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Bursa Malaysia's Half Day Governance Programme

Understanding Financial Statements – Use of healthy scepticism

By Lee Min On, 3 December 2012



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

Session Outline

- **Understanding & scrutinizing Financial Statements**
- **Asking Management probing questions**
- **Challenging the status quo**
- **Simple case study**
- **Questions & comments**





Understanding & scrutinizing Financial Statements

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Financial statements – what they are

Reporting of historical financial performance of an entity (entities) over specified period with comparative figures

Statement
of financial
position
(Balance
Sheet)

Statement
of compre-
-hensive
income
(P&L)

Statement
of cash
flows

Statement
of changes
in equity

Notes to
FS (most
informative)

Financial statements – what they are (cont'd)

Quarterly financial reporting to regulators

**Group
results &
balances**

**Detailed
analysis of
Group's
operating
segments'
performance**

**Statement
of
comprehen-
sive income
(minimum
content)**

**Statement
of cash
flows
(minimum
content)**

**Notes to
Quarterly
Reports
(most
informative)**

What about Management Accounts of individual subsidiaries, significant associates & significant JVs?

Users of financial statements

- Shareholders
- Regulators
- Fund managers/analysts
- Potential investors
- Competitors
- Suppliers & other stakeholders

Because of their extensive circulation & use, the **integrity** of financial statements is **paramount**, especially when they have been **audited**



Financial reporting - whose responsibility?

Focus: Responsibility over Financial Reporting

It is important to note that the **directors**, not external auditors, are **primarily** responsible for preparation of financial statements in accordance with provisions of Companies Act 1965 (Section 166A [3]) & **must sign a directors' declaration before** the audit report can be signed.

Source: Bursa Corporate Governance Guide



Financial reporting - whose responsibility? (cont'd)

Focus: Responsibility over Financial Reporting

June, 2011 - Australian Securities & Investment Committee (ASIC) won its case against the giant property group **Centro**, for its Board of directors failed to spot errors in the financial statements.

(not just peanuts but A\$1.5 billion (short-term liabilities shown as long-term) & omission of A\$1.75 billion guarantees)

Judge ruled:

- 1) they **could not delegate essential duties** when it came to reading financial statements
- 2) directors **cannot abrogate their responsibilities** by simply relying on the advice of others.



Upon appeal, the Board escaped fine & ban. CEO fined only A\$30K whilst CFO was banned from running a corporation for 2 years

Source: The Australian

Financial reporting – whose responsibility? (cont'd)

- Oversight of financial reporting process delegated to Audit Committee (“AC”) – **Board may delegate but not abdicate**
- Board cannot expect **total assurance** w/o proper assessment & consideration of FS
- Key areas of AC’s coverage & Board’s approval:
 - ✓ Changes in/ implementation of major accounting policies
 - ✓ Significant & unusual events
 - ✓ Compliance with accounting standards & other legal requirements
 - ✓ Significant adjustments arising from External Audit
 - ✓ Appropriateness of going concern assumptions
- Board to deliberate on AC’s recommendation & approve FS





The Audit Committee's role in financial reporting

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Principle 5 – Uphold integrity in financial reporting

Prin. No.	Rec. No.	MCCG 2012 Rec.	Commentaries & implications to Boards/Audit Committee
5	5.1	Audit Committee (“AC”) should ensure financial statements <u>comply with applicable financial reporting standards</u>	<p>Deployment of process to ensure changes in reporting standards are notified to AC</p> <ul style="list-style-type: none">➤ <i>What about requiring ALL AC members to be <u>financial literate</u>?</i>➤ <i>Does AC still meet with External Auditors <u>twice a year in absence of Management</u>?</i>➤ <i><u>Should</u> the AC assume oversight of the Risk Management system of <u>Group</u>?</i>



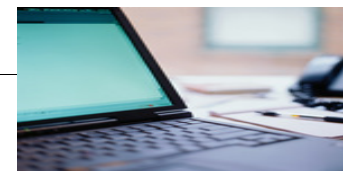
Principle 6 – Recognise & manage risks

Prin. No.	Rec. No.	MCCG 2012 Rec.	Commentaries & implications to Boards/Audit Committee
6	6.2	Board should <u>establish an IA function</u> which reports directly to AC	<ul style="list-style-type: none"> • Identify a Head of IA reporting <u>directly</u> to AC • Head of IA with relevant qualifications • Provides assurance to AC/Board on effectiveness of internal controls (Scope of coverage – strategic, financial, operational & regulatory compliance) • Work to be carried out according to standards set by professional bodies (e.g. <i>The Institute of Internal Auditors, Inc</i>) • review & appraise effectiveness of <u>governance, risk management & internal controls</u> in Company



