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Clarity Bulletin 2

A Practical Approach to the Clarified Singapore Standards on Auditing

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Clarity Bulletin 2: A Practical Approach to the Clarified Singapore Standards on Auditing

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Foreword

The clarified Singapore Standards on Auditing (SSAs) were issued by the Institute of Certified Public Accountants of Singapore (ICPAS) in January 2010, following a clarity consistency review of the various SSAs. The clarified SSAs replace the previous SSAs and are based on the clarified International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC), except for references to the applicable reporting framework. All clarified SSAs are effective for audits of financial statements for periods beginning on or after 15 December 2009. In practical terms, this means that they are effective for audits of financial statements for the year ended 31 December 2010.

This publication has been developed to provide practical guidance to auditors when applying and implementing selected clarified SSAs. It serves to highlight some of the challenges faced by auditors in the application of the new or revised requirements in the clarified SSAs and suggest how auditors may deal with them.

While this publication has been prepared with the auditing professionals in mind, it serves only as a reference for the user and should not be used as a substitute for reading the clarified SSAs. This publication is not meant to be exhaustive and reference to the clarified SSAs should always be made. In conducting an audit in accordance with clarified SSAs, the auditor is required to comply with all the clarified SSAs that are relevant to the engagement.

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SSA 210 *Agreeing the Terms of Audit Engagements*

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Introduction

This Practical Guidance highlights some of the challenges faced by the auditor in the application of the requirements in the clarified standards within SSAs 200 series and suggests how auditors may deal with them. The matters covered have been categorised into areas of responsibilities, quality and communication in an audit of financial statements.

Guiding Principles

Responsibilities

SSA 210 *Agreeing the Terms of Audit Engagements* deals with the auditor's responsibility in agreeing the terms of the audit engagements with management and, where appropriate, those charged with governance (TCWG). With clarified SSA 210, the auditor needs to establish whether the necessary preconditions for an audit are present before accepting or continuing an engagement. The necessary pre-conditions include an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management to the premise on which an audit is conducted.

Quality

Clarified SSA 230 *Audit Documentation* reinforces the requirements to document items/ matters tested, date and names of persons who performed and reviewed the audit work and documentation of discussions of significant matters with management, TCWG and others. Documentation should also include departure from a relevant requirement, reasons for such departure, and how alternative procedures achieve the aim of the requirement. There are also requirements for matters arising after the date of auditor's report and the assembly of the final audit file.

Communication

The extant SSA 260 *Communication with Those Charged with Governance* focuses on the communication of audit matters of governance interest arising from the audit of financial statements, with TCWG. This was essentially a one-way communication from the auditor to TCWG. However, clarified SSA 260 recognises the importance of an effective two-way communication between the auditor and TCWG and includes a new section dealing with the specifics of the new communication process, such as the form, timing, and expected general content of communications.

Clarified SSA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* is a new standard developed as part of the clarity project. This new SSA clarifies the auditor's responsibility with regards to evaluating internal control matters identified during the audit and communicating them to TCWG and to management. This new standard does away with the term "material weakness" in the extant SSA 260 and introduces and defines two new terms – "deficiency in internal control" and "significant deficiency in internal control".

Practical Application

Engagement Contracts

Clarified SSA 210 requires the auditor to confirm a common understanding between the auditor and management and where appropriate, TCWG of the terms of the audit engagement, and of the respective responsibilities of the auditor, management and TCWG. A challenge often seen in the audit of smaller entities is the lack of qualified accountants to prepare financial statements in accordance with the acceptable financial reporting framework. As soon as the auditor is made aware of such difficulties, the auditor should remind management of its responsibilities in the preparation of the financial statements.

Audit Documentation

The requirements in clarified SSA 230 on audit documentation are scalable to suit the circumstances of the particular audit. For example, the documentation of a smaller entity audit would be simpler, but it should still be relevant and compliant with the SSA's objectives of recording what the auditor has done, and providing evidence of judgments. The standard deems it neither necessary nor practical for the auditor to document every matter considered or professional judgment made in an audit. The auditor's point of reference is whether another experienced auditor, having no previous connection with the audit would be able to understand these matters from a review of the audit file.

Communication Process

Among the new requirements in clarified SSA 260, the auditor is required to obtain information relevant to the audit from TCWG of the entity and to promote effective two-way communication between the auditor and TCWG. In order to meet these objectives, it is important for the auditor to determine who the TCWG are. TCWG is defined as "those responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity".

