

MEETING THE GRADE

WHY AUDIT OPINIONS MATTER TO CONSTRUCTION COMPANIES

BCA CRS AND PUBLIC SECTOR CONSTRUCTION PROJECTS


The CRS is administered by BCA to register contractors for the procurement of construction and construction-related services for the public sector in Singapore. Contractors may register in seven major categories² such as Construction Workhead (CW), Construction Related Workheads (CR) and Mechanical and Electrical (ME).

When registering for a selected registration category, companies are generally required to meet certain criteria in the following areas:

- + Track record and performance;
- + Financial capacity;
- + Personnel resources; and
- + Company status with Accounting & Corporate Regulatory Authority (ACRA)

Taking the CW registration category as an example, there are seven different grades (A1, A2, B1, B2, C1, C2 and C3) that a company can apply to be registered under the CW category. However, they must meet the respective minimum requirements for each grade. For example, the A1 grade requires a minimum net worth of \$15 million, while C3 grade requires a minimum net worth of \$25,000.

The grades accorded will determine the size of the public sector construction projects which a company can tender for. For example, companies graded A1 will be able to tender for projects of any size, whereas at the other end of the spectrum, companies graded C3 will have a tendering limit of \$650,000. Table 1 shows the tendering limits for the respective grades in the CW category.



Suppose that a construction company is interested in tendering for a multi-million dollar Housing Development Board (HDB) project which involves the construction of multi-storey carparks and playgrounds for an HDB precinct. Is it eligible to undertake this public sector construction project?

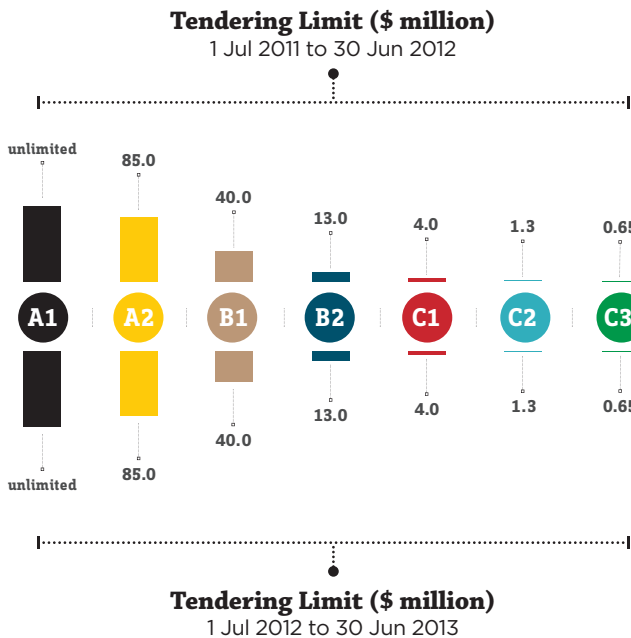
This will depend on whether the company is registered in the Building and Construction Authority (BCA) Contractors Registration System (CRS)¹ under the appropriate registration category specified by HDB, since all construction companies are required to be registered with BCA CRS in order to tender for public sector projects in Singapore.

¹ Please refer to the BCA website for details.

² Please refer to the BCA website for details.

FIGURE 1

Tendering Limits for Construction Workheads³



IMPACT OF AUDITOR'S REPORT ON ASSESSMENT OF NET WORTH

CRS requires audited accounts to determine the company's net worth for grades C2 and above for the CW category. Any modification⁴ made in the auditor's report may affect the company's grade resulting in a lower tendering limit for the company.

To better appreciate how a modified auditor's report arises, it is important to have an understanding of some key challenges faced during the audits of construction companies.

CHALLENGES IN AUDITING CONSTRUCTION COMPANIES

Similar to other professional practitioners like doctors or lawyers, auditors are required to comply with professional standards when performing their audits. In respect of the quality of their work, the auditors have to comply with the stringent requirements of the Singapore Standards on Auditing, the local equivalent of the International Standards on Auditing.

³ Adapted from www.bca.gov.sg/ContractorsRegistry/contractors_tendering_limits.html; the tendering limits for the other categories are also available here. The tendering limits are adjusted every year based on tender price trends.

⁴ A modified auditor's report arises when either the auditor (i) concludes, based on the audit evidence obtained, that the financial statements are not free from material misstatements; or (ii) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements, as a whole, are free from material misstatement.

⁵ ACRA monitors the audit quality of public accountants through the PMP.

Furthermore, owing to the nature of construction projects which usually straddle across more than one accounting period and the significance of management's judgement and estimates over variation orders and estimated cost, it is often a challenge in practice to ensure that the allocation of contract revenue and contract costs over the relevant periods has been properly carried out in accordance with FRS 11 *Construction Contracts*.

