value chain. For example, investors have to demand for high quality financial reports which directors and financial statement preparers have to assume greater ownership in preparing. Audit committees too have an important role in providing effective oversight over the financial reporting and audit process.
- 5.2 Recognising the inter-dependency of roles amongst various stakeholders in the financial reporting value chain, accountancy professional bodies work closely with ACRA to identify initiatives that can be carried out to raise awareness of audit quality and financial reporting issues. Whilst the initiatives are primarily focused on the public accountancy profession, programmes targeting specific segments of the value chain, such as directors, financial statement preparers and audit committees are also developed to promote coordinated efforts in raising the quality of financial reporting. These initiatives are further described below.

### ISCA Initiatives

#### *Imparting Knowledge and Sharing of Experiences*

- 5.3 To better allow its members to share auditing and accounting knowledge and experiences, the following programmes are in place:
- **Technical Clinics**  
Monthly group discussions in the form of technical clinics are held to provide a platform for public accountants from SMPs to discuss issues and share practical solutions on specific accounting and auditing related topics.
  - **Seminar on Observations by ISCA’s Financial Statements Review Committee (“FRSC”)**  
The FRSC conducts reviews of audited financial statements and organises annual seminars to share with the profession common weaknesses and mistakes noted in the presentation and disclosure of financial statements. A set of frequently asked questions arising from the seminar are also compiled and uploaded in ISCA’s website to increase accessibility of the contents of the seminar.

### *Changing Mindsets and Creating Awareness*

5.4 ISCA has also launched a series of seminars and workshops and published commentaries aimed at creating awareness and changing the mindset of its members regarding auditing and accounting issues. Some notable ones that have been carried out and are on-going include:

- Seminars on new and upcoming accounting standards;
- Workshops on financial reporting, integrity and ethical issues; and
- Publishing of technical commentaries relating to accounting standards, auditing issues and financial reporting matters in its in-house journal and other major financial publications.

5.5 In addition, ISCA has also rolled-out various seminars and workshops targeted at preparers of financial statements and company directors. For example, industry focused outreach seminars for the construction sector were held to raise awareness on the common financial reporting and auditing challenges faced in this sector as well as examine how these issues can be collectively addressed. ISCA has also jointly developed the Directors' Proficiency Programme with ACRA, the Singapore Institute of Directors ("SID") and the Singapore Association of the Institute of Chartered Secretaries and Administrators ("SAICSA") to educate directors on their roles and responsibilities. These outreach initiatives aim to encourage involvement of financial statement preparers and directors in raising the overall quality of financial reporting and auditing.

### *Providing Support to Strengthen Systems and Processes*

5.6 Besides enhancing accounting knowledge and technical capabilities of its members, ISCA has also worked on various initiatives to help strengthen public accounting firms' systems and audit processes on the following fronts:

- **SSQC 1 Guidance and Implementation Support**

Since September 2012, on-going initiatives ranging from the issuance of the SSQC 1 Practice Guides and publication of articles to the conduct of courses, technical clinics and workshops have been carried out to encourage and support SMPs in their implementation of SSQC 1 within their firms.

- **The Quality Assurance Review Programme ("QARP")**

The QARP is a voluntary programme that aims to help participating public accountants improve their audit practices. The programme involves review of engagement files conducted by a Quality Assurance Advisor, with

feedback for improvements provided on audit and documentation procedures. Since its launch in October 2012, more than 30 accounting firms have expressed interest in participating in the programme.

- **Online Technical Forum**

Established in October 2012, the forum provides an avenue for members to share their views on a range of financial reporting, auditing and accounting related topics. In 2013, ISCA will also be creating a specific technical forum exclusive to SMPs to encourage greater exchanges and discussion amongst SMPs in their audit and accounting areas of interest.

- **Audit Practical Guidance<sup>25</sup> (“APG”)**

Since August 2010, 11 APGs have been issued. These APGs aim to provide members with guidance and practical advice on avoiding common areas of deficiencies when performing audits.

