

Technical e-Newsletter

June 2007 Issue

SAMPLE CHECKLISTS

Engagement to review financial statements

TECHNICAL DIAGNOSTIC CENTRE

CLRC's Consultative Document 8:

On Capital Maintenance Rule and Share Capital: Simplifying and Streamlining Provisions Applicable to the Reduction of Capital, Share Buy Back and Financial Assistance

A Monthly e-Newsletter published by the Technical Support Unit of AXP Solutions Sdn. Bhd. (693866-X)



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Editors' Notes ~ Super Peak Period

Greeting!

June and July ~ sleepless nights for most of the accountants in practice again!! Year in year out, historical events show that we will definitely meet the deadline, the question is “how” do we achieve the objective!

In this e-economy, there are plenty of tools available to help us achieve our tasks and objectives! Repetitive tasks should now be automated and our brain should be used to add-value to the services provided. This is theory of success in this highly competitive and globalised environment.

In this issue of the e-Newsletter, we have published the sample procedures for the engagement to review the financial statements. Generally, auditors do not express their opinion as to the truth and fairness of the financial statements. However, an auditor is required to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (i.e., negative assurance).

For the **Technical Diagnostic Centre** section, we have studied the eighth CLRC's consultative document on capital maintenance rule and share capital: Simplifying and streamlining provisions applicable to the reduction of capital, share buy back and financial assistance.

As our comments shall reach Companies Commission of Malaysia by 25 July 2007, please let us have your comments, if any, latest by 13 July 2007.

The Checklist illustrated in this e-Newsletter are also available in Microsoft Word and Excel. Please feel free to contact us at support@myAXP.com or **1300 882 AXP (1300 882 297)** if you wish to obtain these complimentary copies.

Happy reading!

Editors
AXP Technical e-Newsletter
June 2007

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Contributions & Comments

AXP Technical e-Newsletter welcomes your contributions on contemporary issues encountered by the profession. We also wish to hear from you on how this e-Newsletter can be improved for more timely and useful information. Your contributions or comments may be sent directly to us at:

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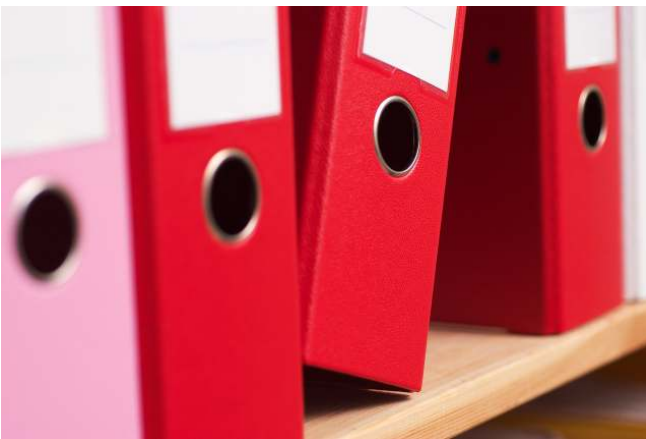
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SAMPLE CHECKLIST

Engagement to review financial statements



OBJECTIVE:

To establish the procedures for the engagement to review financial statements for the financial year / period ended 31-12-06.

CHECKLIST:

No.	Review Procedures
1	Pre-Engagement Activities
1.1	To evaluate whether the acceptance of a prospective client complies with the Code of Ethics, the following and other relevant factors should be considered:
1.1.1	Consider the Firm’s ability, including technical skills & knowledge of the industry, to conduct the engagements.
1.1.2	Consider the capabilities and competence of the personnel, to serve the prospective client.
1.1.3	Best efforts have been made to identify circumstances or relationships that might create threats to independence, including self-interest threat ¹ , self-review threat ² , advocacy threat ³ , familiarity threat ⁴ and intimidation threat ⁵ .
2	Establish the Scope of a Review
2.1	Has the engagement letter been agreed by client (<i>consider the following minimum points to be included</i>)?
2.1.1	Objective of the service
2.1.2	Management’s responsibility for the financial statements
2.1.3	Scope of the review
2.1.4	Sample of the reports or deliverables
2.1.5	The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities
2.1.6	Unrestricted access to records, documents and information
2.1.7	A statement that an audit is not being performed and that an audit opinion will not be expressed
2.2	Has the acknowledged copy of the engagement letter been filed in the audit working paper?
2.3	If the financial statements to be reviewed are prepared for an interim period, or for a financial reporting period shorter than a full financial year, have the financial statements been prepared in accordance with FRS 134 ²⁰⁰⁴ ? (<i>refer to Interim report checklist.doc for further information</i>)

¹ A “self-interest threat” occurs when a firm or a member of the assurance team is likely to benefit from a financial interest in, or has any other self-interest conflict with, an assurance client.

