Surveillance on Financial Reporting

Learning from the Past and Anticipating the Future

It's been two years since the implementation of Financial Reporting Standards (FRS) in Malaysia. For public-listed companies with financial periods beginning on or after 1 January 2006, 18 new FRSs came into effect. Private entities continue to comply with the Private Entities Reporting Standards (PERS).

The Financial Statements Review Committee (FSRC) has completed its review of the first time implementation of FRS by companies and presents here its common review findings for the period July 2007 to June 2008.

Twenty-four companies were selected at random and their financial statements reviewed. Three others were referred to the company by Bursa Malaysia and the Securities Commission. The companies selected for review included public-listed companies, non-listed companies and government linked corporations; and the financial statements selected are those for financial periods ending on or before 30 June 2007.

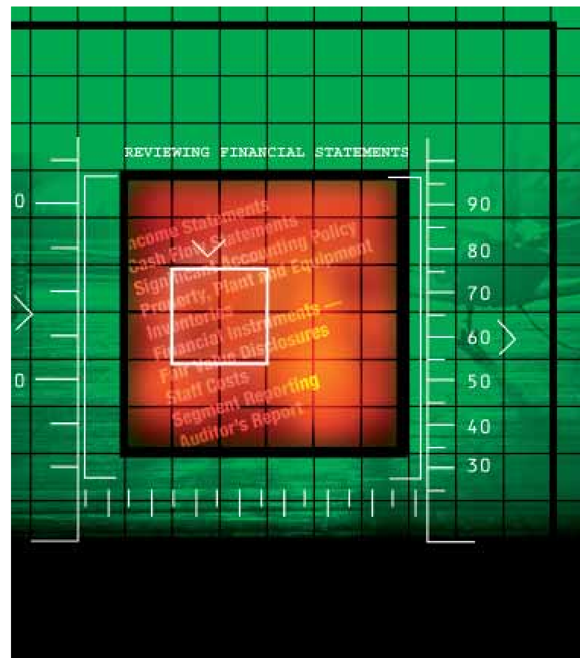
Weaknesses commonly identified by FSRC are shown in Table 1.

Referral to Investigation Committee

During this period, seven cases were referred to the Investigation Committee on financial reporting matters as a result of the penalty tariff, which came into effect in January 2007.

Under Category 3 of the penalty tariff, members who are responsible for the preparation or reporting of the financial statements may be referred to the Investigation Committee and/or other regulatory bodies for appropriate action due to serious non-disclosures or departures from GAAP. Members may also be served with warning letters or reprimands and the financial statements of the company concerned could be put under surveillance for up to four consecutive years.

The reasons for referring the cases to the Investigation Committee include incorrect accounting treatment, numerous unjustifiable errors in financial statements, failure of the auditor to modify his report to highlight going concern issues, and deficiencies in audit work performed.



Financial Statements are the Responsibility of Management

Section 167 of the Companies Act, 1965 states that the company and the directors shall keep such accounting and other records that will sufficiently explain the transactions and financial position of the company and enable true and fair profit and loss accounts and the balance sheet to be prepared.

Under Section 169 of the Act, the directors are required to declare that the financial statements comply with the accounting standards and that they give a true and fair view of the financial position and performance of the company.

It is noted that the duty of preparing financial statements usually rests with the company's management.

Roles of Auditor

Although financial statements are the responsibility of the management, it is also important for auditors to carry out their duty effectively. An auditor conducting an audit in accordance with the approved standards on auditing can get reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Due to the inherent limitations of auditing, the auditor may not obtain absolute assurance that material misstatements in the financial statements will be detected. However, an attitude of professional scepticism is very important when considering the

Table 1 Common Findings of Financial Statements Review Committee, July 2007 – June 2008

