ACCOUNTS RECEIVABLES

HIGHLIGHTS OF TECHNICAL CLINIC

For five consecutive years from 2008 to 2012, there have been repeated findings in the audit of accounts receivables (AR) from the practice monitoring programme for audit practices in the non-public interest entities (non-PIE) segment. In this article, we bring to you the most insightful nuggets on this topic, as discussed at the recent Technical Clinic facilitated by Wee Kong Eng, Partner, KE Wee & Associates.

Q1 What are the most common practical difficulties faced by the auditor, particularly in the audit of AR for small and medium-sized enterprises (SMEs)?

A Evaluating management's assessment of the recoverability of the AR is often a challenging task in audit of SMEs. For most SMEs, such assessment is usually informal and unstructured. Often, management relies on their "experience" and "feeling" to determine the collectability of the outstanding debts. Comments like "The customer is a long time friend" and "will surely pay" are frequently heard. To aggravate the matter, such assessment has been accepted by some auditors in the past, making it harder for the current auditor to challenge the practice.

For a number of SMEs, sales are usually made up of voluminous but individually low-value transactions. Consequently for each customer, the balance may comprise individually low-value transactions which may be significant on a cumulative basis. Hence, in response to non-replies to circularisation of such receivable balances, significant effort is usually required to perform the alternative audit procedures. Such efforts add on to the already strained resource constraints of SMPs.

Q2 For certain companies in the freight-forwarding business, transactions making up each specific AR balance are voluminous and individually insignificant. To add salt to the wound, the auditor is always unable to obtain replies from all the circularised balances. Can the auditor perform alternative audit procedures on certain key transactions within the circularised AR balances for the non-replies?

A Rule number one on sampling is "No cherry picking". The above is an


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example of "samples on samples" which is unacceptable. In order for the auditor to draw a conclusion on the population from which the sample is selected, the use of sampling methodology requires that the entire sample items chosen be tested without exceptions. If there are exceptions, every exception should be investigated and satisfactorily resolved before the results of the audit procedures can be considered as sufficient to provide the relevant and reliable audit evidence necessary to address the assertions intended by the audit procedures.

For illustrative purposes, based on the sample selection planning template in the *Audit Manual for Small Companies*, eight debtors' balances were selected for external confirmation. The auditor is required to corroborate all the eight balances selected either by way of confirmation replies or where there are no replies, by way of alternative procedures. For replies with differences, such differences should be investigated and satisfactorily resolved. For each non-reply, alternative audit procedures should be carried out to obtain relevant and reliable audit evidence on the unconfirmed account balance in its entirety.

EVERY EXCEPTION SHOULD BE INVESTIGATED AND SATISFACTORILY RESOLVED BEFORE THE RESULTS OF THE AUDIT PROCEDURES CAN BE CONSIDERED AS SUFFICIENT TO PROVIDE THE RELEVANT AND RELIABLE AUDIT EVIDENCE NECESSARY TO ADDRESS THE ASSERTIONS INTENDED BY THE AUDIT PROCEDURES.

Q3 **For most of the SMEs, the audit usually commences four to five months after year-end. As alternative procedures can be easily performed to verify the AR balances, is it still necessary to circularise AR? Isn't it a waste of time and resources?**

A At first glance, this notion appears reasonable. Currently, the use of external confirmation is not mandated by any Singapore Standard on Auditing (SSA). However, SSA 330 para 19 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. As auditors, we need to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

Reliability of the audit evidence is one of the key considerations in the process. Audit evidence in the form of external confirmation received directly by the auditor from a confirming party is considered the most reliable and appropriate evidence to address both the existence and completeness assertions for AR. In view of the integral relationship between AR and revenue which carries a presumed risk of fraud, the use of external confirmation procedures is typically expected when auditing AR balances. The expectation is further illustrated in the Audit Practice Bulletin No. 1 of 2010 on *External Confirmation* issued by Accounting and Corporate Regulatory Authority (ACRA) which states that "ACRA expects auditors to continue to use confirmations as a means of obtaining audit evidence to ascertain the existence and/or completeness of assets and liabilities."

In rare circumstances, should the auditor determine not to perform external confirmation procedures, the factors considered and the rationale for decision should be included in the audit working paper. The documentation should include the nature, timing and extent of alternative audit procedures performed. For example, in the audit of a freight-forwarding company, based on the auditor's understanding of the industry and prior years' audit experience, the response rate from AR circularisation is poor and therefore, the use of confirmation would not be effective. In such an instance, the auditor performs alternative audit procedures on the transactions making up the AR balance to subsequent receipts or delivery note with customer's acknowledgement on goods received. To further check that the AR is genuine, the auditor should perform checks through search engines, such as Google or Yahoo, to check that the registered address of the AR is the same as the address indicated on the invoice or perform an ROC search on the AR business profile, that is, ACRA's website.

Q4 Would it make sense to allow the client to send out the AR confirmation request letters to speed up the confirmation process?

A The auditor is required to maintain control over external confirmation requests, which include, *inter alia*, the sending or delivery of the requests to the confirming party. By allowing the client to send out the AR confirmation request letters, the auditor loses control of the confirmation process. Worse, the act will increase the risk that the confirmation requests or replies are intercepted and altered during the process.

SSA 330 PARA 19 SPECIFICALLY REQUIRES THE AUDITOR TO CONSIDER WHETHER EXTERNAL CONFIRMATION PROCEDURES ARE TO BE PERFORMED AS SUBSTANTIVE AUDIT PROCEDURES.

To speed up the confirmation process, one suggestion is to send confirmation requests as soon as the year-end accounts are closed. By doing so, the debtors are likely to respond as the balances are current and information is readily available. If replies are not received within two to three weeks from the date of request, the auditor can follow up by sending a reminder on the confirmation request or calling the debtors.

