

Audit Oversight Board

Conversation with Academia

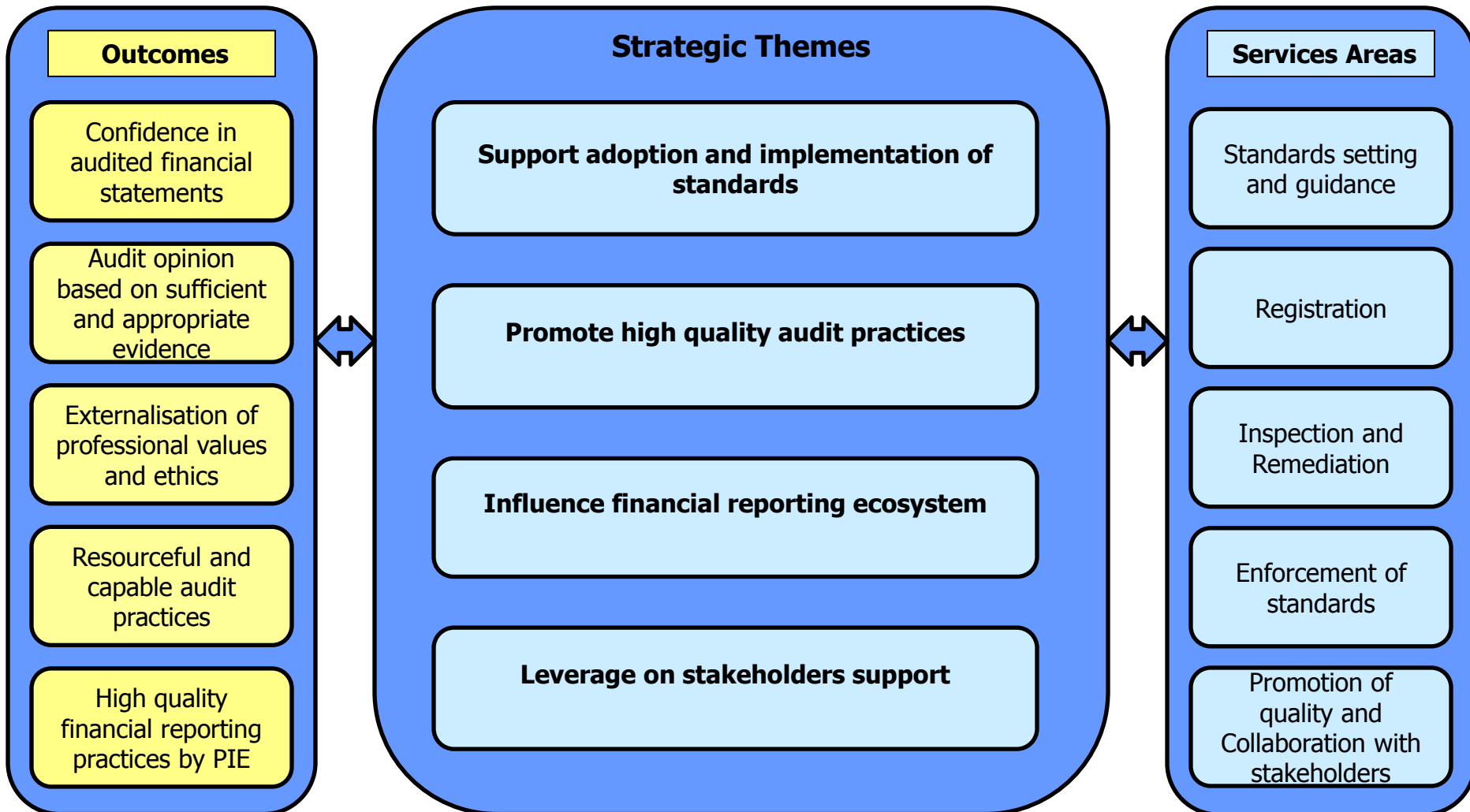
***Presentation by
Lim Fen Nee
Audit Oversight Board***