Understanding FS – *some key areas of focus*

- Assess Group's **financial condition** & consider its “going concern” ability
- Monitor **integrity** of financial information & understand effects of changes in **accounting policies**
- Assess process on recording of transactions to address **accuracy, completeness, existence & consistency** (*cut-off issues*)
- Understand methods to account for **complex & unusual** transactions (*intra-group transactions*)
- Analyze **key ratios** (margins, turnover, etc) vis-à-vis **industry**
- Consider Related Party Transactions/ Conflict of Interest Situations, their financial realities & whether they are within shareholders' mandate/ in Company's best interest
- Communicating significant accounting policy & audit adjustments



Understanding FS – *key areas of focus (cont'd)*

- **Policies** on clear reporting & submission of FS adequately communicated to Management
- Satisfied that Management has submitted accurate FS information, including **versions control**
- Adequate **time** given to review FS & related information (including **non-financial information**)
- Sufficiency & competency of **resources** for reporting function
- Evaluation of domestic & international **audit results**, both internal & independent
- How to stay apprised of **highly technical accounting standards**, including changes thereof – briefing by external auditors, etc.
- Use of **external help** – valuation, impairment, etc.





Asking Management probing questions

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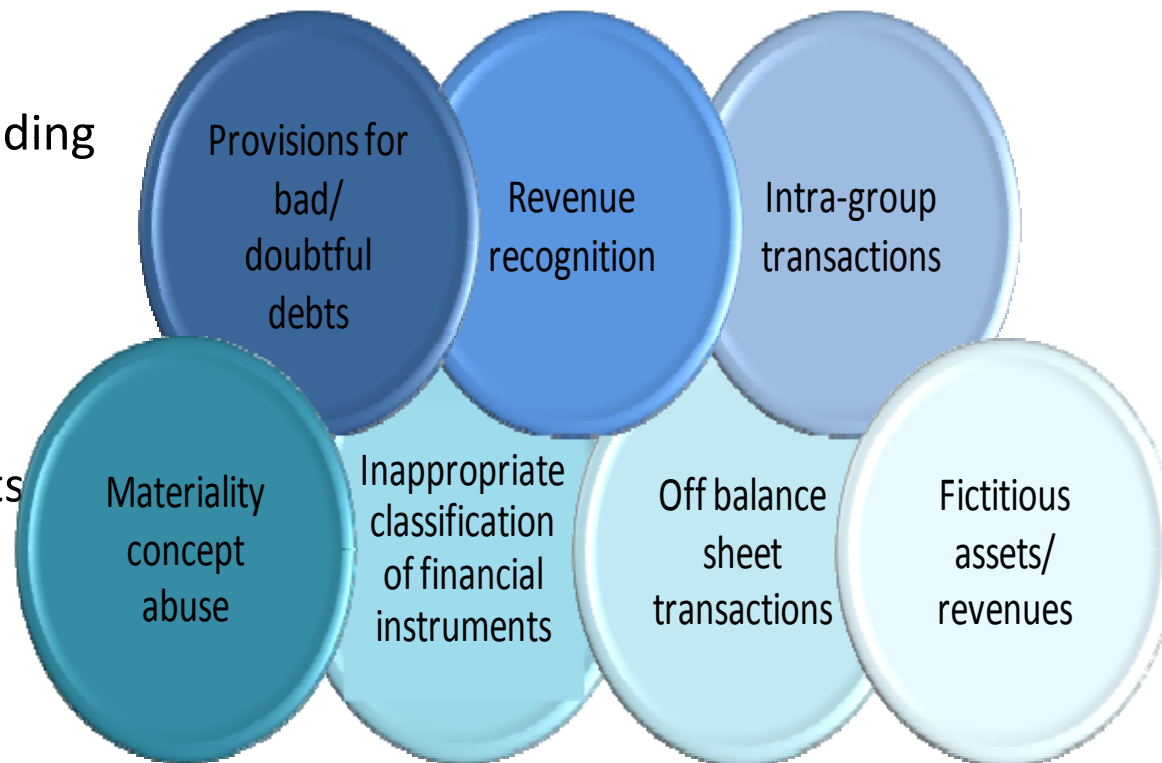
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Key drivers to assist Audit Committee in questioning Management on financial reporting