In cases where the auditor is required to issue an audit opinion shortly after the balance sheet date to meet the tight reporting deadline of the audit client, the auditor may consider performing circularisation at an interim date prior to the balance sheet date. Thereafter, the auditor needs to perform audit procedures to validate the movements during the intervening period between the interim date and the balance sheet date.

Q5 If the auditor receives AR replies via fax or email, can the auditor accept the replies received without performing additional audit procedures?

A Let's alter the question slightly. Is the auditor very certain that the AR confirmation received via fax or email is indeed from the customer? In recent years, technology has advanced tremendously. The fax confirmation replies may be sent from a residential address of the Chief Executive Officer of the company under audit, who is trying to manipulate the revenue and profit of the company. Similarly, an email confirmation reply may also come from a non-existent customer's email account created by a Finance Manager trying to cover up a potential scam of siphoning cash from the company under audit. The auditor needs to apply an appropriate level of professional scepticism regarding such confirmations received.

Generally, it is hard to establish the proof of origin for confirmations

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received by fax and email. In view of the susceptibility of email and fax confirmations to fraud, further audit procedures should be performed to verify these confirmations. The auditor should check the accuracy of the mailing address or fax number of the intended confirming parties and call the intended confirming parties directly regarding the confirmed balances. Of course, the audit work performed in addressing the reliability of replies prior to placing reliance needs to be documented properly as evidence of work done.

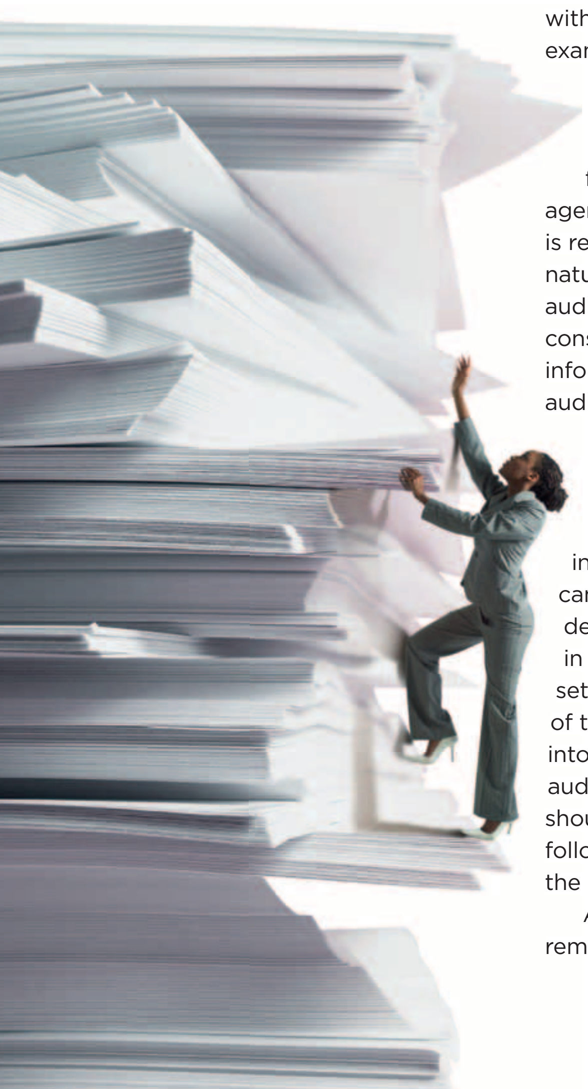
Q6 Knowing that management's words should not be taken at face value, how should the auditor address the issue of a material debt that is long overdue?

A It is management's responsibility to assess the recoverability of the outstanding receivables while the auditor's responsibility is to evaluate the management's assessment. As part of the evaluation, the auditor should inquire into the basis of management's assessment and corroborate the representations by management on the recoverability of outstanding receivables.

Where such evidence is not available, the auditor should independently evaluate the credit-worthiness of the customer and the ability to repay the outstanding amount. Such evaluation may include reviewing subsequent receipts and correspondences with the debtor, independently examining past payment patterns, or reviewing the debtor's financial statements or credit rating report purchased from a reputable credit rating agency. Professional judgement is required when determining the nature and extent of additional audit procedures, taking into consideration the availability of information needed in the respective audit procedures.

In a scenario where the debtor is a publicly-listed corporation, there would be readily available financial information which the auditor can use to assess the ability of the debtor to repay the debt. However, in a contractual agreement setting out the repayment terms of the outstanding debts entered into between the company being audited and the debtor, the auditor should review the agreement and follow up with the management on the repayments.

After performing all the above, remember to document the audit work performed and the conclusion whether an impairment provision is considered necessary.



Q7 It is always a challenge for the auditor to persuade the client to provide for impairment of AR because of the potential financial impact on the overall financial statements. Is qualification a solution?

A Not necessarily. Upon identifying the potential recoverability issue, the auditor should first engage with the management. For SMEs, management usually consists of one or two key personnel who are very involved in the company's business operation and know their customers well. Discussion with appropriate management personnel instead of finance personnel will usually provide the auditor with insight on management's basis of their recoverability assessment. Further audit procedures as set out in Q6 can then be performed to corroborate management's assessment.

If the auditor, after performing further audit procedures, is still of the view that impairment is necessary, the auditor should determine the implications to the financial statements. If the auditor concludes that the possible effect on the financial statements is material and management is unwilling to provide for the impairment, qualification is likely to be inevitable. In this scenario, the auditor will need to communicate with those charged with governance on the qualification and the circumstance that leads to the qualification to the audit opinion. Last but not least, have these properly documented! CPA

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