SINGAPORE CA QUALIFICATION EXAMINER'S REPORT

MODULE: Assurance (AS)

EXAMINATION DATE: 14 June 2017

Section 1
General comments

It is pleasing to report that the June 2017 examination cohort performed better overall compared to past cohorts. However, as in previous examination sessions, common weaknesses observed include providing answers that were not pertinent to the respective cases and the inability of some Candidates to demonstrate application of their knowledge to the facts presented. In order to score well, a Candidate must address each question requirement specifically.

Candidates should make good use of the 15-minutes reading time to plan their approach to the examination. As the questions can be attempted in any order, a good Candidate will use this flexibility to their advantage when planning their time and determining which question to attempt first.

In order to achieve a passing grade, Candidates must frame their answers in accordance with the Singapore Standards on Auditing and demonstrate application of Singapore Financial Reporting Standards to explain, express an opinion on, propose audit procedures, and/or identify/rectify the audit issues posed. In order to achieve a merit pass or better, Candidates must display a deep understanding of business processes and demonstrate an elevated level of knowledge and techniques, with synthesis and evaluation of the facts presented and emphasise the critical points, as well as being able to communicate their answers using professional terminology.

Section 2
Analysis of individual questions

Question 1

The case scenario focused on a review engagement of the financial statements of an acquisition target company. Multiple issues were identified during the review.

Part (a) focused on the financial statements of the prior year, which did not include any bank guarantees issued by the company, but the bank confirmation report showed two outstanding guarantees. The guarantees were issued by the company in favour of a third party. The third-party company subsequently purchased financial assets from the case study company. The management of the target company denied any guarantee was given by the company and insisted the bank report was wrong.
Part (a) required Candidates to explain why this issue should be reported to the acquirer.

- The first reason was that the guarantees were material. This potential liability may affect the acquisition decision of the acquirer.
- The second reason was it is unusual for management not to raise an objection with the bank when the bank report contained a material error, as claimed by the management.
- The third reason was the guarantee amount was exactly the same amount as the sale proceeds from disposing of the financial assets. It seems that the company was financing its sale of financial assets.

Most Candidates were able to identify and explain the first two reasons well. Some Candidates did not consider the context of the engagement, which was performing a review of financial statements as part of an acquisition due diligence review. They wrongly interpreted the engagement as a review of the work performed by a component auditor and framed their answer as if they were the principal auditor and focused on the deficiency of the worked performed by the auditor of the acquisition target company.

Part (b) required Candidates to apply professional scepticism to the case in relation to the acquisition target company selling quoted financial assets way above market price. This part was poorly answered. Many Candidates provided answers relating to the accounting treatment of the financial assets. Most Candidates did not find it unusual that the company was able to sell the financial assets at 33% above market price. Thus, they were not able to expand the discussion from here, e.g. removing the 'toxic' assets off balance sheet to avoid mark to market and recording a significant loss in the income statement. Candidates are reminded that they should be familiar with the glossary of terms from the Singapore Standards on Auditing. For instance, professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence. Applying professional judgment and scepticism are essential skills for all Professional Accountants.

Part (c) focused on a current loan due for repayment within 12 months from the balance sheet date, but the loan was classified as a non-current liability in the balance sheet at year-end. Shortly after year-end, the company was able to extend the loan repayment period by more than one year. There was a second loan from another bank, which included a covenant requiring the company to maintain a minimum current ratio. The balance sheet figures showed the company just met the minimum current ratio requirement.

Part (c) required Candidates to assess the risk of material misstatement in relation to the CLASSIFICATION of the first loan as a non-current liability. Appropriate reference to Singapore Financial Reporting Standards (FRSs) was required. Part (c) also required Candidates to comment whether the misstatement was likely due to error or intentional. Most Candidates correctly pointed out the first loan was a current liability at balance sheet date. Some Candidates correctly used FRS 1 – Presentation of Financial Statements as the basis for classification. However, most Candidates did not use paragraph 73 of FRS 1 to explain the misstatement. FRS 1.73 – "If an entity expects, and has the discretion, to refinance or roll over
an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.”