The determination of TCWG may be less than straightforward in certain situations. For example, in entities with supervisory boards or with audit committees, the relevant persons may be the boards or the audit committees. However, in entities where a unitary board has established an audit committee, the findings may be communicated to the audit committee, or with the whole board depending on the importance of the audit matters of governance interest. In entities which are owned by other foreign entities, the persons making up TCWG may be representatives from the parent entity. Management and TCWG may not always be two distinct separate parties. In the case of Singapore-registered branches of foreign entities, TCWG may be the general manager charged with the responsibility of the Singapore operations. In cases where the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate.

Clarified SSA 260 includes specific considerations where all of TCWG are also involved in managing the entity as the communication process would differ depending on the governance structure, as well as the expectations and needs of TCWG. The auditor needs to ensure that communication of significant findings to individuals with management responsibilities also reaches all of TCWG and not just some of them. This requirement may be fulfilled in a variety of ways. These include providing TCWG with a copy of the written communication of significant findings from the auditor, including an explicit reminder in the letter to management that significant findings must be communicated to TCWG or having discussions with management on how they have communicated the significant findings to TCWG.

The extent of the auditor's effort in promoting the effective two-way communication with TCWG is another potential challenge. Whilst the requirement is for the auditor to take steps to achieve such communication, it is not always easy to demonstrate how the requirement has been achieved. Formal communications may be more appropriate in a larger entity audit. These may take the form of structured presentations and written reports. In a smaller entity, where both management and

TCWG may operate in an informal manner, the ongoing contact and dialogue between the auditor and TCWG may be more verbal than written. Where this is the case, it is important for the auditor to include in his audit documentation the matters communicated, and when and to whom they were communicated. It is also important to ensure the communications occur throughout the audit, not limited to one after the completion of the audit.

While clarified SSA 260 allows the communications with TCWG to take either the written or verbal form, it requires that certain communications be in writing. These are communications relating to the auditor's independence in the case of listed companies and significant findings noted by the auditor in the course of the audit where the auditor is of the view that oral communication would not be adequate.

Clarified SSA 265 is a new standard that focuses on communication of deficiencies in internal control that the auditor identified in an audit of financial statements to TCWG and management and specifically requires the auditor to communicate significant deficiencies in writing to reflect the importance of these matters and assist TCWG in fulfilling their oversight responsibilities. The determination of what is significant, whether it is of sufficient importance to merit attention by TCWG or management, is left to the judgment of the auditor.

Conclusion

Recognizing the importance of effective two-way communication in an audit of financial statements, clarified SSA 260 provides an overarching framework for the auditor's communication with TCWG. The guidance seeks to provide guidance in the determination of TCWG and the extent of the communication, however, the exercise of professional judgment is key in evaluating whether the communication is adequate for the purpose of the audit.

It is important that audit documentation provides sufficient and appropriate record of basis for the auditor's report and the auditor's point of reference as to what is sufficient documentation is whether another experienced auditor, having no previous connection with the audit would be able to understand these matters from a review of the audit file.

SSA 320 *Materiality in Planning and Performing an Audit*

Introduction

Clarified SSA 320 *Materiality in Planning and Performing an Audit* deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. This Practical Guidance provides guidance on the determination of materiality in an audit of financial statements. It looks at certain circumstances which may need to be considered when determining materiality.

Guiding Principles

Clarified SSA 320 paragraph 4 states that the auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.

Clarified SSA 320 paragraph 10 also states that when establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures (i.e. specific materiality levels for particular classes).

The aggregate of uncorrected and undetected misstatements could exceed materiality for the financial statements as a whole or exceed the materiality set for particular transactions, account balances or disclosures. Hence Clarified SSA 320 introduces the concept of performance materiality. Performance materiality is the amount(s) set to reduce to an appropriate low level the probability that the aggregate of the misstatements exceeds the materiality for the financial statements or materiality for particular classes of transactions, account balances or disclosures. Hence Clarified SSA 320 requires the auditor to set:

(a) An overall financial statement level materiality;
(b) One or more specific materiality levels for particular classes of transactions, account balances or disclosures, where applicable, e.g. related party transactions or remuneration of management; and
(c) Performance materialities for each of the materiality levels set in "a" and "b" above.

