CONSIDERATIONS FOR AUDIT CYCLE

Starting Off on the Right Footing

BY
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Over the years, investors' expectations of trusted financial information in promoting investment and economic growth have been rising, and audit quality becomes essential in meeting these expectations. To achieve a high quality audit, auditors ought to get the planning of an audit right, especially in areas which are more complex and require significant judgement. Engagement teams must ensure that adequate work is performed to address significant audit risks before forming their conclusions and issuing the right opinion. In this article, we discuss certain key audit considerations that should be relevant for the upcoming audit cycle to serve as a timely reminder for all auditors.

We identified some of the more judgemental or complex audit areas, including those that have recently been the subject of attention and focus by regulators. The following discussion should not be relied upon as definitive or all-inclusive, and should be read in conjunction with the applicable rules, standards and guidance in their entirety.

1 REVENUE RECOGNITION

Revenue is typically a significant account, often involving significant

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risks that warrant special audit consideration, and is therefore a focus area in regulatory inspections. The following paragraphs discuss the application of the key requirements in the Singapore Standards on Auditing (SSA) that auditors should be mindful of when auditing revenue. Although the new accounting standard on revenue recognition will come into effect only in 2017, auditors should take the opportunity to engage management early to educate them on the potential impact of the new revenue standard, including evaluating the form and content of the financial statements disclosure.

Testing Revenue Recognition, Presentation and Disclosure

Testing the recognition of revenue from contractual arrangements

To audit revenue, auditors should first understand the nature of the company's principal businesses, the different types of sales or service contracts, and its controls over revenue including the company's development of accounting estimates for project revenue. This also includes understanding the company's key products, services and business processes that affect revenue, such as the key provisions of contractual arrangements and the extent to which contractual terms are standardised internally.

Evaluating the presentation of revenue

When understanding the contractual terms of sales, it is important for auditors to evaluate whether the company is the principal or agent in the transactions. This evaluation will determine whether revenue is properly presented as gross or net.

Testing whether revenue was recognised in the correct period

The risk of material misstatement arising from fraud or error results in improper revenue recognition.

Audit procedures, such as performing cut-off tests, should be specifically designed to address the risk of material misstatement related to revenue recorded in the incorrect accounting period.

Evaluating the required financial statements disclosures

Auditors should perform procedures to identify, assess, and address the risk of omitted, incomplete, or inaccurate disclosures. Qualitative considerations are especially important to the evaluation of misstatements in disclosures that are more narrative in nature.

Other Aspects of Testing Revenue

Responding to fraud risks associated with revenue

SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires auditors to presume that there is a fraud risk involving improper revenue recognition and to evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

When responding to fraud risks, it is important to design and perform procedures that seek reliable evidence that would be difficult for potential perpetrators to manipulate, such as evidence obtained directly from independent and knowledgeable third-party sources. Additionally, incorporating an element of unpredictability in the audit procedures makes it more difficult for individuals looking to perpetrate a fraud to anticipate, and therefore, more difficult to conceal an intentional misstatement. Some examples of unpredictable audit procedures include selecting lower value items for testing and performing audit procedures on an unannounced basis.

Performing substantive analytical procedures to test revenue

Auditors should first evaluate whether management override of controls might have allowed fraudulent adjustments outside of the normal period-end financial reporting process to have been made to the financial statements.

Auditors should also assess the reliability of data used by considering the source of the data and the conditions under which it was gathered. Before using the results obtained from substantive analytical procedures, auditors should either test the design and operating effectiveness of controls over the financial information or perform other procedures to support the completeness and accuracy of the underlying information.

Performance of substantive analytical procedures involves comparisons of relationships and trends. When unusual fluctuations cannot be explained, auditors are required to perform additional audit procedures in response to significant unexpected differences.

Testing revenue in companies with multiple locations

When a company has operations in multiple locations or has multiple business units, auditors are required to determine the extent to which audit procedures should be performed at selected locations or business units in gathering sufficient audit evidence. Factors relevant to the assessment include materiality of location or risks of material misstatement associated with the location, individually or in aggregate, when applied to the company as a whole.

2 AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE MEASUREMENTS

When auditing accounting estimates, including fair value measurements, auditors are responsible for evaluating how accounting estimates have been developed, assessing the reasonableness of accounting estimates made by management in the circumstances, assessing whether they are presented in conformity with applicable accounting principles, and are appropriately disclosed. Examples of management estimates may include those related to purchase price allocations, impairment assessments, allowance for doubtful accounts, and uncertain tax positions.

In evaluating the reasonableness of management's estimates, auditors should obtain an understanding of how management developed the estimate and use one or a combination of the following approaches:

- Review and test the process used by management to develop the estimate;
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, and
- Review subsequent events or transactions occurring prior to the date of the auditor's report.

Auditors should focus on key inputs and assumptions that are:

- Significant to the accounting estimate;

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The engagement partner is responsible for setting an appropriate tone that emphasises the need to maintain a questioning mind throughout the audit and to exercise professional scepticism in gathering and evaluating evidence so that engagement team members have the confidence to challenge management representations.

- Sensitive to variations;
- Deviations from historical patterns;
- Subjective and susceptible to misstatement and bias.

Additionally, auditors should consider historical experience of the company in making past estimates as well as knowledge of the industry. A retrospective review is required of significant accounting estimates reflected in the prior-year financial statements to determine whether management's judgements and assumptions related to the estimates indicate possible bias. This review will also inform the auditors on estimation uncertainty or other historical difficulties encountered.

3 PROFESSIONAL SCEPTICISM

Auditors are required to plan and perform their work with professional competence and due care, which requires auditors to exercise professional scepticism. Professional scepticism should be exercised throughout the audit process, including in those areas of the audit that involve significant management judgements and transactions that are outside the normal course of business. In exercising professional scepticism, auditors should not be satisfied with less-than-persuasive evidence because of a belief that management is honest. For example, when applying professional scepticism in response to identified fraud risks, auditors should (a) modify the planned audit procedures to obtain more reliable evidence regarding relevant assertions, and (b) obtain sufficient appropriate evidence (for example, third-party confirmations and examination of documentation from independent sources).

The engagement partner is responsible for setting an appropriate tone that emphasises the need to maintain a questioning mind throughout the audit and to exercise professional scepticism in gathering and evaluating evidence so that engagement team members have the confidence to challenge management representations. The engagement partner and other senior engagement team members should also be involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified in a timely manner, and addressed appropriately.

Professional scepticism involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence (rather than merely obtaining the most readily available evidence to corroborate management's assertions), and critically evaluating all evidence regardless of whether it corroborates or contradicts management's assertions.

CONCLUSION

While the above considerations may appear intuitive, it does not hurt to be reminded of the basic audit principles which are fundamental to audit quality. Strengthening audit quality is the key to mitigating the risk of issuing a wrong audit opinion; it pays to get it right from the start. ISCA

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