COMMON FINDINGS ON APPLICATION OF FRS/ STANDARDS ON AUDITING	RELEVANT STANDARDS/STATUTES AND RECOMMENDED PRACTICE
1 Income Statements ■ In the presentation of income statements, certain expenses are classified by nature and others by function. Entities that classify expenses by function did not provide adequate additional information on the nature of expenses.	*FRS 101, Presentation of Financial Statements* requires an entity to present, either in the face of the income statement or in the notes to the income statement, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity. FRS 101 requires entities classifying expenses by function to disclose additional information on the nature of expenses.
2 Cash Flow Statements ■ Cash flow items of operating, financing and investing activities (e.g. borrowings and purchase of investment) were classified wrongly.	*FRS 107, Cash Flow Statements* requires the cash flow statement to report cash flow during the period classified by operating, investing and financing activities. The Standard provides a definition for each of the 3 classifications and guidance on classifying cash flows into these classification.
3 Significant Accounting Policy ■ Omission or incomplete disclosure of accounting policy for material items in the financial statements. ■ Disclosure of accounting policies that are not specific to the entity.	*FRS 101* requires disclosure of the basis of preparation of the financial statements and the specific accounting policies used which disclose the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.
4 Property, Plant and Equipment ■ Accounting policy does not clearly state the adjustment for impairment losses.	*FRS 116, Property, Plant and Equipment*, paragraph 30 requires an item of property, plant or equipment to be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
5 Inventories ■ No description provided for net realisable value	*FRS 102, Inventories* requires disclosure of the accounting policies adopted in measuring inventories, including the cost formula used.
6 Financial Instruments — Fair Value Disclosures ■ Non disclosure of fair values of the financial guarantee (e.g. on banking and credit facilities of subsidiaries) ■ Non-disclosure of fair value of non-current financial assets/liabilities ■ Non-disclosure of fair value of the amount due by/to subsidiary companies and associated companies due to a lack of fixed repayment terms and inability to estimate fair value without incurring excessive costs.	*FRS 132, Financial Instruments: Disclosure and Presentation* requires an entity to disclose the fair value for each class of financial assets and financial liabilities in a way that permits it to be compared with the corresponding carrying amount in the balance sheet.
7 Staff Costs ■ No adequate analysis on staff costs to disclose e.g. wages, salaries, bonuses, defined contribution retirement benefit plan, equity compensation benefit and other employee benefits.	*FRS 101* requires disclosure of employee benefits expense i.e. the short term employee benefits, post employment benefits, other long term employee benefits and termination benefits.
8 Segment Reporting ■ Non-disclosure or inadequate disclosure of the accounting policy on segment reporting. Entities disclosed segmental information reporting but did not disclose the accounting policy for segment reporting.	*FRS 114, Segment Reporting* requires that policies relating to segment reporting, such as identification of segments, method of pricing inter-segment transfers and basis of allocating revenues and expenses to segments to be disclosed.
9 Auditor's Report ■ Auditor's Report not modified/qualified regardless of the going concern issue faced by the company.	*ISA 570, Going Concern* requires an auditor to determine, based on the audit evidence obtained, if in the auditor's judgment, a material uncertainty exists related to events or conditions that alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern. *When going concern assumption is appropriate:* If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding an emphasis of matter paragraph that highlights the existence of a material uncertainly relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the notes in the financial statements that disclose the matters set out in paragraph 32 of ISA 570. If adequate disclosure is not made, the auditor should express a qualified or adverse opinion as appropriate. *When going concern assumption is not appropriate :* The auditor should express an adverse opinion if the financial statements have been prepared on a going concern basis.

risks of material misstatement due to fraud. Professional scepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* requires an auditor to maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

Anticipating the future

The current economic conditions are particularly challenging for companies. In such circumstances, the FSRC draws particular attention of the management to the following:

1 Fair Value Measurements and Disclosures

Determining fair value in the current market turmoil is a challenge by companies. Depending on the accounting policy selected, the impact of fair value accounting may be seen with regard to management's determination of the value of goodwill and intangibles acquired in a business combination, investment properties, share-based payments, pension liabilities and financial instruments.

The recent crisis in the banking sector around the world and the resulting illiquidity in the market make it even harder to fair value the financial assets and liabilities. Unavailability of information as the market becomes inactive affects the degree of estimation uncertainty, as estimates need to be made on the basis of information which uses inputs that are unobservable.

It is worthwhile to note that whether inputs are observable or not, preparers of financial statements need to have evidence to support them. This is because while estimation of fair values is difficult in light of market uncertainty, it has not proved impossible to obtain sufficient information to record them in financial statements.

2 Impairment of Assets

The current tough economic times are having a significant effect on a wide range of businesses with some already reporting reduced sales volumes and reduced margins. These reductions mean that for many businesses the assumptions used to estimate the value of goodwill, property, plant and equipment or other assets will need to be revised.