While determining materiality is a matter of professional judgment, clarified SSA 320 paragraphs A3 and A4 provide guidance on the identification of appropriate benchmarks for the determination of materiality for the financial statements as a whole. Such benchmarks include profit before tax, total revenue, gross profit, total expenses, total equity and net asset value.

Clarified SSA 320 paragraphs 12 and 13 also requires the auditor to revise materiality in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount initially. If the auditor concludes that a lower materiality than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Practical Application

Section 7 of the Guidance Notes of the ICPAS Audit Manual for Small Companies (AMSC) provides guidance on the determination of materiality for the financial statements as a whole. The benchmarks and percentages that can be considered for use are as follows:

Range of turnover or gross assets	Percentage of turnover or gross assets	Percentage applied on profit before tax
S$5m and below	3.0%	5.0% to 10.0%
> S$5m to S$6.5m	2.5%	
> S$6.5m to S$8m	2.0%	
> S$8m to S$10m	1.5%	
Over S$10m	1.0%	

The level of materiality is a matter of professional judgment. It should not be calculated as an average of the above three benchmarks.

Generally, the auditor should select a benchmark that is relatively stable and should apply the benchmark consistently from year to year. If the selected benchmark fluctuates significantly, it may be necessary to normalise the selected benchmark before applying the appropriate percentage to calculate materiality. For example, if the company is in a loss making position due to an exceptional impairment loss on non-current assets, the auditor should add-back the impairment loss to loss before tax before applying the appropriate percentage to determine materiality.

The following situations are some examples in which profit before tax may not be an appropriate benchmark for determining materiality:
- Companies in break-even or loss making positions;
- Companies with operating income which fluctuates from year to year;
- Non-profit organisations; and
- Companies in the development stage or start-up stage.

The auditor shall determine specific materiality levels for particular classes of transactions, account balances and disclosures which may include (but not limited to):
- Related party transactions;
- Significant estimates or valuations;
- Directors' remuneration;
- Directors' expense accounts;
- Commissions payable;
- Legal expenses; and
- Other sensitive expense accounts.

The materiality and the specific materiality levels determined should be used to determine the nature, timing and extent of further audit procedures for such classes of transactions, account balances and disclosures.

The AMSC also provides guidance on the determination of performance materiality for particular classes of transactions, account balances and disclosures. It is determined by dividing materiality by the risk factor. The risk factor is determined by considering the financial statement level risk and the assertion level risk and could range from a risk factor of 1.2 to 2.5 for the particular classes (table in form C8.4). Alternatively, as the performance materiality based on the materiality for the financial statements as a whole is typically to reduce it to an appropriately low level, it could be determined by applying (by means of multiplication) the following percentages to materiality for the financial statements as a whole: (a) low financial statements audit risk = 80%; or (2) high financial statements audit risk = 70%.

Conclusion

The determination of materiality requires professional judgment and is not a mechanical exercise using a standard formula or calculation. It is an ongoing exercise throughout the audit as the auditor needs to evaluate whether the judgment regarding materiality remains appropriate as the audit progresses.

It is important that the auditor includes in the audit documentation the materiality amounts and the factors considered in their determination. The audit documentation should also include the revision made to the materiality amounts as the audit progresses. If no revision is necessary, the audit documentation should include the auditor's re-evaluation of the judgment regarding materiality and the basis for concluding that no revision is necessary.

SSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

SSA 580 *Written Representations*

Introduction

This Practical Guidance serves to highlight the new requirements included in two clarified auditing standards within the SSA 500 series, namely, clarified SSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* and clarified SSA 580 *Written Representations*. In addition, this Practical Guidance also discusses some of the common practical challenges that the auditor is likely to encounter in the course of his audit in complying with these new requirements.

Guiding Principles

Clarified SSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

Clarified SSA 540 is a combination of two previous auditing standards – SSA 540 *Audit of Accounting Estimates*, and SSA 545 *Auditing Fair Value Measurements and Disclosures*. These two standards were combined into one single standard since fair value measurements are essentially accounting estimates, and the same principles apply in the auditing of fair value measurements and other types of accounting estimates such as depreciation expense and provisions for impairment of accounts receivables.

