Tutorial 5 (Week 6): Financial Statements Integrity

(a) Refer to the Independent Auditor's Report and identity the Key Audit Matters (KAM) highlighted by the auditors. For each KAM, answer the following:

   i.   Which area of the financial statement does the KAM relate to, and why is it considered significant by the auditors?

   ii.   How might management potentially use this area to influence or manage reported earnings?

   iii.   Identify one key audit procedure performed by the auditors that you believe best addresses this risk, and briefly explain why.

KAM #1: Recoverability of debt and equity investments in a subsidiary

(i)   Relates to investments (assets). It is significant because recoverability depends on long-term projections of ridership, fare adjustments, government grants, and operating costs. These involve substantial management judgment and estimation uncertainty.

(ii)   Management could adopt overly optimistic assumptions (e.g., higher ridership growth, larger fare increases, or lower cost growth) to avoid recognizing impairment losses, thereby inflating asset values and reported profit.

(iii)   Auditors tested the appropriateness of key assumptions in management's discounted cash flow model, including growth rates and discount rates, with the assistance of valuation specialists. This procedure best addresses the risk because it directly challenges the reasonableness of the assumptions that drive the recoverable amount and ensures impairment, if any, is not understated.

KAM #2: Recognition and measurement of provision for accident claims

(i)   Relates to provisions for accident claims. It is significant because estimating the timing and amount of settlements requires judgment. Management must assess probability and amount of claims based on historical data and current information, which involves uncertainty and subjectivity.

(ii)   Management could understate provisions to boost earnings or overstate provisions to create a "cookie jar" reserve, smoothing income across years.

(iii)   Auditors evaluated the reasonableness of assumptions by comparing management's estimates against historical claims data, settlement patterns, and accident reports. This

is most effective because it grounds the estimates in objective past evidence, reducing the scope for manipulation.

(b) Imagine you are an analyst in the investment team of SBS Transit. You have been tasked by your supervisor with looking at the financial statements of two potential companies that SBS might invest in. Net income for the past five years of the two companies are given as follows:

Year	Alpha Auto Company	Beta Bus Company
2021	$2,500,000	$5,000,000
2022	$4,000,000	$3,500,000
2023	$6,000,000	$8,000,000
2024	$7,500,000	$2,000,000
2025	$8,500,000	$10,000,000

If both companies are seeking similar amount of investment from SBS Transit, in terms of shareholding and amount, which of these two companies appear to be a more attractive investment? Explain your reasoning. What alternate sources of data would you look for to find out if the reported earnings accurately portray the business performance of the two companies?

Both Alpha Auto and Beta Bus earned the same total net income of $28.5 million over the five years combined. However, their earnings patterns are very different.

- Alpha Auto: Net income rose steadily from $2.5m in 2021 to $8.5m in 2025. This consistent growth signals stability and improving profitability.

- Beta Bus: Net income was far more volatile. It peaked at $8m in 2023, plunged to $2m in 2024, then surged to $10m in 2025. Such swings suggest cyclicality or exposure to external shocks, raising concerns about risk and management effectiveness.

Based on this analysis, Alpha Auto appears more attractive, especially for investors who value stable and predictable returns. Beta Bus, however, may appeal to investors with a higher risk appetite who are seeking larger potential gains. Unless SBS Transit has a specific strategy or synergy that fits with Beta Bus, Alpha Auto is the safer choice.

That said, net income alone is not enough to fully evaluate performance. As an analyst, you should also consider other factors such as (but not limited to):

- Cash Flow from Operations – Are profits supported by real cash inflows?

- Revenue Growth – Is sales growth sustainable and reliant on a few key customers?

- Profit Margins – How efficient is the company in controlling costs?

- Balance Sheet – Does the company have manageable debt and good liquidity?

- Earnings Quality – Are profits affected by aggressive accounting choices? Did auditors raise any concerns about accounting judgments or estimates?

- Industry & Market Risks – How exposed is the business to regulations or competition?

- Non financial factors – What is the reputation of the company? Does it have strong brand image?

~ End of Tutorial 5 Solutions ~