Integrity of Financial Reporting may be affected by:

- difficult economic times (KPI-driven, profit guarantee, etc)
- changes to regulations & understanding their implications (IFRS, FRS, MFRS)
- performance pressures
- rapid business growth
- complexities of financial instruments
- liquidity constraints
- internal control changes
- related party arrangements

Some vulnerable areas that may impair integrity of FS



Questioning Management's representation

Some sample questions – assuming Group's business is understood

- ✓ What is your assessment of overall control environment?
 - ✓ What materiality level did you employ in assessing whether financial reports are presented in a true & fair view?
 - ✓ What are the financial statements captions where significant differences exist between the current & prior period? Why have these variances occurred?
- ✓ What were the major financial reporting standards & regulatory changes instituted during the year & what was their impact to the Company's financial report?
- ✓ Which aspects of the Company's financial viability & sustainability do you feel least comfortable with?



Source: Bursa Corporate Governance Guide

Questioning Management's representation (cont'd)

Asking tough questions in tough times



Questioning Management's representation (cont'd)

Some obvious "anomalies"

- Significant bank borrowings with no/ little **borrowing cost**
- Substantial bank deposits with no/ insignificant investment income
- Large amounts of bank balance with large amounts of bank overdrafts
- Substantial amount of plant & equipment but minimal repairs/ maintenance
- Significant number of idle assets but huge amount of rental of buildings/land
- Huge spike in Q4 revenue/earnings & contribution margin - no major product diversifications





Challenging the status quo

Auditors

Some challenges faced by AC when dealing with auditors (The “eyes” & “ears” of AC)

- Internal audit function reports **directly** to AC
 - AC reviews **competency** of IA personnel
 - A **statement on IA function to be included in Annual Report** – whether performed in-house or outsourced & **costs** incurred for year
 - AC has right to convene meetings with external auditors, internal audit (or both) in **absence** of other directors or employees
- ❖ Meet with external auditors twice in absence of EDs & Management
 - ❖ Any **external help** needed to vet quarterly reports – limited review by EA
 - ❖ Assessment of IA’s competence – ***professional IA standards deployed (MCCG 2012)***
 - ❖ Assessment of EA’s professional **independence**
 - ❖ **Continuous engagement** by AC Chairman with Senior Management, Head of IA & EA



Questioning the “eyes & ears” of AC

Internal Auditors

What’s your assessment of Company’s financial reporting processes, both internal & external?

Have you had sufficient access to all areas of Company & appropriate resources to facilitate your work?

What’s your assessment of Company’s compliance with regulations?

Any other concerns that should be considered by AC, e.g. limitation in scope?

External Auditors

Which aspects of our financial report cause you most concern?

How would you evaluate the IA function on its approach to identifying, assessing, monitoring & reporting on financial risks & controls?

Are financial reporting policies which have been applied, usual or unusual for a company in our industry?

Any changes in accounting policy or disclosure likely to be challenged?



Questioning the “eyes & ears” of AC

Warren Buffet, CEO of **Berkshire Hathaway** suggests **4 questions** the AC can pose to the **auditors**:

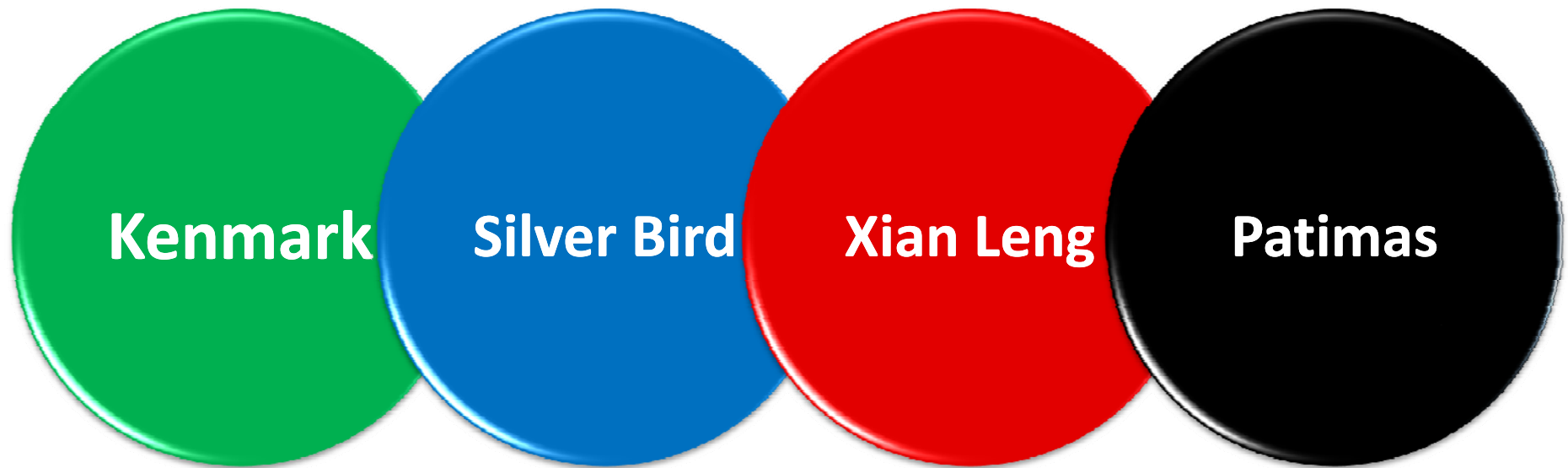
- ✓ *Would the external auditors report the financial statements differently?*
- ✓ *If the auditor were an investor, would the information received be sufficient?*
- ✓ *Is the Company following the same IA procedures that the Head of IA would have followed?*
- ✓ *Is the auditor aware of accounting/ operational actions resulting in revenue or expenses reported in a different period?*





A simple case study – exercising foresight

Some recent financial reporting fiascos



A visit to the Arowana Farm



www.NiwanRed.com

Financial reporting fiasco – Xian Leng Holdings Bhd

Special audit shows questionable payments in Xian Leng



None of the other directors were aware of the issuance of the cash cheques

Xian Leng Holdings Bhd said a special audit has revealed that **RM85.7 million** in payments under capital expenditure (CAPEX) had been made to 4 contractors under questionable circumstances.

“The bulk of the payments were made via cash cheques & there was lack of corroborative evidence showing that amount was paid to and/or received by the 4 contractors.

[Apart from ex-directors who were involved in authorisation of payment & cheques], ***“none of the other directors, whether past, present, independent or executive were aware of the issuance of the cash cheques...”***

Release of Material Findings of the Special Audit to Bursa Securities, Xian Leng Holdings Bhd, 5 April 2012

Statements of comprehensive income
For the financial year ended 31 January 2012

		Group		Company	
	Note	2012	2011	2012	2011
		RM	RM	RM	RM
Revenue	3	14,898,053	20,676,668	288,000	288,000
Other income	4	1,456,549	1,212,850	-	-
Employee benefits expense	5	(3,055,106)	(2,754,876)	(316,300)	(322,280)
Changes in inventories		649,268	576,903	-	-
Purchases of inventories		(7,651,609)	(8,906,581)	-	-
Depreciation	11	(5,378,101)	(6,856,177)	-	-
Impairment loss on property, plant and equipment	11	(63,328,276)	-	-	-
Impairment loss on investment in subsidiaries	12	-	-	(11,717,991)	-
Other expenses		(4,005,944)	(3,089,745)	(3,340,718)	(235,545)
Operating (loss)/profit	7	(66,415,166)	859,042	(15,087,009)	(269,825)
Finance costs	8	(1,643,153)	(1,876,348)	-	-
Loss before tax		(68,058,319)	(1,017,306)	(15,087,009)	(269,825)
Income tax expense	9	11,825,526	269,743	-	(7,587)
Loss net of tax and total comprehensive loss for the year		(56,232,793)	(747,563)	(15,087,009)	(277,412)