<u>New Requirement: The Risk- based Approach</u>

Clarified SSA 540 requires the auditor to adopt a risk-based approach when auditing accounting estimates and the related disclosures. The risk-based approach requires the auditor to firstly obtain an understanding of the process that management uses to identify, measure and record accounting estimates, as well as the relevant internal controls that management has put in place in that process. Armed with this understanding, the auditor is then required to perform certain risk assessment procedures to identify and evaluate if there are any significant risks of material misstatements to the financial statements arising from these accounting estimates. If the auditor identifies any such risks, the auditor is required to perform additional substantive audit procedures to respond to these risks.

Clarified SSA 580 *Written Representations*

<u>Basis for Obtaining Written Representations has Changed</u>

There is a key difference between the clarified SSA 580 and the previous SSA 580, and that is the basis for obtaining written representations from management. Under the previous standard, the basis for obtaining such representations is when the auditor considers that other audit evidence cannot reasonably be expected to exist. This has led to situations where auditors appear to have placed too much reliance on management written representations to support their audit opinions.

Clarified SSA 580 still requires the auditor to obtain management written representations, but only as a support to other audit evidence. Situations or circumstances where other sufficient appropriate audit evidence cannot reasonably be expected to exist are very rare and hence the auditor should be able to gather other audit evidence and not merely rely on management representations.

Practical Application

Understanding How Management Identifies and Makes Accounting Estimates

In obtaining an understanding of how management identifies those transactions, events or conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements, clarified SSA 540 paragraph 8(b) provides that the auditor makes inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing accounting estimates. Examples of such changes include changes to the entity's operations or regulatory environment that may require the entity to make new accounting estimates.

In obtaining an understanding of how management makes the accounting estimates, the auditor seeks to understand the method or model used by management to derive the accounting estimates. The auditor also needs to understand the relevant controls that management has put in place to ensure that the underlying data on which the accounting estimates are based are reliable, relevant and complete.

Staying Alert to Management Bias

The application of accounting policies and the determination of accounting estimates is influenced by management's judgment and such judgment may involve intentional or unintentional management bias. When auditing accounting estimates, the auditor should always maintain professional skepticism and recognize that there is a possibility that management bias may exist. For example, when the auditor becomes aware that management has made changes to accounting estimates or the estimation methods but such changes are not substantiated with changes in circumstances, the auditor should critically challenge management on the reasons for making the changes. Another example of situations where the auditor should remain alert to the presence of management bias is where the financial reporting framework does not prescribe any particular estimation method to be used. In these situations, it is important for the auditor to consider management's rationale for selecting certain methods over others. The auditor should be satisfied that management did not intentionally select a particular method because it gives a more favourable estimate for management objectives.

In practice, management bias can be difficult to detect, especially at individual account level. It may be identified when considered together with other accounting estimates, or when observed over a number of accounting periods.

Assumptions that Depend on Management's Intent

Very often, management has to make certain assumptions when they make accounting estimates. The auditor should evaluate if the significant assumptions are relevant, complete and are internally consistent within the entity. Assumptions that depend on management's intention to carry out certain courses of actions present particular challenge to the auditor. To audit the reasonableness of such assumptions, the auditor can review management's history of carrying out its stated intentions, as well as evaluate the entity's ability to carry out the intended plans. In addition, the auditor can also review subsequent events up to the date of the auditor's report to obtain evidence that such events are consistent with management's intention.

Testing the Accounting Estimates

Clarified SSA 540 paragraph 13 requires the auditor to perform certain procedures to audit the accounting estimates. The type of procedures to perform will depend on the nature of the estimate involved. For estimates that are routine in nature, the auditor may review subsequent events for the outcome so as to ascertain the appropriateness of the accounting estimate. For example, the subsequent sale of inventory items after the year end may provide audit evidence regarding the accuracy of management's estimate of the net realizable value as at year end. In this case, there would not be a need to perform additional audit procedures regarding this estimate.

On the other hand, for investment properties carried at fair values, the review of subsequent events is not an appropriate audit procedure. This is because fair values of assets and liabilities are time-specific and are determined for a particular point in time, which is usually the financial year end date. Information obtained after the year end may not be reflective of the conditions that exist as at year end. In this case, the auditor will have to perform other procedures such as evaluating the appropriateness of the valuation method used, taking into account the nature of the asset being valued, testing the reasonableness of the assumptions as well as the key inputs used by management in the valuation process.

