

PROFIT AND LOSS HIGHLIGHTS OF TECHNICAL CLINIC

Since year 2008, common deficiencies relating to profit and loss components, for accounting firms that audit the non-public interest entities (non-PIE), were frequently highlighted in the practice monitoring programme. Mona Low, Managing Partner of Low, Yap & Associates, facilitated a lively discussion among fellow practitioners in a technical clinic on Profit and Loss. We bring you some of the highlights below.

Q1 For a local trading company, are sales invoices adequate evidence to check that the customers have received the goods? How will the auditors ascertain that the sales transactions recognised have occurred and are genuine?

A Sales invoices are internally generated documents by the company and by themselves, will not provide sufficient evidence that the goods have been delivered to the buyers. To ascertain that the sales transactions recognised have occurred and are genuine, auditors should obtain evidence of customers' acknowledgement of receipt of goods, which are usually indicated in the delivery orders. For some companies, sales invoices, instead of delivery orders, may be used for customers'



acknowledgement of goods received. The acknowledgement of receipt of goods by customers on sales invoices may provide reliable evidence of the occurrence of the sales. In addition to the details, the dates of acknowledgement by the customers indicated on the delivery orders or sales invoices must be checked to make sure the sales transactions have been recorded in the correct

accounting period.

UNDER THE SINGAPORE COMPANIES ACT, THE DIRECTORS AND MANAGERS OF THE COMPANY ARE REQUIRED TO KEEP PROPER ACCOUNTING AND OTHER RECORDS WHICH WILL SUFFICIENTLY EXPLAIN THE TRANSACTIONS AND FINANCIAL POSITION OF THE COMPANY.

Q2 In the case of overseas sales, it is unlikely that the customers will acknowledge goods received on the delivery orders issued by the company. How should

the auditors check the occurrence of such sales?

A For overseas sales, the company usually transports the goods to a destination designated by the customers by sea or air freight. Delivery documents such as bills of lading (BOL) and airway bills (AWB) issued by the shipper and cargo airlines respectively will provide the auditor with reliable evidence of these sales. BOL and AWB usually contain the following details relating to (i) the details of the goods that are loaded onto the vessel or aircraft to the consignee, (ii) the name and

address of the consignee and (iii) the acknowledgement of goods for shipment signed by the shipper or cargo airlines. For samples selected, auditors should trace the details of the sales invoices to BOL or AWB to confirm the occurrence of sales to overseas customers.

Q3 **Smaller companies may not have the practice of issuing delivery orders and/or requiring the customers to sign as evidence of receipt on the delivery orders or invoices. What should the auditors do?**

A Under the Singapore Companies Act, the directors and managers of the company are required to keep proper accounting and other records which will sufficiently explain the transactions and financial position of the company. It is therefore the management's responsibility to provide the auditors with the necessary documents to support the sales transactions that are recorded in the books.

In such circumstances, the auditors should highlight to the management their responsibility to maintain proper accounting and other records, and the possible legal consequences for non-compliance. The auditor should ask if management can provide other relevant documents which can support the sales transactions. Where the management is unable to provide further documentation, the auditor may consider requesting for external confirmations from the customers to confirm the sales transactions during the year.

If the auditor has exhausted all possible solutions with the management and is still unable to establish the occurrence of sales, the auditor will need to consider

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the implication to the overall financial statements. If the auditor has exhausted all avenues available to verify that the good has been delivered, he or she should assess the materiality and pervasiveness of the matter in determining the need to modify the audit report and the type of modified report.

Q4 For retail sales, goods are generally sold using cash terms at the point of sales (POS). The POS system is usually used to capture the receipts of payments from customers detailing the goods that have been sold. Can the auditors simply test the sales by reconciling the daily sales captured in the POS system with the general ledger without performing further audit procedures?

A The answer is no. Sales report generated from the POS system is an internally generated document that is inadequate as evidence of the receipt of goods by the customers. To verify the occurrence of sales, the auditors should trace the sales recorded in the POS system to the payments received.

Let's illustrate using an example of a retail shop selling beauty and fragrance products where customers purchase and make payment either in cash, credit cards or NETs (an abbreviation for Network for Electronic Transfers). On a sample basis, the auditors should check the daily sales recorded to payments received by:

- i) vouching to the banked-in slips for cash sales;
- ii) vouching to the daily statements from credit card companies on credit card sales; and
- iii) vouching to the daily statement from NETS on collection on behalf of the company

Q5 It has also been frequently highlighted that cut-off test for sales are often poorly performed. Is selecting a sample of five transactions before and after year-end sufficient to address the cut-off assertion?