Statements of financial position as at 31 January 2012

		Group		Company	
	Note	2012 RM	2011 RM	2012 RM	2011 RM
Assets					
Non-current assets					
Property, plant and equipment	11	78,498,335	147,584,047	-	-
Investments in subsidiaries	12	-	-	47,282,009	59,000,000
		<u>78,498,335</u>	<u>147,584,047</u>	<u>47,282,009</u>	<u>59,000,000</u>
Current assets					
Inventories	13	6,938,700	6,289,446	-	-
Trade and other receivables	14	1,979,940	3,227,499	10,632,619	13,985,646
Prepayments		365,604	79,353	7,509	7,509
Tax recoverable		438,781	264,837	199,269	199,269
Cash and bank balances	15	540,340	796,475	2,178	6,293
		<u>10,263,365</u>	<u>10,657,610</u>	<u>10,841,575</u>	<u>14,198,717</u>
Total assets		<u><u>88,761,700</u></u>	<u><u>158,241,657</u></u>	<u><u>58,123,584</u></u>	<u><u>73,198,717</u></u>
Equity and liabilities					
Current liabilities					
Borrowings	16	15,257,579	15,629,681	-	-
Trade and other payables	17	1,040,527	351,021	51,392	33,352
Tax payable		-	35,800	-	-
		<u>16,298,106</u>	<u>16,016,502</u>	<u>51,392</u>	<u>33,352</u>
Net current (liabilities)/assets		<u>(6,034,741)</u>	<u>(5,358,892)</u>	<u>10,790,183</u>	<u>14,165,365</u>
Non-current liabilities					
Borrowings	16	3,090,154	4,787,232	-	-
Deferred tax liabilities	18	2,579,856	14,405,382	-	-
		<u>5,670,010</u>	<u>19,192,614</u>	<u>-</u>	<u>-</u>
Total liabilities		<u>21,968,116</u>	<u>35,209,116</u>	<u>51,392</u>	<u>33,352</u>
Net assets		<u>66,793,584</u>	<u>123,032,541</u>	<u>58,072,192</u>	<u>73,165,365</u>
Equity attributable to equity holders of the Company					
Share capital	19	72,704,500	72,704,500	72,704,500	72,704,500
Reserves		(5,910,916)	50,328,041	(14,632,308)	460,865
Total equity		<u>66,793,584</u>	<u>123,032,541</u>	<u>58,072,192</u>	<u>73,165,365</u>
Total equity and liabilities		<u><u>88,761,700</u></u>	<u><u>158,241,657</u></u>	<u><u>58,123,584</u></u>	<u><u>73,198,717</u></u>

(b) Going concern assumption

The Group reported a net loss of RM56.23 million (2011 : RM0.75 million) for the financial year ended 31 January 2012 and, as of that date, the Group's current liabilities exceeded its current assets by RM6.03 million (2010 : RM5.36 million). Subsequent to the financial year, the Group has disposed of certain parcels of non-core land for RM3.20 million, the proceeds of which were received in March 2012. The Group is also in the midst of disposing additional parcels of non-core land for RM5.48 million, of which a 10% deposit of RM0.55 million was received in May 2012. The balance of RM4.93 million is expected to be received in July 2012. In addition, the Group has sufficient other assets that may be disposed without impacting the normal operations of the Group, should the need arise to further improve the cash flows of the Group. With these steps, the Group's net current liabilities is expected to be significantly reduced and the directors are confident that the Group will be able to generate sufficient cash flows to meet its obligations and to continue as a going concern.

Cost of capital expenditure on fish ponds incurred in previous years

On 4 October 2011, the Group announced that there were possible financial irregularities relating to capital expenditure of RM17.36 million incurred in previous financial years ("FY"). The Group subsequently clarified that the RM17.36 million was incurred in FY2006 and FY2008.

On 17 October 2011, the Group announced that they had appointed an independent party to conduct a special audit on capital expenditures for land development, fish ponds, tools and equipment and construction-in-progress for the 7 financial years from FY2002 to FY2008.

On 5 April 2012, the Group announced that the special audit was completed. The salient facts highlighted in the special audit report were as follows:

- Records in relation to financial years ended FY2002 to FY2004 were unavailable as the Group does not keep accounting records beyond the period of 7 years as required by Section 167(2) of the Companies Act 1965. The special auditors thus restricted their scope of work to cover FY2005 to FY2008.
- Between FY2005 to FY2008, the Group recorded RM90.7 million as incurred on fish farm development (i.e. construction of fish ponds and related assets). Out of the RM90.7 million, RM85.7 million was shown as paid to 4 contractors. Out of the RM85.7 million, RM85 million was paid via cheques and the balance of RM0.7 million was paid by cash.