24 August 2015

Agenda

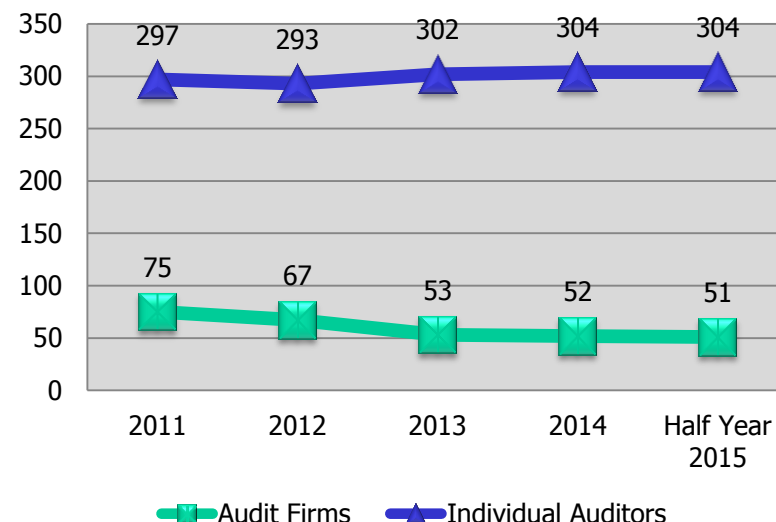
1. About the Audit Oversight Board
2. Practical Experiences
3. Development Highlights

"Fostering high quality independent auditing to promote confidence in the quality and reliability of audited financial statements of public interest entities in Malaysia"



Registration as at 30 June 2015

Profile of audit firms	No. of audit firms	No. of individual auditors	No. of PIEs	% of Market Capitalisation
≥10 partners	8	182	931	95.77%
5 – 9 partners	6	29	80	0.61%
2 – 4 partners	35	91	120	3.50%
Sole proprietor	2	2	6	0.01%
TOTAL	51	304	1,144	99.89%



Recognition as at 30 June 2015

Profile of audit firms	No. of audit firms	No. of individual auditors	No. of PIEs	% of Market Capitalisation
Singapore	3	6	5	0.02%
UK	1	2	1	0.06%
Hong Kong	1	2	1	0.02%
Subtotal	5	10	7	0.10%



Practical Experiences

Professional scepticism –

An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

For example, conditions with:

- Conflicting audit evidence
- Information that casts doubt over document reliability or responses to inquiries
- Possible fraud conditions



Professional judgment –

The application of training and knowledge and experience to the facts and circumstances in the process of making decision.

Examples of decisions include:

- Determination of materiality and audit risk
- Designing nature, timing and extent of audit procedures
- Evaluation of whether the audit evidence obtained is sufficient and appropriate and whether more work is needed
- Drawing conclusions based on audit evidence obtained



Case Study 1 : Asset Impairment

Example: Investment in a subsidiary which has been loss-making and in net current liabilities position

	Actual 2012	Projection 2013	Forecast 2014	Forecast 2015	Forecast 2016	Forecast 2017	Terminal value	
Revenue	150	350	385	424	466	512		
Cost of sales	(135)	(245)	(270)	(296)	(326)	(359)		
Gross Profit	15	105	115	128	140	153		
GP Margin	10%	30%	30%	30%	30%	30%		
Admin and other cost	(65)	(85)	(94)	(10)	(11)	(12)		
(LBT) / PBT	(50)	20	21	25	27	29		
Tax (20%)	-	(4)	(4)	(5)	(5)	(6)		
(LAT) / PAT	(50)	16	17	20	22	23	1,300	
				773				
				100				
				500				
				600				
				173				

Key assumption 1:
Increase in revenue in FYE 2013 due to one new customer

Key assumption 2:
Constant growth rate (g) of 10% year on year

Key assumption 3:
Calculated based on a growth rate of 11%

Key assumption 4:
WACC (r) of 13%

Value in Use = NPV = 773

Carrying amount of Sub A = 100

Goodwill = 500

600

173

CONCLUSION:
NO IMPAIRMENT ON ASSETS AND GOODWILL

Case Study 1 : Asset Impairment

Example: Investment in a subsidiary which has been loss-making and in net current liabilities position