Few Candidates attempted to answer whether the misclassification of the loan was due to error or intentional. Those Candidates who did, correctly stated that the likely purpose was to avoid breaching the covenant of the second loan (maintain a minimum current ratio).

Part (d) focused on how the acquirer proceeded to acquire the target company with consideration that consisted of cash (US$200 million) and a 5-year bond (face value $50 million and fair value of $40 million). Due to local law (which required purchase consideration to be paid in cash), the acquirer handed US$250 million cash to the seller and received US$50 million from the seller for the bond issue. The acquirer recorded goodwill on acquisition of US$10 million and a gain on bond issue of US$10 million.

Part (d) required Candidates to explain the misstatement in the goodwill on acquisition. The misstatement arose because the acquirer had treated the cash paid and bond issue as two separate transactions, i.e., the cash as an investment cost and the bond as a financial transaction, instead of treating both transactions as part of the total purchase consideration paid to acquire a subsidiary. This part was poorly answered. Most Candidates repeated the FRS 103 Business Combinations principles without applying these to the case. Few Candidates correctly stated the total purchase consideration was US$240 million (the fair value of the consideration paid) and not US$250 million. Most Candidates identified the overstatement of goodwill, but were not able to explain why.

The final part of Question 1 (Part (e)), required Candidates to outline whether the acquisition of the new subsidiary and the related goodwill should be included as a Key Audit Matter (KAM) in the audit report. Most Candidates were able to apply the criteria of a KAM to the case correctly.

Question 2

This question focused on a Singapore listed company that held a mine and a 10-year mining lease licence. There were three issues in the case relating to the audit of the financial statements of the company. The first issue related to a mine that was acquired eight years ago. The 10-year operating licence for the mine would expire in two years’ time, and most of the mining plant and equipment also had remaining useful lives of two years. The acquisition of the mine gave rise to goodwill, which accounted for 30% of total assets.

The second issue related to an ethical threat arising from a close personal relationship between an audit assistant in the engagement team and the Finance Director (FD). The audit assistant met the FD during the interim audit and applied for leave before the final audit for her wedding to the FD.
Overall, Candidates did well in Question 2.

**Part (a)** required Candidates to comment on the ethical issues and evaluate whether the ethical threats were significant or not. Most Candidates correctly identified familiarity as the main ethical threat affecting the objectivity of the audit assistant. However, few Candidates explained the familiarity threat in that the audit assistant may become too accepting of the accounting work and explanation particularly from the FD.

Some Candidates correctly evaluated the significance of the threat by analysing the influence the FD had over financial reporting and the scope of audit work performed by the audit assistant. Most answers suggested appropriate safeguards. However, very few answers made use of the information given in the case, which stated that the audit assistant applied for leave during the final audit and, if approved, would have achieved the same effect as removing her from the audit engagement. Some answers suggested a quality review of the audit without realising the scope affected was ‘the work done by the audit assistant’ and not the entire audit.

**Part (b)** required Candidates to discuss the ethical issues and audit issues that should be reported to the Audit Committee post interim audit. Most Candidates correctly identified the close relationship between the audit assistant and the FD as the main ethical issue to be reported. Surprisingly, some Candidates did not comment on potential ethical issues at all and focused only on the audit issues. This outcome may be due to Candidates not reading the requirement carefully.

Some Candidates wrongly identified the finance team as lacking competence, as an ethical issue. The competence of the finance team was not mentioned in the case at all and was therefore not a relevant issue. Furthermore, from the auditor’s perspective, if the finance team lacked competence, this would give rise to an inherent risk and a control risk.

Most Candidates correctly identified the management assumption that the mining licence that is due to expire in two years’ time will be renewed, as the audit issue because management had not started the process of renewal of the licence. Related to this, most Candidates correctly identified the impairment analysis performed by management may be inappropriate as the main risk of material misstatement.