Management's Refusal to Provide Written Representations

In the event that management refuses to provide certain written representations which the auditor considers necessary to support the other audit evidence he has gathered, the auditor needs to consider how this affects his prior evaluation of management's integrity. Furthermore, the auditor also has to evaluate the effect that this may have on the reliability of other representations obtained during the course of the audit. In certain situations, management's refusal to provide the necessary representations may also affect the type of audit opinion to be issued. For example, in auditing certain fair value accounting estimates, if management refuses to provide written representation that they believe all the significant assumptions used are reasonable, this presents a limitation of scope for the auditor since he is now unable to conclude on the reasonableness of the key assumptions based on the other audit evidence alone. As the assumptions can have significant impact on the accounting estimates, the auditor may be unable to conclude if the estimates have been appropriately derived and hence he may have to qualify his audit opinion accordingly.

Conclusion

In conclusion, while the new requirements introduced in clarified SSA 540 and SSA 580 may result in the auditor performing more procedures, the fundamental underlying principles remain unchanged, and that is, the auditor needs to maintain professional skepticism and exercise professional judgment in planning for and performing audit procedures to gather audit evidence so as to form an opinion on the appropriateness of accounting estimates and the related disclosures included in the entity's financial statements.

SSA 600 *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*

SSA 620 *Using the Work of an Auditor’s Expert*

Introduction

This Practical Guidance focuses on clarified SSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* and seeks to provide useful guidance in the areas of understanding component auditors and determining component materiality. Guidance will also be provided on clarified SSA 620 *Using the Work of an Auditor's Expert*, focusing on evaluating the professional competency of the expert and the adequacy of the expert's work.

Guiding Principles

Clarified SSA 600 paragraphs 19 and 20 set out the requirements relating to understanding the component auditor, and these include the requirement for the group engagement team to obtain an understanding of component auditors where it plans to request the component auditors to perform work on the financial information of components.

Clarified SSA 600 also requires group engagement team to determine component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit, amongst others, as set out in paragraphs 21 to 23.

Paragraphs 9 and 12 of clarified SSA 620 require the auditor to evaluate the competency, capabilities and objectivity, and the adequacy of the auditor's expert's work for the auditor's purposes.

Practical Application

Clarified SSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

<u>Obtaining an Understanding of Component Auditors</u>

One of the challenges often faced is the requirement for the group engagement team to obtain an understanding of component auditors who are requested to perform work by the group engagement team. This requirement applies irrespective of the relationship between the group engagement team and the component auditor (i.e. the requirements apply even if the component auditor and group engagement team are from the same network). However, where the group and component auditors belong to the same network and apply common quality control and monitoring policies and procedures and a common audit methodology etc, this can have an impact on the nature, timing and extent of the procedures to be performed to obtain an understanding of the component auditors, and this assessment should be clearly documented.

The group engagement team's experience with the component auditor is a key factor in obtaining an understanding of that component auditor's professional competence. In order to obtain that information, particularly in the first year of a new group audit engagement, the group engagement team should interact with the auditors of each significant component. Interactions may occur through visits, video conferences, or conference calls. This understanding can also be obtained through the review of the component auditor's resume/curriculum vitae (e.g., details of the engagements and industries with which the component auditor has been involved). After interacting with component auditors and gaining experience with the component auditors, the group engagement team may use that experience to determine the nature of the procedures required to obtain an understanding in subsequent years.

If a letter of instructions is sent to the component auditors, the group engagement team may consider including confirmation requests on the following to facilitate documentation requirements:

- Request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirm that the component auditor will cooperate with the group engagement team. This may mitigate the risk that the component auditor may deny access to relevant audit documentation sought by the group engagement team;
- Component auditor's independence; and
- Compliance with ethical requirements that are relevant to the group audit.

A questionnaire may also be developed for the component auditor to complete to assist the group engagement team in obtaining an understanding of the component auditor's professional competence among other matters.

Following are two examples of different facts and circumstances a group engagement team may encounter regarding component auditors and what the group engagement team can do to understand the component auditor.

<u>Scenario 1</u>

Component auditor is not from the same network. The component audit partner is newly assigned and the group engagement team has not worked with the component audit partner in the past on other audit engagements. In this situation, the group engagement team may perform the following procedures:

- Understand the component auditor's audit methodology, regulatory and professional oversight environment, and quality control and monitoring processes and procedures in place;
- Group engagement partner can engage a partner in his network firm that operates in the same jurisdiction as the non-network component auditor in a discussion as to whether the partner knows the component auditor and the audit firm, , their professional competence, the reputation of the firm and any experience in working with them;
- Request for and review the resume of the component audit partner;
- Interview the component audit partner through telephone calls to gain an understanding of the audit partner's experience in the industry and involvement in other group audit engagements; or
- Visit the component auditor to be involved in the audit planning of the component and to gain personal experience with the new component audit partner.