² A “self-review threat” occurs when any product or judgment of previous engagements needs to be re-evaluated in reaching audit conclusions, or when a member of the engagement team was previously a Director or Officer of the client, or was an employee in a position to exert direct and significant influence over the accounts being reviewed.

³ An “advocacy threat” occurs when a firm or a member of the assurance team, promotes, or may be perceived to promote, an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client.

⁴ A “familiarity threat” occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client’s interests.

⁵ An “intimidation threat” occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

No.	Review Procedures
3	Planning
3.1	Has a plan been worked out (<i>consider the following minimum points to be included</i>)?
3.1.1	To understand the business
3.1.2	To understand the entity's organization and capital structure
3.1.3	To understand the accounting systems and operating characteristics
3.1.4	To understand the nature of its assets, liabilities, revenues and expenses
3.1.5	To understand other matters relevant to the financial statements
3.2	When using the work performed by another auditor or an expert, are we satisfied that such work is adequate for the purpose of the review?
3.3	Have we applied the same materiality considerations as would be applied for the audit of the financial statements?
4	General Review Procedures
4.1	Inquire whether all financial information is recorded completely, promptly and after the necessary authorization.
4.2	Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
4.3	Consider the results of previous audits and review engagements.
4.4	Inquire about the accounting policies and consider whether: <ul style="list-style-type: none"> ➤ they comply with relevant financial reporting standards; ➤ they have been applied appropriately; and ➤ they have been applied consistently and, if not, consider whether disclosure has been made of any changes, and the reasons for the changes.
4.5	Read the minutes of the meetings of shareholders, board of directors and other appropriate committees.
4.6	Inquire about the existence of transactions with related parties.
4.7	Inquire about contingencies and commitments.
4.8	Inquire about plans to dispose of major assets or business.
4.9	Obtain the financial statements and discuss them with management.
4.10	Consider the adequacy of disclosure, classification and presentation in the financial statements.
4.11	Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods.
4.12	Inquire for any unusual fluctuations or inconsistencies in the financial statements.
4.13	Consider the effect of any unadjusted errors.
4.14	Consider obtaining a representation letter.
5	Review Procedures for Financial Statements
5.1	Cash
5.1.1	Obtain the bank reconciliations. Inquire about any old or unusual reconciling items with client personnel.
5.1.2	Inquire about transfers between cash accounts for the period before and after the review date.
5.1.3	Inquire whether there are any restrictions on cash accounts.

No.	Review Procedures
5.2	<i>Receivables</i>
5.2.1	Inquire about the accounting policies for trade receivables and determine whether any allowances are given on such transactions.
5.2.2	Obtain a schedule of receivables and agree with the trial balance.
5.2.3	Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
5.2.4	Obtain trade receivables aging report. Inquire about the reasons for unusually large accounts, credit balances on accounts or any other unusual balances, and the collectibility of receivables.
5.2.5	Discuss with management the classification of receivables, net credit balances and amounts due from shareholders, directors and other related parties in the financial statements.
5.2.6	Inquire about the method for identifying "slow payment" accounts and setting allowances for doubtful debts and consider the reasonableness.
5.2.7	Inquire whether receivables have been pledged, factored or discounted
5.2.8	Inquire about the procedures applied for a proper cut-off of sales and sales returns.
5.2.9	Inquire whether any accounts represent goods shipped on consignment and, if so, whether adjustments have been made to reverse these transactions and include the goods in inventory.
5.2.10	Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made.
5.3	<i>Inventories</i>
5.3.1	Obtain the inventory list and determine whether: <ul style="list-style-type: none"> ➤ the total agrees with the balance in the trial balance; and ➤ the list is based on a physical count of inventory.
	Inquire about the method for counting inventory.
5.3.2	Where a physical count was not carried out on the balance sheet date, inquire whether: <ul style="list-style-type: none"> ➤ a perpetual inventory system is used and whether periodic comparisons are made with actual quantities on hand; and ➤ an integrated cost system is used and whether it has produced reliable information in the past.
5.3.3	Discuss adjustments made resulting from the last physical inventory count.
5.3.4	Inquire about procedures applied to control cut-off and any inventory movements.
5.3.5	Inquire about the basis used in valuing each category of the inventory and the elimination of inter-branch profits.
5.3.6	Inquire whether inventory is valued at the lower of cost and net realizable value.
5.3.7	Consider the consistency of the inventory valuation methods, including factors such as material, labor and overhead.
5.3.8	Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.
5.3.9	Compare inventory turnover with that in previous periods.
5.3.10	Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realizable value.
5.3.11	Inquire whether any of the inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.
5.3.12	Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.
5.4	<i>Investments (including associated companies and marketable securities)</i>
5.4.1	Obtain a schedule of the investments at the balance sheet date and agree with the trial balance.
5.4.2	Inquire about the accounting policy for the investments.
5.4.3	Inquire from management about the carrying values of the investments. Consider whether there are any impairment losses.
5.4.4	Consider whether there has been proper accounting for gains, losses and investment income.
5.4.5	Inquire about the classification of long-term and short-term investments.