	Actual 2012	Projection 2013	Forecast 2014	Forecast 2015	Forecast 2016	Forecast 2017	Terminal value	
Revenue	150	350	385	401	429	459		
Cost of sales	(135)	(245)	(262)	(281)	(300)	(329)		
Gross Profit	15	105	112	120	129	138		
GP Margin	10%	30%	30%	30%	30%	30%		
Admin and other cost	(65)	(85)	(91)	(97)	(104)	(111)		
(LBT) / PBT	(50)	20	21	23	25	27		
Tax (20%)	-	(4)	(4)	(5)	(5)	(5)		
(LAT) / PAT	(50)	16	17	18	20	22	249	

Key assumption 1:
Increase in revenue in FYE 2013 due to one new customer
↓
Supported by a mere "Letter of Intent"

Key assumption 2:
Constant growth rate (g) of 10% year on year
↓
Historical growth of company last 5 years = 5%, Forecasted for next 2 years – 7%

Key assumption 3:
Calculated based on a growth rate of 11%
↓
Basis to higher growth rate?

Key assumption 4:
WACC (r) of 13%
↓
Entire group's average WACC, not specific to Sub A which actual cost of capital = 16%

Value in Use = NPV = 178

Carrying amount of Sub A = 100

Goodwill = 500

If r = 16%, g = 7%

IMPAIRMENT

=

600

(422)

CONCLUSION:
~~NO IMPAIRMENT ON ASSETS AND GOODWILL~~

Case Study 2 : Estimates – Property Development

Example: Review of budgets - Project A (55% completed)

Direct construction costs	Budgeted (RM'm)	Actual (RM'm)	Variance (RM'm)
Preliminary expenses	5.5	5.4	0.1
Main building works	40.3	49.6	(9.3)
Architectural works	7.7	-	7.7
M&E works	6.2	-	6.2
Common cost	0.8	-	0.8
	60.5	55.0	5.5
Contingency	2.4	-	2.4
Total	62.9	55.0	7.9

2. Common cost allocated between 5 phases using "land area" → **challenge on the basis of allocation**

3. Contingency estimated as 4% of cost → **challenge on why 4%**

1. Audit procedures to **understand** the management's budgeting process

4. Compare budget to total cost incurred to-date → **did not identify cost overrun at main building cost**

5. Contingency cost RM2.4m insufficient to cover cost overrun in main building works. No revision of budgeted cost → **completeness of budgeted cost not addressed**

6. Budgeted revenue = RM65.0m → If budgeted cost revised to RM69.7m, **foreseeable losses of RM4.7m not identified**

RM14.7m

Case Study 3 : Bank Reconciliation of Bank A – FYE 31.12.14

			RM'million
Bank balance per General Ledger			18.7
Add: Unpresented cheques			
Cheque Dates	Amount RM	Subsequent Clearance Date	
27.12.2014	2,080,000	15.01.2015	3.8
29.12.2014	1,750,000	10.01.2015	
Less: Uncredited lodgment			
Cheque Dates	Amount	Subsequent Clearance Date	
24.12.2014	2,941,000	28.01.2015	(23.6)
26.12.2014	3,450,000	26.01.2015	
27.12.2014	4,500,000	27.01.2015	
27.12.2014	1,070,000	28.01.2015	
28.12.2014	4,950,000	29.01.2015	
24.12.2014	985,000	Not verified	
27.12.2014	980,000	Not verified	
27.12.2014	995,000	Not verified	
27.12.2014	850,000	Not verified	
27.12.2014	998,000	Not verified	
28.12.2014	950,000	Not verified	
28.12.2014	983,000	Not verified	
Bank balance as per Bank statement as at 31.12.2014			(1.1)