The Sixth Public Report for ACRA's Practice Monitoring Programme (PMP)⁵, issued in August 2012, noted an increased number of findings in the audit of construction companies. These findings could be due to difficulties faced by the auditors in their audit of construction companies. Some of these difficulties include:

+ Verifying the stage of completion

Some auditors have difficulty ascertaining if the revenue recognised is reflective of the actual amount of work completed. This arose from the inability of the auditors to obtain sufficient appropriate audit evidence to independently verify management's assessment of the stage of completion of the construction contracts.

+ Ascertaining total contract sum (revenue recognition)

Due to numerous subsequent variation orders received by certain construction companies, some auditors may find it a challenge to ascertain the completeness and accuracy of the total contract sum.

+ Assessing total estimated contract costs and contract costs incurred to-date

Some auditors were unable to obtain sufficient audit evidence to corroborate management's assessment of the total estimated contract costs and the occurrence of costs incurred to-date. It is not acceptable for the auditors to rely only on management's representation of the total estimated contract costs.

+ Assessing provisions made for foreseeable losses

Delays, cost overruns, liquidated damages and compensation could occur for certain construction contracts resulting in overall losses of these contracts. Such losses may not have been provided for as they may not have been identified by management. Even if such losses are identified, there may not be proper documentation of management's assessment of such losses.

CAUSES OF THE CHALLENGES

The above challenges arose primarily from poor

maintenance of supporting documents and accounting records, lack of proper financial reporting close process, lack of communication between the operational staff and accounting staff, and inadequate understanding of FRS 11 by the accounting and finance staff, leading to non-compliance with the standard.

Poor maintenance of supporting documents and accounting records

Operational staff and project managers of construction companies may have relied on verbal confirmations when processing variation orders and may not have maintained a proper trail to support the transaction, resulting in inability to furnish the required supporting document to the auditors.

Lack of proper financial reporting close process

Accounting staff may be overly focused on the posting of accounting entries and may not have performed proper cutoff procedures and analytical review to assess the percentage of completion of each contract as well as to assess the reasonableness of revenue, expenses, provisions and WIP balance recognised in the management accounts.

Lack of communication between the operational staff and accounting staff

Operational staff and project managers would not be familiar with FRS 11 requirements. Unfortunately, in most companies, the accountants could not articulate the requirements of FRS 11 to operational staff and worse, operational staff and project managers may not be informed of the necessary supporting documents to be maintained to support every transactional entry into the accounting system.

Lack of understanding of FRS 11 by the finance staff

Accounting and finance staff may not be properly trained to comply with FRS 11. This may have arisen either due to the misconception that they could rely on auditors to help them with the financial reporting close process or simply due to unwillingness of employers to invest in training.

CHALLENGES MUST BE ADDRESSED

At the end of the day, companies are required to comply with FRS 11 requirements and auditors are required to

gather sufficient appropriate audit evidence to corroborate such compliance in order to issue a clean audit opinion on the company's financial statements. In light of the PMP findings, one can expect auditors to carry out more robust checks going forward. If auditors are unable to obtain the necessary audit evidence, they will not hesitate to issue a modified audit opinion to comply with the professional standards.

Strengthening the company's financial reporting processes and better preparation for the audit brings a number of benefits to companies. Besides avoiding the potential adverse business impact brought about by a modified audit opinion, having the proper processes in place also enables companies to mitigate business risks in certain areas. For instance, proper documentation on customer approval of variation orders reduces the risks of recoverability in the event of billing disputes.

Given these benefits, companies will do well to properly prepare for an audit, as well as to work hand-in-hand with their auditors to resolve any reporting or auditing issues to avert a modified audit opinion.

WHAT NEXT?

This article explores in greater detail the challenges faced by preparers of financial statements. For guidance on the audit procedures to be performed when auditing longterm construction contracts, please refer to Practical Guidance 11 *Audit of Longterm Construction Contracts*⁶, which was issued by ICPAS in September 2012.

In our next instalment, we will provide practical examples on how construction companies can overcome the aforementioned challenges through a combination of staff education, improved internal processes and controls over maintenance of accounting records, financial reporting close process, improved communication between operational and finance staff as well as enhanced engagement with their auditors. **CPA**

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ICPAS is holding a Technical Discussion Group (TDG) Session in late November to raise awareness and enhance the standard of preparation of financial statements relating to FRS 11. Please refer to www.icpasce.org.sg for more details on the TDG.

“AUDITORS HAVE TO COMPLY WITH THE STRINGENT REQUIREMENTS OF THE SINGAPORE STANDARDS ON AUDITING, THE LOCAL EQUIVALENT OF THE INTERNATIONAL STANDARDS ON AUDITING.”

⁶ Practical Guidance 11 *Audit of Longterm Construction Contracts* is available at www.icpascaa.org.sg/publications/articles