No.	Review Procedures
5.5	<i>Property and Depreciation</i>
5.5.1	Obtain a schedule of the property indicating the cost and accumulated depreciation and agree with the trial balance.
5.5.2	Inquire about the accounting policy for depreciation and distinguishing between capital and maintenance items. Consider whether the property has any impairment loss.
5.5.3	Discuss with management the additions and deletions to property and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.
5.5.4	Inquire about the consistency of the depreciation method and rates and compare depreciation charges with prior years.
5.5.5	Inquire whether there are any liens on the property.
5.5.6	Discuss whether lease agreements have been properly reflected in the financial statements in accordance with FRS 117.
5.6	<i>Prepaid expenses, intangibles and other assets</i>
5.6.1	Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof.
5.6.2	Inquire about the basis for recording these accounts and the amortization methods used.
5.6.3	Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.
5.6.4	Discuss the classification between long-term and short-term accounts with management.
5.7	<i>Loans payable</i>
5.7.1	Obtain from management a schedule of loans payable and agree with the trial balance.
5.7.2	Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management’s actions and whether appropriate adjustments have been made in the financial statements.
5.7.3	Consider the reasonableness of interest expense.
5.7.4	Inquire whether loans payable are secured.
5.7.5	Inquire whether loans payable have been classified between non-current and current.
5.8	<i>Trade payables</i>
5.8.1	Inquire about the accounting policies for trade payables and whether the entity is entitled to any allowances given on such transactions.
5.8.2	Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
5.8.3	Obtain a schedule of trade payables and agree with the trial balance.
5.8.4	Inquire whether balances are reconciled with the creditors’ statements and compare with prior period balances.
5.8.5	Compare turnover with prior periods.
5.8.6	Consider whether there could be material unrecorded liabilities.
5.8.7	Inquire whether payables to shareholders, directors and other related parties are separately disclosed.
5.9	<i>Accrued and contingent liabilities</i>
5.9.1	Obtain a schedule of the accrued liabilities and agree with the trial balance.
5.9.2	Compare major balances of related expense accounts with similar accounts for prior periods.
5.9.3	Inquire about approvals for such accruals, terms of payment, compliance with terms, collateral and classification.
5.9.4	Inquire about the method for determining accrued liabilities.
5.9.5	Inquire as to the nature of amounts included in contingent liabilities and commitments.
5.9.6	Inquire whether any actual or contingent liabilities exist which have not been recorded in the accounts. If so, discuss with management whether provisions need to be made or whether disclosure should be made in the notes to the financial statements.