<u>Scenario 2</u>

Component auditor is not from the same network, but has been involved in the audit for many years. Given the involvement of the group engagement team with the component auditor in the past, they have established a strong working relationship with the component auditor and understand his professional competence and that it is relevant and appropriate for the purposes of the group financial statements. The group engagement team also has an understanding of the component auditor's audit methodology, quality control and monitoring policies and procedures as well as their regulatory environment. As the group engagement team already understands the component auditor's professional competence, they can rely on that knowledge from previous years' engagements for the current year. In this situation, the group engagement team may perform the following procedures:

- Include prior experiences with the component auditor, as stated above, in the audit documentation;
- Request the component audit partner to confirm whether anything in relation to ethical requirements, professional competence and group engagement team involvement in the work of

the component audit has changed since the previous year. (eg. changes in his professional qualifications, if any; from the prior year).

Determination of Component Materiality

Another practical challenge that group engagement teams may face is the determination of component materiality. Aggregation risk is the risk that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole ("group materiality"). Aggregation risk varies depending on the number, nature, and characteristics of the components. For example, there may be greater aggregation risk as:

- The number of components within the group increases;
- The individual components are similar in size; and
- The complexity and/or de-centralization of the IT systems used to gather and process the financial information of components increases.

The determination of component materiality is not a mechanical exercise and requires professional judgment. If component materiality is set too high, there is a greater risk that planned procedures may fail to meet their objectives. If component materiality is set too low, more testing may be performed than is necessary, which is inefficient.

In circumstances where the number of components are limited or when one or more of the components individually represents a significant portion of the group's key financial measures, it may be appropriate to set component materiality slightly less than group materiality. For example, where a group has four components and one component (Component A) is determined to be financially significant representing 85% of group income before tax and the other three components are determined to not be significant representing 6%, 6% and 3% of group income before tax respectively, the group engagement team may determine component materiality for Component A to be a high percentage of group materiality as the aggregation risk is limited.

In circumstances where there are a large number of components and no single component represents a significant portion of the group's key financial measures (e.g. a group has 50 components of equal size), it may be appropriate to set component materiality at a reasonable amount less than group materiality.

In circumstances where components are subject to statutory audit requirements, it may be appropriate to set component materiality at the materiality level for the statutory audit, provided it is possible to complete the audit of the reporting packages using materiality levels for the statutory audit procedures in time to meet the reporting deadlines to the group engagement team.

The above examples are for illustration purposes only and will not be applicable in all situations. Engagement teams will need to assess the facts and circumstances and exercise professional judgment in arriving at the component materiality. Appropriate documentation should be maintained to demonstrate how component materiality was determined.

Clarified SSA 620 *Using the Work of an Auditor's Expert*

In relation to the application of clarified SSA 620, the practical challenges often encountered by the auditor relate to the evaluation of the competency of the expert as well as the adequacy of the auditor's expert's work for the auditor's purposes. If that expert's work involves use of significant assumptions and methods, the auditor should evaluate the relevance and reasonableness of those assumptions and methods in the circumstances. If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data should be evaluated. These requirements apply even if the expert is within the same firm or same network firm.

Some best practices relating to the use of the experts, for example a property valuation expert include:

- Assessing the professional qualification of both the property valuation firm and the individual valuer by performing procedures such as conducting internet searches, checking with other partners within the firm who may have dealt with the same property valuation firm and/or the individual valuer, or direct interview with the valuer;
- Providing adequate instructions to the experts as to the required scope and depth of their work and the related audit objectives, the output required by the auditor and how it will be used/assessed by the auditor (including audit materiality levels), preferably in writing;
- Conducting a planning meeting with the expert including the audit partner, manager and the expert to understand more about the expert's experience and credentials and determine if the expert possess the necessary skills or knowledge in that particular field e.g. valuation of industrial buildings vs. private property;
- Understanding the different property valuation methods so that appropriate procedures can be designed to challenge the assumptions used for each method e.g. for the Capitalization Rate method, the capitalization rate used is a key assumption, and the auditor can perform sensitivity analysis to determine the impact on the valuation with changes made to the capitalization rate. The auditor can discuss with the valuer how this rate was determined and then perform research on industry trends to determine if the rate used was appropriate. The auditor can also perform research to identify any recent sales of comparable property to ascertain whether the value calculated using the Capitalization Rate method appears reasonable;
- Where discussions are held with the expert to understand the valuation report and conclusions, these discussions should be documented, including questions raised, challenges made to the assumptions used in the valuation reports, conclusions and responses received from the expert;
- Testing the source data used by the expert e.g. where inputs to the valuation are extracted from lease agreements, the auditor can verify by tracing to the original copies of those agreements. If estimates are used, a retrospective review could be performed;
- Using results of subsequent events review performed to determine if assumptions or estimates made are still appropriate e.g. assumptions may have been made that the rental of one of the units will continue for the next two years. Subsequent events review may, however, provide evidence that the tenant has terminated the lease prematurely.