Some Candidates commented that using the inflation rate for the discount rate was inappropriate, but without explaining why it may be inappropriate. In addition, some answers suggested the value-in-use estimate by management may be overly optimistic without explaining why. Most Candidates did not use specific information provided in the case that the value-in-use analysis used projected gross cash inflow and thus cash outflows were not considered when estimating the value-in-use, e.g., the cash flow needed to replace mine equipment was mentioned only by a few Candidates. This funding requirement will overstate the value-in-use and overstate the recoverable amount resulting in the risk of not recognising any impairment loss.
Part (c) required Candidates to describe the audit procedures to assess the reasonableness of:

- Using the full capacity of the mine to project the cash inflow; and
- Using the inflation rate as the discount rate.

The answers given in relation to 'using the full capacity of the mine assumption' were generally better than the answers given in relation to 'using the inflation rate as the discount rate', however, only a handful of Candidates correctly suggested reviewing the historical capacity utilisation and orders on hand to assess the projected utilisation. The answers given to assess the reasonableness of using inflation rate as the discount rate were generally too generic, i.e., not specific to the facts of the case and not justified. For example, some answers stated the auditor should consider whether the inflation rate was appropriate. Some Candidates did not appear to understand what discount rates are and suggested comparing the rate used by the company to 'published market rates'.

The third issue in the case involved the company’s decision to close an 85% owned subsidiary. The decision was announced after year-end. Both the subsidiary’s financial statements and the consolidated financial statements did not reflect the impact of the decision. The audit report with an unmodified opinion had been signed, handed to management, but had not yet been issued to shareholders.

Part (d) required Candidates to describe the impact of the closure decision on the subsidiary’s financial statements. Most answers correctly identified the subsidiary was no longer a going concern and the financial statements should not be prepared using the going concern basis. Some Candidates commented that the closure results in 'discontinued operations' in FRS 105 – Non-Current Assets Held for Sale and Discontinued Operations. This would have been a relevant consideration if the question was on the impact of the closure on the consolidated financial statements, but the question was about the impact on the subsidiary’s financial statements.

Part (e) followed the line of questioning from Part (d) and required Candidates to explain the impact on the audit report if the subsidiary's financial statements were not amended to reflect the fact that it was not a going concern. As the signed unmodified audit report was still with management and had not yet been issued, the auditor should recall the audit report and issue an audit report with an adverse opinion due to the wrong basis on which the financial statements were prepared. Most answers to this part were satisfactory. However, some answers included the situation if the financial statements were to be amended that they be prepared on a liquidation basis. This was unnecessary and did not attract any marks because the question clearly stated the situation that the financial statements failed to take into account the decision to close down.

Question 3

The case scenario was a listed property developer outsourcing its internal audit function to an audit firm.
Part (a) required Candidates to suggest internal controls that the company could implement to identify and report the sale of properties to directors, key management (and their families), and staff. Unfortunately, this part was poorly answered. Some answers gave control objectives rather than control procedures. For example, the company should ensure sales to related parties, such as directors, should be separately accounted for – this is an objective to be achieved and not a control procedure. Some controls suggested were also not practical, for example, suggesting the audit committee identify related parties.

For Part (b) the following stringent controls over procurement of construction firms as contractors for property development were considered:

- Purchase orders between $10,000 and $50,000 require minimum three quotations to be obtained and compared;
- Purchase orders exceeding $50,000 and up to $100,000 require closed tenders to be conducted; and
- Purchase orders exceeding $100,000 require open tenders to be conducted.

Part (b) required Candidates to describe appropriate audit procedures to identify any purchase orders that had been split into smaller value orders to bypass the above controls. Generally, this part was poorly answered. Some Candidates suggested reviewing the accounts payable list to identify creditors with balances that exceeded the limit. Some Candidates suggested reviewing the approval process for purchase orders. Both of which do not answer the question posed.

For Part (c) the case scenario stated that the Audit Committee was concerned that the procurement staff may receive inducements from suppliers and award contracts that are not best value for money. Part (c) required Candidates to describe three audit procedures to identify any purchases that might indicate an inducement had been given. The answers to this part were generally satisfactory, although some answers deviated from the requirement, for example, some Candidates suggested how controls can be improved which was not what the question asked for.