No.	Review Procedures
5.10	<i>Income and other taxes</i>
5.10.1	Inquire from management if there were any events, including disputes with taxation authorities, which could have a significant effect on the taxes payable by the entity.
5.10.2	Consider the tax expense in relation to the income for the period.
5.10.3	Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including prior periods' figures.
5.11	<i>Equity</i>
5.11.1	Obtain and consider a schedule of the transactions in the equity accounts, including new issues, retirements and dividends.
5.11.2	Inquire whether there are any restrictions on retained earnings or other equity accounts.
5.12	<i>Income statement</i>
5.12.1	Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.
5.12.2	Discuss whether the recognition of major sales and expenses has taken place in the appropriate periods.
5.12.3	Consider extraordinary (for companies prepared financial statements in accordance with PERS) and unusual items.
5.12.4	Consider and discuss with management the relationship between related items in the revenue account and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the auditor.
5.13	<i>Review of subsequent events</i>
5.13.1	Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.
5.13.2	<p>Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:</p> <ul style="list-style-type: none"> ➤ any substantial commitments or uncertainties have arisen subsequent to the balance sheet date; ➤ any significant changes in the share capital, long-term debt or working capital up to the date of inquiry; and ➤ any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.
5.13.3	Obtain and read the minutes of meetings of shareholders, directors and other committees subsequent to the balance sheet date.
5.13.4	Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process.
5.13.5	Consider the need for adjustments or disclosure in the financial statements based on the above findings.



AXP TECHNICAL DIAGNOSTIC CENTRE

CLRC's Consultative Document 8:

On Capital Maintenance Rule and Share Capital: Simplifying and Streamlining Provisions Applicable to the Reduction of Capital, Share Buy Back and Financial Assistance



Introduction

In April 2007, Corporate Law Reform Committee (“CLRC”) issued its eighth Consultation Document which discusses the following capital maintenance rules, i.e., the share buy back, the financial assistance and the reduction of capital provisions in the Companies Act 1965.

The capital maintenance rules reviewed in this Consultation Document are recommended with the intention of preventing dissipation of company's funds that will prejudice creditors.

Therefore, some restatement and reform to the existing capital maintenance rules have been proposed. Furthermore, the CLRC’s Consultative Document proposes to introduce a 'solvency test' regime that would be based on a 'balance sheet' solvency test and a 'cash flow' solvency test.

CLRC invites comments on the issues set out in this consultative document, and comments shall reach Companies Commission of Malaysia by **25 July 2007**.

Thus, if you have any further comments on our views, please feedback to us latest by **13 July 2007**.



Consultative Questions

QUESTION 1:

Do you agree that the current procedure of obtaining the court's confirmation which is provided for under section 64 of the Companies Act 1965 should still be retained?

Our Comments

No, we do not agree, due to the following reasons:

- ✓ Court's confirmation is a mere formality to endorse the Company's proposal.
- ✓ The process is time consuming and causes delay to corporate exercise, which is no longer suitable for the current business environment.
- ✓ Court's confirmation may not prevent dissipation of company's funds that will prejudice creditors or minority shareholders, which is the intention of this Consultative Document.

QUESTION 2:

Do you agree to the introduction of an additional alternative procedure that a company may reduce its capital provided it satisfies the solvency test?

Our Comments

Yes, we agree. The introduction of this alternative procedure will further liberalise the reduction of capital, which is essential to make Malaysia a better choice for investment.

QUESTION 3:

Do you agree that the solvency test should be as follows:

“The company is able to satisfy the solvency test if:

- (i) the company is able to pay its debts as they become due in the normal course of business (“cash-flow” solvency); and
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities (“balance sheet” solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

- (a) must have regard to -
 - (i) the most recent financial statement of the company; and
 - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;
- (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances”.

Our Comments

Generally, we agree with the proposal that the “solvency test” requires both the tests are met. However, the following are our comments to further improve the definition:

- ✓ To set a time frame for “Cash-flow” solvency test, says twelve months, as it may be difficult to determine the ability to pay its debts beyond a reasonable time frame.

- ✓ For the most recent financial statements used to determine the value of the assets and liabilities, we propose that the "most recent" financial statements should not be earlier than a date, says six months from the date of the proposed capital deduction.
- ✓ Furthermore, to determine the basis of the preparation of the most recent financial statements, i.e., the financial statements should be prepared in accordance with the financial reporting standards approved by the MASB.

QUESTION 4:

Do you agree that the directors should be required to make a declaration of solvency? If yes, should the solvency test be made by all the directors or a majority of the directors? Should the solvency statement be supported by an auditor's report (in the case of a company that must have its accounts audited)?

Our Comments

Yes, we agree that the directors should be required to make a declaration of solvency as the directors are primarily responsible for the management of the Company, and the directors shall be responsible for the consequence of any capital deductions or share buyback.