The above requirements and suggested best practices (except bullet point 2) may also be applied where management has engaged an expert. In this situation, the auditor may want to obtain the copy of instructions or engagement letter between management and the expert to evaluate the terms of the agreement so as to determine the appropriateness of management's expert's work for the auditor's purposes.

Conclusion

The above guidance seeks to provide useful practical procedures that the auditors may perform in the areas of understanding component auditors, determining component materiality, evaluating the professional competency of the expert and evaluating the adequacy of the expert's work. However, the exercise of professional judgment and professional skepticism are key factors to determine the nature, timing and extent of those procedures and the breadth and depth of documentation required to demonstrate that sufficient and appropriate audit evidence has been obtained.

SSA 705 *Modifications to the Opinion in the Independent Auditor's Report*

SSA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

Introduction

This Practical Guidance serves to highlight the requirements of clarified SSA 705 *Modifications to the Opinion in the Independent Auditor's Report* and clarified SSA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

Guiding Principles

Clarified SSA 705 serves to deal with the expression of an appropriate modified opinion on a set of financial statements when:

(a) An auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) An auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Clarified SSA 706 serves to deal with the auditor's opinion which draws users' attention to a matter of importance that is fundamental to users' understanding of the financial statements or other matters that is relevant to users' understanding of the audit, the auditors' responsibilities or the auditor's report.

Practical Application

The previous auditing standard SSA 701 *Modifications to the Independent Auditor's Report*, dealt with 4 types of modifications:

- Emphasis of matter;
- Qualified opinion;
- Disclaimer of opinion; or
- Adverse opinion.

With the clarity project, SSA 701 was split into two new clarified auditing standards, namely, clarified SSA 705 *Modifications to the Opinion in the Independent Auditor's Report* and clarified SSA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

Concept of "Pervasive"

While the types of modified opinion have not changed in substance, SSA 705 paragraph 5(b) now provides a definition of "pervasive" and provides more guidance on the effect "pervasiveness" has on the modified audit opinion, i.e. qualified versus adverse versus disclaimer of opinion. The following table, reproduced from paragraph A1 of SSA 705, shows the effect of "pervasiveness" on the modified opinion:

Nature of Matter Giving Rise to the Modification	*Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements*	
	Material but Not Pervasive	*Material but Pervasive*
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Other matter paragraph

SSA 706 introduced an "Other Matter" paragraph, which can be included in the independent auditor's report. This paragraph communicates to users of the financial statements on matters that are not presented or disclosed in the financial statements, if auditors believe that the users of these financial statements should be informed. These matters could relate to the audit itself, the auditors' responsibilities in relation to the audit or specific to the auditor's report. One such example includes the situation where the auditor is unable to withdraw from an audit engagement when there is a limitation on the scope of the audit imposed by management during the audit engagement.

Presentation layouts of auditors' reports

The clarity project achieves the alignment of presentation layouts of the auditors' reports by mirroring the format of the auditor's report in SSA 700 which is applicable mainly to statutory auditor's report in Singapore. This deliberate change introduced by the clarity project serves to promote consistency and readability of auditors' reports.

Previously, SSA 701 does not prescribe the positioning of the modified paragraphs within the independent auditors' reports. With the clarified SSA 705 and SSA 706, it is now very easy to identify the type of modified audit opinion rendered on the audited financial statements by looking at the headings of the various paragraphs within each auditor's report. The type of modification rendered is named in the title of the headings; for example: Qualified opinion, Adverse opinion or Disclaimer of opinion. Accompanying immediately before each modified opinion is the "Basis for modified opinion" paragraph.