Part (d) and Part (e) were based on a scenario where a potential customer asked for an inducement as a condition to award the contract to the company. Part (d) required Candidates to identify and evaluate the ethical issue in relation to the potential customer’s demand for a bribe. Most Candidates highlighted a self-interest threat, but failed to discuss whether the threat was significant. As bribery is illegal in Singapore (and most other jurisdictions), the self-interest threat is significant, regardless of the amount involved. Few Candidates mentioned the illegal nature of corruption. Under the Prevention of Corruption Act and the Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act, it is not the size of the payment that makes it a bribe, it is the intention, and the Corrupt Practices Investigation Bureau (CPIB) will investigate any suspected incidents of bribery, regardless of the amount involved.
Part (e) required Candidates to suggest three actions that the bid manager should take in relation to the inducement request from the potential customer. Most Candidates correctly suggested the inducement request should be reported to the appropriate level of management and to withdraw from the tender. However, some Candidates wrongly considered this as a money laundering case and suggested filing a suspicious transaction report with the relevant authority.

Question 4

The case study featured a listed company and one of its overseas subsidiaries – Tonway – was audited by a component auditor. There was a suspected irregularity in Tonway’s newly formed coating division. It was suspected that Tonway's management had set up an entity, YY, which used the assets of Tonway to provide services to Tonway’s customers. YY billed the customers for the service resulting in lower reported revenue in Tonway. Furthermore, YY also billed Tonway for fictitious services. The component auditor of Tonway believed that the revenue contribution from the new coating division was immaterial and thus any potential understatement in revenue was immaterial and would not affect the audit opinion on Tonway’s financial statements.

Part (a) required Candidates to consider, from the perspective of the principal auditor, whether they agreed with the component auditor’s view that the issue was immaterial and did not affect audit opinion. This part was poorly answered. Most Candidates focused on the statement that the revenue from the coating division was immaterial and thus any issue would be immaterial. However, the issue at hand was unrecorded revenue. The understatement of revenue may be material resulting in the reported revenue being misstated. Most Candidates failed to use the information given in the case that the revenue generating assets in the coating division were heavily utilised and thus revenue was expected to be high.

The case stated the Audit Committee of the parent intended to engage the principal auditor’s firm to carry out a special audit on the suspected irregularity in Tonway, the overseas subsidiary. Part (b) required Candidates to identify the ethical issues involved and explain the decision whether to accept the appointment or not. Most Candidates focused on the self-interest threat arising from the additional fee income the audit firm would earn. Few Candidates correctly identified the self-review threat, as any potential losses quantified in the special audit will be reflected in Tonway’s financial statements for consolidation. In arriving at the decision, the audit firm should consider whether the potential irregularity is likely to be material to the consolidated financial statements. Few Candidates considered this point in their answer.

Following on from Part (b), the facts of the case suggested that the new entity ’YY' and the management of Tonway might be related. Part (c-i) required Candidates to describe the audit procedures to determine whether the management and shareholders of YY were connected to Tonway’s directors and management. Most Candidates correctly suggested performing a company search on YY to identify YY’s shareholders and directors. Part (c-ii) required Candidates to describe audit procedures to identify potential understatement of revenue due
to YY billing the customer instead of Tonway billing the customers. This part was poorly answered. Most answers provided a typical understatement test for a trading company, i.e., trace sales orders to delivery notes to sales invoices to ledger. The majority of Candidates failed to use the information provided in the case. For instance, from the asset utilisation report, the auditor could identify the customers where the assets were assigned for the coating services to be performed. Thus, the auditor could then trace this information to the sales invoices. If no invoices were raised, this would indicate understated revenue.

Part (d) focused on an instance of unsupported expenses paid by Tonway to YY. Part (d-i) required Candidates to describe the procedures to determine the control deficiencies in the payment process. Most Candidates went on to describe the proper control procedures that the company should have in place for approving payment. Part (d-ii) required Candidates to describe the audit procedures to determine the ACTUAL PAYEE of the unsupported expenses. This part was poorly answered. Some Candidates suggested reviewing the bank statement to identify the payee. This would only be possible if the payment was in the form of a telegraphic transfer (the bank statement usually shows the name of the TT payee and a reference number, but the number of characters allowable is usually quite limited). Some Candidates wrote about vouching payment vouchers and supporting documents when the case clearly stated that these were UNSUPPORTED expenses. i.e., no supporting documents were available.