FRS 136, *Impairment of Assets* clearly indicates that significant changes that adversely affect the economic environment in which the entity operates are an indication that assets may be impaired (FRS 136.12), thus triggering a need to estimate the recoverable amounts of the assets. The recoverable amount, which largely depends on the future estimated cash flows, will have to be closely scrutinised and reflect estimation that best explains the environment in which the asset is used. And what may in the past have been a routine valuation problem may become the source of a significant risk.

Do take note that key assumptions on which management bases its cash flow projections should be described (FRS 136. 134(d)(i)); and the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts should be disclosed and any growth rate that exceeds the relevant long term average growth rate should be justified (FRS 136.134(d)(iv)).

3 Going Concern Assessment

FRS 101, *Presentation of Financial Statements* contains a requirement for management to make an active assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.

FRS 110, *Events after the Balance Sheet Date* also gives guidance on evidence of going concern status from subsequent events. Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

There are many areas which the directors could look at when deciding whether the company will continue in operational existence for the foreseeable future and hence as a going concern. Probably, the directors could challenge critical assumptions included in the budgets and forecasts; consider how sensitive the company has been to particular past events; review the liquidity and borrowing requirements; and ensure that there are no anticipated shortfalls in facilities against requirements or breaches of covenants.

Preparers of financial statements are reminded that in accordance with paragraph 116 of FRS 101, there should be disclosures of key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Further guidance is provided in paragraph 120 of the same standard. It is important to recognise that high quality financial reporting in the current economic environment helps to enhance the public's confidence in the company. AT

Function of FSRC

The FSRC was established by the Council of MIA to monitor the quality of financial statements for the purpose of determining compliance with statutory and other requirements, approved accounting standards and approved auditing standards, and generally accepted accounting and auditing standards and practices. The FSRC also looks into matters referred to it by other regulators and may review financial statements where there are public interest issues involved.

Auditors, Look Out for These in the Coming Peak Season …

Often, when the financial stability of the entity is being threatened there is a higher possibility that management would commit fraudulent financial reporting. 2008 proved to be a year of uncertainties. Rising inflation rates, the downward trend of the world economy and the recent global financial crisis has created pressure on management. The auditor must be aware that this situation may tempt management to find opportunities to manipulate the financial results.

ISA 315, U*nderstanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* requires an auditor to obtain an understanding of the entity and its environment, including its internal control mechanism, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

Once the entity and its environment is understood, the auditor should evaluate whether the activities and transactions reflected in the financial statements are consistent with his understanding of the entity and the environment. This article highlights areas which may require heightened audit emphasis by the auditor and where professional scepticism is particularly important in the coming 2008 year end:

Management Estimates

Certain items in the financial statements can only be estimated. Estimation calls for judgment by the management. Examples would be in the areas of providing allowance for bad debts, estimating fair value of financial assets and liabilities and also the useful lives of assets.

ISA 540, *Audit of Accounting Estimates* requires an auditor to assess whether the accounting estimate is reasonable in the circumstances and appropriately disclosed.

Engaging an expert would provide an independent estimate for comparison to management's estimate. An auditor could also extend enquiries to individuals outside of management and the accounting department to obtain further evidence on the management's ability and intent to carry out plans that are relevant to developing the estimates.

Revenue Recognition

Recent cases flagged in the newspapers highlighted attempts to inflate revenues by creating fictitious transactions.

Profitability or trend level expectations of investment analysis, institutional investors, significant creditors or other external parties may create pressure for management.

The auditor may perform substantive analytical procedures to identify unusual or unexpected revenue relationships or transactions. Confirming with customers on specific contract terms and also enquiring on sales or shipments near the end of the period may also be carried out in response to this risk.

ISA 500, *Audit Evidence* states that audit evidence is more reliable when it is obtained from sources outside the entity.

Change of Accounting Policy

A sudden decision by the management to change its accounting policy should be further assessed.

FRS 108, *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to select and apply its accounting policies consistently for similar transactions, other events and conditions unless another standard or interpretation specifically requires or permits categorisation of items for which different policies may be appropriate.

This requirement is there to prevent management from changing its accounting policies to suit its own purpose. However, in this period of uncertainty, management may opt to change its accounting policy if the option gives a better result. For example, changing its policy from cost method to revaluation method for property, plant and equipment or vice-versa.

In assessing the reasonableness of the change in policy, the auditor may compare the company's policies against the industry norm, enquire on all alternatives considered in selecting the accounting policy and also look at the overall impact of the new accounting policy on the financial statements.