- **ISCA’s Audit Manual for Small Companies**

To continuously serve as a robust and useful guidance to its users on the auditing process, a periodic update to the manual has been undertaken and is scheduled for completion in December 2013.

- **Practical Audit Workshop Rollout**

This is a proposed programme scheduled to be launched in several phases beginning from 2014 to 2016. Under this programme, comprehensive audit training will be provided for staff in SMPs. Modules will be customised in accordance to the SMPs’ needs and different levels of proficiency (associates, seniors and managers).

## **CPA Australia Initiatives**

### *Singapore Accountancy Alliance*

5.7 CPA Australia has formed a Singapore Accountancy Alliance for audit practitioners from SMPs. The alliance seeks to assist this group with resources in a range of areas including business growth, technical training, talent quality, succession planning and brand building. Membership of this alliance is currently limited to CPA Australia members.

### *Recent Publications*

5.8 Over the past year, CPA Australia has released several publications in the area of productivity, business management and corporate governance. These publications are:

- The ‘Accounting and Productivity: Answering the Big Questions’ guidebook which was published in support of Singapore’s national drive to increase productivity. The publication, which is a joint collaboration with Singapore Management University, sought to provide perspectives on what enhancing productivity means to accountants and offer suggestions on how the profession can improve productivity.
- The ‘Financial Guide for SMEs’ which provides useful basic financial grounding for business owners with little financial background. This resource guide aims to help audit practitioners educate clients that operate small businesses.
- A research report on ‘Family Business in Singapore’ which seeks to gain insights into family businesses and identify attributes that contribute to their success. The publication would also be relevant to SMPs that are family-owned.
- The ‘Corporate Governance Case Studies’ which aims to raise awareness and promote thoughtful discussion on key corporate governance issues in companies across several markets, particularly in Asia. The collection of case studies will be useful for SMPs offering advisory services focusing on governance and risk management.

### *Ongoing Initiatives*

5.9 In addition to the above new and recent initiatives, CPA Australia has the following on-going initiatives to help equip its members with necessary skills and knowledge:

- For members’ continuing professional development, a monthly series of workshops focusing on current challenges and emerging trends in public practice in the areas of tax, practice management, audit and business refining strategies are held under its ‘Public Practice Development Program’.
- Practice management knowledge portals are accessible via the CPA Australia website to provide members with easy access to resources and technical guides.

- CPA Australia provides a mentor service under the Quality Assurance Review Mentor Program for its members who require guidance in identifying areas for improvement in their audit work. Through the conduct of reviews on the members' audit work, the programme offers a constructive and educational opportunity to assist its members in delivering good quality audits.

## ACCA Initiatives

- 5.10 ACCA continues to hold regular “Practitioners’ Clinics” for public accountants. These clinics discuss the latest technical and business issues relevant to SMPs, including the latest PMP findings and Audit Practice Bulletins or Practice Directions issued by ACRA. These clinics also provide a platform for public accountants to network and share auditing practices with others in the profession.
- 5.11 ACCA regularly conducts and publishes various research reports that are relevant to public accountants. ACRA has been collaborating with ACCA in some of its research. These include the most recent survey in 2013 which focuses on the financial reporting value chain and the role of preparers in ensuring high quality audit. In addition, following up from the Singapore survey on talent attraction and retention in larger accounting firms in 2012, similar surveys were also conducted by ACCA in Malaysia and Thailand. These surveys provide a regional perspective on the talent attraction and retention factors in the public accountancy sector which can assist local public accountants who have or are planning to have some presence across the region.
- 5.12 At the global level, ACCA provides a wide spectrum of research outputs that addresses concerns and issues impacting public accountants. On an ongoing basis, it also champions the value of audit to society and businesses worldwide.
- 5.13 ACCA also conducts a Global Forum for Audit and Assurance. This Forum serves to provide input into audit standards setting and aims to help identify, evaluate and champion new and alternative forms of assurance, which bring value to investors, businesses and the public.
- 5.14 Other ACCA initiatives include conducting regular seminars, workshops and conferences which cover technical, business, leadership and management topics relevant to public accountants and SMPs.

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