A In order to perform a robust cut-off test, the auditors need to obtain an understanding of the company's cut-off procedures and assess the risk of material misstatement of revenue arising from any cut-off test. Rather than select a fixed sample number of transactions before and after year-end, the auditors should select adequate samples in the period during which the risk of cut-off is assessed to be high.

When determining the nature and extent of the audit procedures to address the cut-off assertion, the following factors should be considered:

① Risk of cut-off errors

Where the risk of cut-off errors is higher, the cut-off test will need to be more rigorous with more samples being tested and/or period covered extended. Indicators of higher risk of cut-off errors include but are not limited to the following:

- i) Delivery orders are not pre-numbered or accounted for on a periodic basis;
- ii) Delivery orders are not issued in proper sequence;
- iii) Quantity of goods delivered or shipped is not reconciled to the quantity of goods billed;
- iv) Management incentives to meet revenue goals is unusually high; and
- v) Numerous or individually significant sales transactions occur near the end of the year

② Nature of sales

Depending on the nature of sales, the extent or method of testing may vary. For example, for retail sales, auditors may test the sales on the last day before and first day after year-end by tracing to the daily receipts to make sure the sales are recorded in the proper period. For a trading company, it may be more appropriate to extend the period covered to one week or even one month before and after year-end, taking into consideration the risk of cut-off errors, as illustrated earlier. Also, the test will involve vouching to delivery orders or sales invoices acknowledged by the customers.

③ International commercial terms (incoterms) used - for overseas trading sales

For overseas trading sales, incoterms are commonly used to determine when risks and rewards of the ownership are transferred. The auditor should examine the incoterms when performing the sales cut-off test to determine if the company has recorded sales in the correct accounting period during the year-end audit.

Let's illustrate with a company which ships goods to its customers using the incoterm - Delivered Duty Paid. The occurrence of sales happens only when the freight forwarder delivers the goods to the buyer's premises as specified by the buyer and after settling the necessary import duties and taxes, assuming no further conditions need to be met. The auditors need to assess the estimated length of time it takes to complete the sales process, which may vary with destinations. If the entire process takes approximately two weeks, the testing period will likely be two weeks or more before the year-end date.

Q6 Can the auditors rely on the confirmation received from the executive directors for their audit of the remuneration of directors without performing further audit procedures?

A The confirmation of remuneration received from directors addresses the completeness and accuracy of executive directors' remuneration as at financial year-end. However the confirmation on its own is insufficient evidence that the director has been correctly paid and remuneration correctly recorded. The auditors should verify to the directors' employment contracts to ascertain the validity of the directors' remuneration including benefits-in-kind. Smaller companies may not prepare or maintain written employment contracts. In such an instance, the auditor can perform alternative audit procedure to

reconcile the directors' remuneration to the IR8A submitted by the director to the Inland Revenue Authority of Singapore. In addition, a written management letter should be issued to those charged with governance to recommend that the company prepare formal employment contracts for each executive director, setting out clearly all the elements of remuneration including benefits.

Q7 Usually for a trading company, the auditors would perform audit procedures on office rental and staff costs. For the other operating expenses, can the auditors simply agree with the stated amount to general ledger and not perform further audit procedures?

A It depends. In most audits, the auditors will consider three key

factors to determine the extent of audit procedures to be performed. The factors considered include (1) whether the balances are material; (2) whether the balances have a higher risk of misstatement and (3) whether the balances are required to be tested by the Singapore Standards on Auditing (SSA).

For the other operating expenses, the auditors should make sure that all the material operating expenses are tested. In addition, the auditors can make use of analytical review procedures to identify expenses with significant or unusual fluctuations, or where the amount of expenses is not in line with expectations formed at the planning stage as these expenses are likely to have a higher risk of misstatement for testing. Auditors should also pay attention to expenses which by nature are susceptible to misstatement, for instance, travelling and entertainment expenses. Where staff or management are expected to travel frequently in the course of their work, the auditors should select samples and to check that the travelling and entertainment expenses recorded are incurred for business purposes. Last but not least, SSA 501 para 9(c) specifically requires the auditors to review the legal expense account in order to identify potential litigation and claims involving the entity which may give rise to a risk of material misstatement. **CPA**



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