Default on Loans and Borrowings

There is a higher risk of companies defaulting on loans and borrowings in this period of uncertainty. Perhaps the auditor should review the covenants of the loan agreements for potential breaches, rigorously assess whether the company is able to meet the repayment of debts and the possibility of it defaulting on loans and borrowings. He might also need to consider that banks may not be in a position to re-

structure loans or provide more funding in light of the recent collapse of a number of financial institutions around the world.

Should the auditor find evidence that the company would not be able to meet the repayment requirements, he must assess whether adequate disclosure has been made in the financial statements. The auditor should also assess the ability of the company to carry on as a going concern should the loans and borrowings become due.

If adequate disclosure is made in the financial statements, ISA 570, *Going Concern* requires an auditor to express an unqualified opinion but modify the auditor's report by adding an emphasis of matter paragraph highlighting the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draw attention to the note in the financial statement that discloses the matter. If not, a qualified or adverse opinion should be expressed.

Significant, Unusual or Highly Complex Transactions

Particular attention should also be given to significant, unusual and highly complex transactions, especially if this happens near the year-end or immediately after the year-end. Examples include creation of special purpose entities, off balance sheet transactions and classification and de-recognition of financial instruments.

The auditor needs to obtain an understanding of the transaction and assess its impact on the financial statements. Reviewing the minutes of meetings of shareholders, board of directors and audit committee, as well as all the relevant contracts will assist the auditor in assessing the situation.

Fraud Indicators

Auditors should be alerted when they detect indicators such as:

- Dominating CEO/MD's presence
- Unreasonable ratio when comparing receivable balances and revenue for the period
- Receivables were written off without efforts to collect
- A major part of the income comes from one off items
- Either consistent or rapid earnings growth in order to meet analysts' growth expectations
- Complex or messy reconciliations, and there are unexplained items on reconciliations
- Inconsistent or vague responses from management or employees arising from inquiries or analytical procedures

Auditors are reminded that Section 174 (8A) of the Companies (Amendment) Act 2007 that came into effect 15 August 2007 imposes a duty on them to report to the Companies Commission of Malaysia if in the course of audit, they discover a serious offence involving fraud or dishonesty committed against the company by the officers of the company. Failure to provide a written report will attract criminal penalty. In addition, according to Section 320 of the Capital Markets and Services Act 2007, if an auditor is of the professional opinion that there has been a breach of securities laws or rules of the exchange or any matter which may adversely affect the financial position of the listed company, the auditor must immediately submit a written report on the matter to the Securities Commission.

Fair Value Measurements and Disclosures

Challenges faced by companies in determining fair value in the current market turmoil pose an even more challenging task to the auditors as they are expected to assess whether the fair value measurements and disclosures in the financial statements are appropriate.

ISA 545, *Auditing Fair Value Measurements and Disclosures*, provides guidance to auditors on the audit considerations relating to the measurement, presentation and disclosure of material assets, liabilities and specific components of equity presented or disclosed at fair value in financial statements. Whilst auditors should principally refer to this standard for guidance, other standards may also be applicable, in particular those that deal with understanding the entity and its environment, responding to assessed risks, using the work of an expert, obtaining management representations and communicating with those charged with governance.

The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) recently issued a practice alert to assist auditors. It highlights areas within the ISAs that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty.

Auditors are encouraged to refer to this practice alert titled "Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment". It is available at the IFAC website at *http://web.ifac.org/download/Staff_Audit_Practice_Alert.pdf.*

Impairment of Assets

FRS 136 requires an entity to assess at each reporting date whether there is any indication that an asset may be impaired. If there is such an indicator, the entity shall estimate the recoverable amount of the asset. Auditors are reminded that client management shall be the party making the impairment assessments with the required rigour; and it is inappropriate for auditors to do impairment assessments on behalf of the client because, if they did so, their audit independence would be impaired. Instead, the auditors must insist that the client management carry out its obligations.

Before arriving at their conclusion, auditors need to carefully assess the estimation used by the management for this purpose. If the recoverable amount is less than its carrying amount, the asset is impaired and the impairment loss shall need to be recognised immediately in the income statement.

It is important that relevant questions are asked and assessments made on the reasonableness of the responses received before a conclusion is drawn.

ISA 500 and ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* require the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion and the auditor should evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the financial statements. AT