As for emphasis of matter and other matter paragraphs that are issued under the requirements of SSA 706, these paragraphs are also titled accordingly and placed immediately after the opinion paragraph.

Conclusion

The above guidance seeks to provide useful practical guidance on how to apply the principles contained within the clarified auditing standards in regards to modifications of auditors' reports.

SSA 800 *Special Considerations—Audits Of Financial Statements Prepared In Accordance With Special Purpose Frameworks*

SSA 805 *Special Considerations—Audits Of Single Financial Statements And Specific Elements, Accounts Or Items Of A Financial Statement*

Introduction

This Practical Guidance serves to highlight the new requirements included in clarified SSA 800 *Special Considerations — Audits Of Financial Statements Prepared In Accordance With Special Purpose Frameworks* and clarified SSA 805 *Special Considerations — Audits Of Single Financial Statements And Specific Elements, Accounts Or Items Of A Financial Statement*. In addition, this Practical Guidance also discusses some of the common practical challenges that the auditor is likely to encounter in the course of his audit in complying with these new requirements.

Guiding Principles

Clarified SSA 800 serves to deal with the reporting on a complete set of financial statements prepared in accordance with a special purpose framework.

Clarified SSA 805 serves to deal with the reporting on a single financial statement or a specific element, account or item of a financial statement, whether it is prepared in accordance with a general purpose framework or special purpose framework.

Practical Application

The previous auditing standard SSA 800 *The Independent Auditor's Report on Special Purpose Audit Engagements*, dealt with:

- Reports on Financial Statements Prepared in Accordance with an Other Comprehensive Basis of Accounting;
- Reports on a Component of Financial Statements;
- Reports on Compliance with Contractual Agreements; and
- Reports on Summarized Financial Statements.

With the clarity project, this auditing standard was split into three new clarified auditing standards, namely, clarified SSA 800 *Special Considerations—Audits Of Financial Statements Prepared In Accordance With Special Purpose Frameworks*, clarified SSA 805 *Special Considerations—Audits Of Single Financial Statements And Specific Elements, Accounts Or Items Of A Financial Statement* and clarified SSA 810 *Engagements To Report On Summary Financial Statements*.

<u>Reports on Compliance with Contractual Agreements</u>

One of the major issues introduced by the clarity project is the removal of this reporting section from the previous SSA 800. With this removal, it is no longer possible for auditors to issue any compliance opinion in respect of contractual agreements. Auditors are now required to conduct such compliance audits in accordance with the requirements set out in SSAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information*.

<u>Reports on a Component of Financial Statements</u>

The requirements for reporting on component of financial statements have been extended with the introduction of clarified SSA 805. Prior to the clarified auditing standard, the audit opinion allowed to be expressed only includes "…component is prepared, in all material respects, in accordance with the applicable financial reporting framework or identified basis of accounting." With clarified SSA 805, the audit opinion expressed could also include "…component presents fairly, in all material respects, in accordance with the applicable financial framework" if the financial framework applied is that of a fair presentation framework as defined in clarified SSA 700 paragraph 7(b).

In addition, special considerations is required when reporting on single financial statements or specific elements, accounts or items of a financial statement; when a modified opinion, emphasis of matter paragraph or other matter paragraph has been included in the auditor's report of the same entity's complete set of financial statements. In particular, an unmodified opinion on the components is not allowed if an adverse opinion or a disclaimer of opinion has been concluded on the complete set of financial statements.

Management's responsibilities for choice of basis of preparation

One other major change is on the need for management to acknowledge its responsibilities in determining the acceptable basis of preparation when they have a choice of financial reporting frameworks for the preparation of special purpose financial statements, single financial statements or specific elements, accounts or items of a financial statement.

Presentation layouts of reports

Another major change introduced by the clarity project is in terms of the alignment of presentation layouts of the auditors' reports issued to mirror the requirements set out in clarified SSA 700 which are applicable mainly to statutory auditor's report in Singapore. This deliberate change introduced by the clarity project serves to promote consistency and readability of auditors' reports. One of the practical challenges faced in this area by auditors and clients relates to the acceptability of the clarified auditors' reports by the intended recipients as the recipients of these reports may not be able to appreciate the reasons for the change in wordings and presentation of the reports.

Conclusion

The above guidance seeks to provide useful practical guidance on how to apply the principles contained within the clarified auditing standards in regards to special purpose reporting.

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