Audit Procedures

Checked amount to client's GL

Checked to subsequent clearance

5 transactions amounted to RM16.9 million were checked to subsequent clearance based on RM1.0 million threshold

Clearance dates more than 25 days were not investigated

INSUFFICIENT AUDIT PROCEDURES

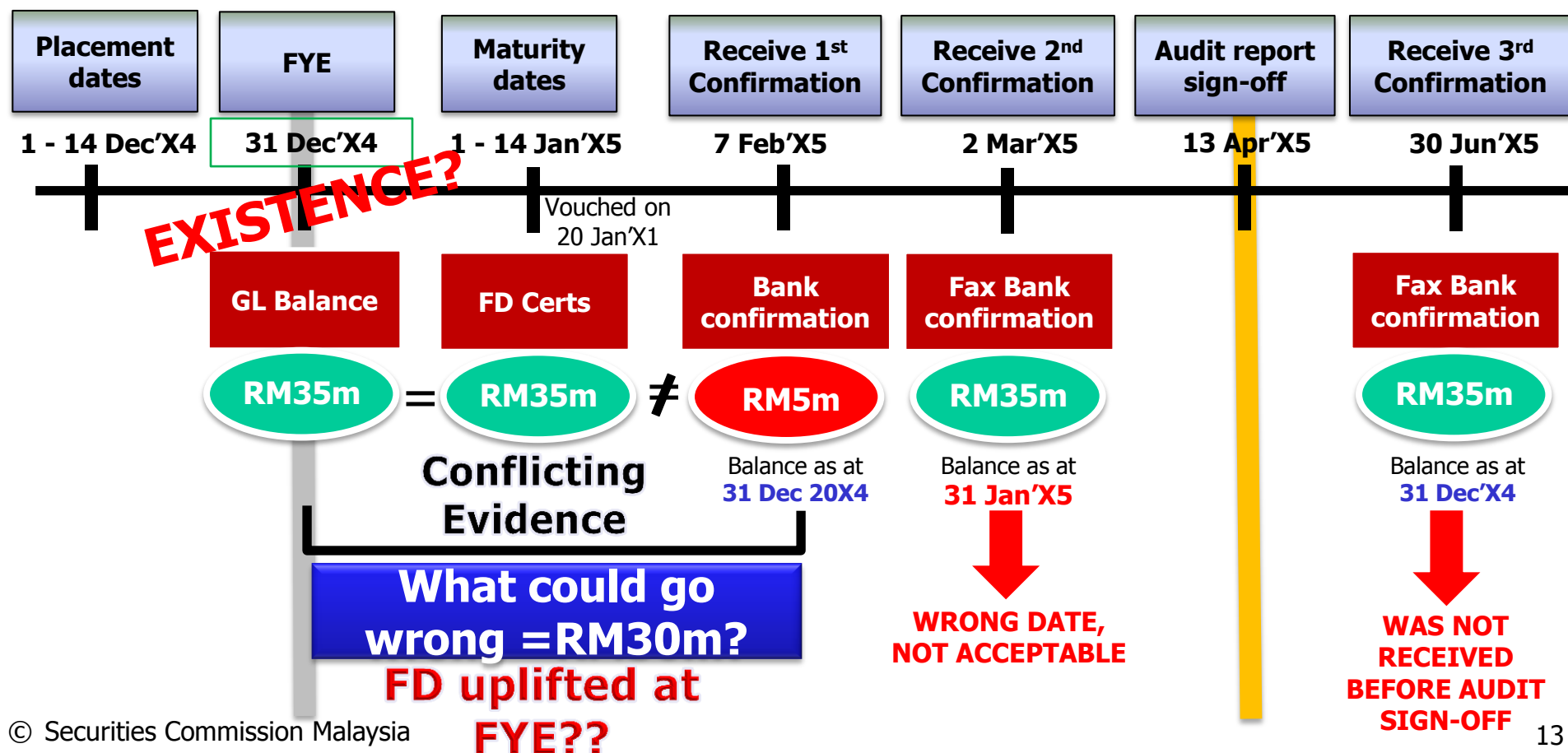
APPROPRIATE PROFESSIONAL SKEPTICISM?