Furthermore, the declaration of solvency should be made by all the directors as the Board of Directors, as a whole, shall formulate the directions of the Company.

We are of the opinion that the solvency statement shall be supported by an auditor's report for its "most recent financial statements" as mentioned in Question 3. Having the most recent financial statements audited will make the financial statements more reliable. We believe that this procedure will not complicate the matter since the financial statements of the companies are required to be audited annually.

QUESTION 5:

Do you agree that the creditors of a company (whether private or public) that is reducing its capital under the alternative procedure should be given the right to object to the reduction?

Our Comments

Yes, we agree, this is to ensure that the interests of the creditors are better protected.

QUESTION 6:

Do you agree that the grounds for objections should be that the creditors have not been offered security for the debts or any other safeguards or that the company does not have sufficient assets?

Our Comments

Yes, we agree. As these creditors do not normally have any security on the outstanding amounts owed by the company, thus, they should be offered the chance to object to any capital deductions.

QUESTION 7:

Do you agree that a creditor who did not have reasonable grounds for the objection should be liable to pay costs?

Our Comments

Yes, we agree. This will facilitate the operations of the legal system. However, sufficient and reasonable time frame should be available for the creditors to accumulate the evidences required.

QUESTION 8:

Do you agree that there should be criminal liability for directors in relation to the declaration of solvency?

Our Comments

We agree that there should be criminal liability for directors as the decision on whether or not the company is solvent is made by the directors.

However, unless the directors possess the necessary financial knowledge, we propose that directors should be able to rely on experts' opinions in making the solvency statements, for instance, audited financial statements, valuation report from approved valuers, etc.

Furthermore, the directors should be criminally liable for the declaration of solvency ONLY IF they knowingly made groundless or false statements based on the evidence available at the date the declaration is made.

QUESTION 9:

Do you agree that it should be possible for the company to recover from shareholders the amount that they have received in relation to the reduction except where they have received the distribution in good faith?

Our Comments

Yes, we agree.

QUESTION 10:

Do you agree to the introduction of the solvency test as stated above as part of section 67A?

Our Comments

Yes, we agree.

QUESTION 11:

Do you agree that the declaration of solvency for a share buy back is to be made by only a majority of the directors?

Our Comments

No, we do not agree as the directors are primarily responsible for the management of the Company, and the objection from any one of the directors, with reasonable ground, shall be sufficient to make the proposal of the share buy-back invalid.

QUESTION 12:

Do you agree that the words “on the market of the Stock Exchange on which the shares are quoted in section 67A(3B)(b)” should be removed to enable the treasury shares to be sold not just on the stock exchange but via direct business transaction?

Our Comments

Yes, we agree. However, we propose that the transfer shall be complied with the relevant rules of the Stock Exchange and a price which reflects current share prices.

QUESTION 13:

Do you agree that if the company decides to re-sell the treasury shares, a time frame should be stated for the treasury shares to be resold and that the treasury shares are to be cancelled if not resold within this time frame? If yes, what would be the appropriate time frame?

Our Comments

Yes, we proposed that, if the company decides to re-sell the treasury shares, it shall sell within 12 months from the date of the share buy-back, otherwise they should be cancelled.

QUESTION 14:

Do you agree that:-

(a) a company should be allowed to give financial assistance in relation to the acquisition or purchase of its shares subject to the company satisfying the solvency test?

OR

(b) only a private company is allowed to give financial assistance in relation to the acquisition or purchase of its shares subject to the company satisfying the solvency test?

Our Comments

We agree that both private and public company should be allowed to give financial assistance in relation to the acquisition or purchase of its shares subject to the condition that the solvency test is satisfied.

QUESTION 15:

Do you agree that (subject to compliance with the solvency test) a company may give financial assistance only if the company obtains a special resolution from the shareholders?

Our Comments

Yes, we agree.

QUESTION 16:

Do you agree that (subject to compliance with the solvency test) a company may also give financial assistance without obtaining the shareholders' approval if the board so resolves? If yes, do you agree that the amount of the financial assistance, inclusive of the amounts of any other financial assistance by the company must not exceed 5 per cent of the aggregate of amounts received by the company in respect of amounts received by the company in respect of the total paid-up capital of the company and reserves as disclosed in the most recent financial statements of the company?

Our Comments

No, we do not agree.