Cost of capital expenditure on fish ponds incurred in previous years (cont'd)

- The special auditors requested and obtained cheque images for a total value of RM37.9 million. Based on the cheque images, RM37.4 million appeared to be drawn in favor of a former director or a company substantially owned by the said former director.
- The special auditors were not able to obtain the cheque images for the remaining value of RM47.1 million and were thus not able to establish the identity of the payee of these cheques.
- All 4 contractors were sole proprietorships. The business registrations of 3 of the 4 contractors expired within a year after registration.

In view of the above findings, the directors in office at the time the above findings were announced were of the opinion that the payments were irregular and that they may not reflect the true value of the fish pond construction work performed by the 4 contractors from FY2005 to FY2008.

The special auditors had not, up to the time the findings were announced, managed to interview the 4 contractors to clarify how much (if not all) of the RM85.7 million the contractors had received for the work done by them for the construction of fish ponds and related assets.

As the special auditors were not able to obtain the cheque images for the remaining value of RM47.1 million and were not able to interview the 4 contractors the current directors of the

The directors are in the midst of identifying and appointing an appropriate valuer to estimate the cost of the fish pond construction work incurred from FY2005 to FY2008. As at 31 January 2012, these assets continue to be carried at the amounts originally recorded (i.e. the amount that was paid out), less accumulated depreciation and impairment losses.

At this juncture, pending the completion of the proposed cost estimation exercise, the directors do not have sufficient information to ascertain the actual cost of the fish ponds constructed and the impact, if any, on the financial statements arising from any difference between the amounts paid in FY2005 to FY2008 and the actual cost of the fish ponds constructed.

The cost of the fish ponds and the amount of the accumulated depreciation and impairment losses may be adjusted upon completion of the proposed cost estimation exercise which has yet to commence as at the date of this report.

During the current financial year, an impairment loss of RM51.9 million was provided in respect of the Group's fish ponds. Further details on the impairment is disclosed below. Following the impairment loss, the net carrying amount of the fish ponds as at 31 January 2012 was approximately RM10.3 million.

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**Independent auditors' report to the members of
Xian Leng Holdings Berhad (cont'd)
(Incorporated in Malaysia)**

Basis for qualified opinion

As disclosed in Note 11 to the financial statements, the Group paid RM85.7 million for construction of fish ponds during the financial years ended 31 January 2005 to 31 January 2008. As at 31 January 2012, the net carrying amount of the above fish ponds was RM10.3 million (2011:RM64.8 million). The amount of depreciation and impairment recognized during the financial year ended 31 January 2012 on the said fish ponds were RM2.6 million (2011: RM2.6 million) and RM51.9 million (2011: Nil) respectively.

Based on the special audit conducted during the year, the directors are of the opinion that certain of the payments may be irregular and that they may not reflect the actual cost of construction of the fish ponds. The directors are currently in the midst of appointing a valuer to determine the estimated cost of the construction work of the above fish ponds.

Pending the completion and outcome of the proposed valuation exercise, we are not able to conclude as to whether the RM85.7 million represents cost of construction of the fish ponds. Accordingly, we are unable to satisfy ourselves as to the depreciation charge and the impairment loss for the current and prior financial year, and consequential effects, if any, on the tax expense, tax payable, deferred taxation and retained earnings.

Qualified opinion

In our opinion, except for the possible effects, if any, of the matters described in the basis for qualified opinion paragraph, the financial statements have been properly drawn up in accordance with Financial Reporting Standards and the Companies Act, 1965 in Malaysia so as to give a true and fair view of the financial position of the Group and of the Company as at 31 January 2012 and of their financial performance and cash flows for the year then ended.



Key takeaways

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Key takeaways for the Internal Auditor



Do I really understand the Group's business? (Why is Group performing so well? Do I know the critical success factors?)

Are structured processes in place to address Completeness, Existence & Accuracy of transactions? Do the processes address the Valuation & Ownership/Obligations on assets/liabilities & off Balance Sheet items, including how such items are Presented in financial statements?

How are RPTs/COI identified & addressed – is there a structured framework to address completeness, transfer pricing & adherence to mandate on RRPTs?

Am I using the work of, or feedback from, assurance providers, e.g. auditors, valuers, etc., adequately on financial reporting?

Have I exercised professional scepticism & asked pertinent probing questions of Management on areas I'm unclear of, especially on financial performance?





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Questions & comments

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