Checked overdrawn amount to Bank Statement

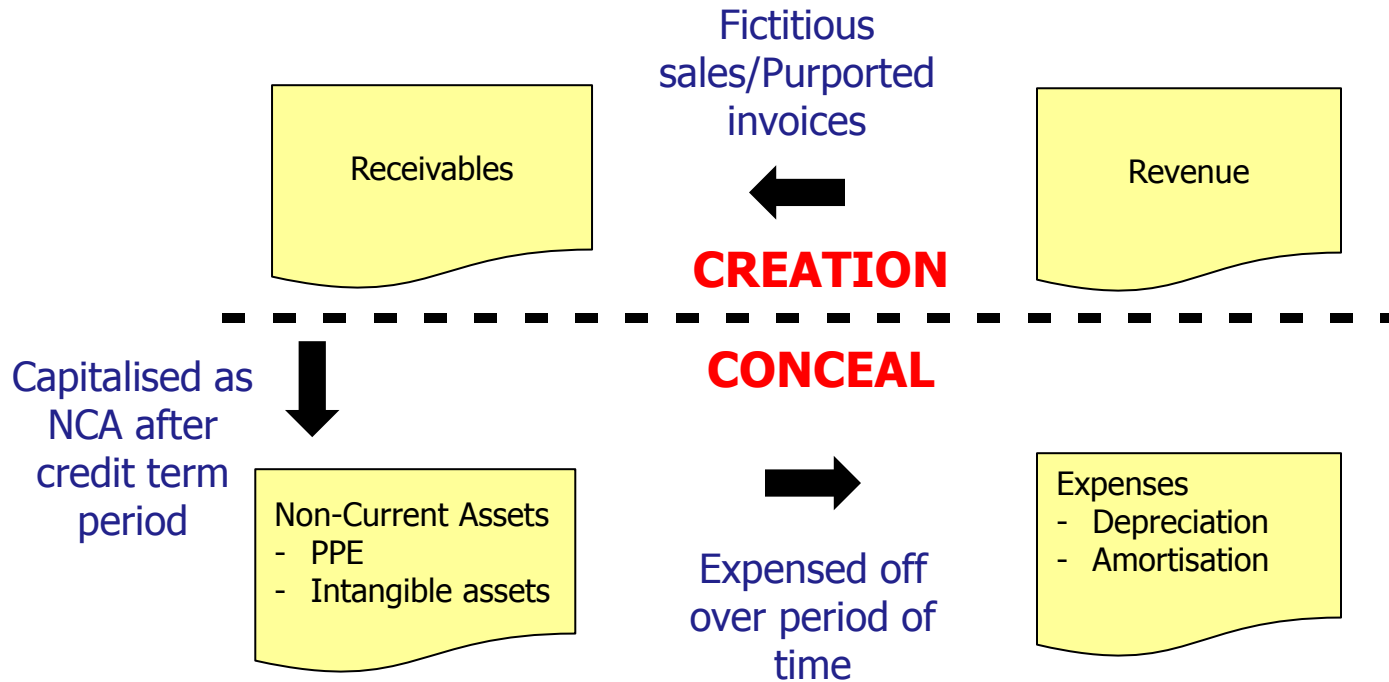
From huge balance to an overdrawn position

Case Study 4 : Conflicting Audit Evidence

Included in the company's cash and bank as at 31 Dec 20X4 YE is an FD of RM35 million

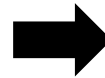


Case Study 5 : Creative Accounting - Fraudulent Activities?



Case Study 5 : Creative Accounting - Fraudulent Activities? (contd.)

Prevention and detection of Fraud



Auditors' responsibility

- Management (preparer) and Board/Audit Committee **primarily responsible** for prevention and detection of fraud
- Oversight consideration include:
 - Potential override of controls
 - Potential inappropriate influence over financial reporting



- To obtain reasonable assurance that financial statements are free from material misstatements whether caused by **fraud** or error
- To maintain appropriate level of professional skepticism throughout the audit
- Relevant procedures include:
 - Inquiry
 - Testing/review



Developments Highlights

Existing Auditor's Report

Director's Responsibility

Auditor's Responsibility

Opinion

Basis for Opinion

Report on Other Legal and Regulatory Requirements

Other Matters

Name of Signing Partner

New Auditor's Report

Opinion

Basis for Opinion

Key Audit Matters

Going Concern

Other Information

Responsibilities of Management / Those Charged with Governance

Auditor's Responsibilities

Explicit statement of auditor independence and fulfilment of other ethical responsibilities

Report on Other Legal and Regulatory Requirements


Name of engagement partner

Effective
15 Dec 2016

} Greater prominence

→ **Mandatory for PLCs**

} May be in an appx/website/etc.

 New/revised reporting requirements

 Enhanced reporting requirements

Extract from auditor's report on 2014 annual report of Rolls-Royce plc

The measurement of revenue and profit in the Civil aerospace business

Refer to pages 101 and 102 (Key areas of judgement – Measurement of performance on long-term aftermarket contracts), pages 104 and 105 (Significant accounting policies – Revenue recognition and TotalCare arrangements) and pages 69 to 71 (Audit Committee report – Financial reporting)

The risk – The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can extend over significant periods and the profitability of these arrangements typically assumes significant life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in assessing engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. The inherent nature of these estimates means that their continual refinement can have an impact on the profits of the Civil aerospace business that can be significant in an individual financial year. The assessment of the estimated outturn for each arrangement involves detailed calculations using large and complex databases with a significant level of manual intervention.

1. Why the matter was determined to be a KAM?

3. Reference to related disclosures.

Our response – We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on such contracts is accurately reflected in the Financial Statements; these controls operated over both the inputs and the outputs of the calculations. We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates showed any evidence of conscious or unconscious management bias in the context of the heightened pressure on and incentives for management to meet the latest guidance discussed above. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes, detailed assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of contingencies and analysis of the impact of known technical issues on cost forecasts. Our analysis considered each significant airframe that is powered by the Group's engines and was based on our own experience supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuer was objective and suitably qualified. We also checked the mathematical accuracy of the revenue and profit for each arrangement and considered the implications of identified errors and changes in estimates.

Our findings – In 2013, our testing identified weaknesses in the design and operation of controls and we assessed the effectiveness of the Group's plans for addressing these weaknesses. In planning the 2014 audit, we anticipated that the control weaknesses identified in 2013 audit would be remediated. However, our testing identified continuing, albeit reduced, control weaknesses in some areas and so, as in 2013, we increased the scope and depth of our detailed testing and analysis from that originally planned. Overall, our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious (2013 audit finding: mildly cautious) profit recognition and we found no indication of conscious or unconscious bias.

2. How the KAM was addressed in the audit?

"... our assessment is that the assumptions and resulting estimates ... resulted in **mildly cautious profit recognition** ..."

IMPORTANCE OF IT

Drive business growth via new sales channels:

- Company website
- E-commerce websites
- Social media
- Mobile devices

Drive efficiency

- Automated processes
- Straight through processing
- Paperless transactions

Supports business operations

Sales, payroll, inventory management, production

Supports decision making

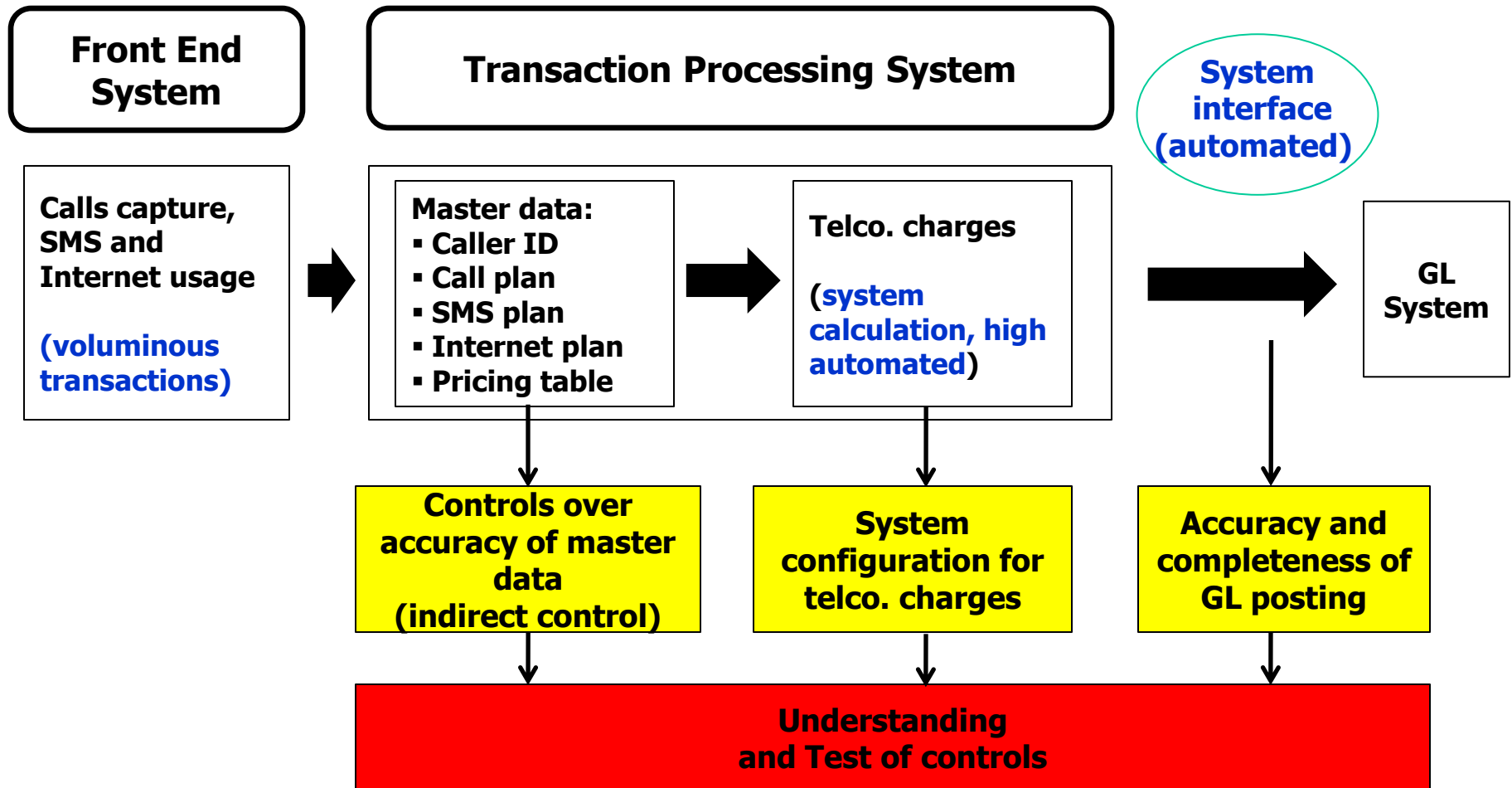
IMPLEMENTATION OF NEW SYSTEMS / TECHNOLOGY

- Web application and payment systems
- Data analytics (e.g. sales trends)
- Outsourcing of IT services and hardware (e.g. web hosting)
- Standalone business support systems (Finance / Accounts, HR, Manufacturing)
- Integrated systems (e.g. ERP systems)

IT RISKS



IMPACT OF IT RISKS ON AUDIT ?



Impact of Technology

- Audit profession needs to evolve
- *Audit 2020 : A Focus of Change*

http://www.forbes.com/forbesinsights/kpmg_audit/index.html

- 'Technology is only an enabler – only critical thinking by the auditor can lead to the analysis of more dimensions of the issues'

