

Suruhanjaya Sekuriti
Securities Commission
Malaysia

Audit Oversight Board
Annual Inspection Report
– Findings and Insights

2017

AUDIT OVERSIGHT BOARD
Annual Inspection Report 2017
– Findings and Insights

© Audit Oversight Board, Securities Commission Malaysia, 2018

Address

No. 3 Persiaran Bukit Kiara
Bukit Kiara
50490 Kuala Lumpur
Malaysia

Telephone

+603 6204 8900

Websites

<http://www.sc.com.my/audit-oversight-board> www.investsmartsc.my

Fax

+603 6201 1888

The cut-off date for the data included in this report was 31 December 2017

Contents

INTRODUCTION	4
What AOB does with Findings?	5
What should PIE Directors do with Findings?	5
AOB’s Strategic Themes	6
PART I	8
Insights into the Audit Profession	
Element 1: Leadership Responsibilities for Quality within the Firm	10
Element 2: Relevant Ethical Requirements	12
Element 3: Acceptance and Continuance of Client Relationship and Specific Engagements	13
Element 4: Human Resources	14
Element 5: Engagement Performance	16
Element 6: Monitoring	18
PART II	20
Inspection Findings and Observations from Firm Level Review	
PART III	24
Inspection Findings and Observations from Engagement Level Review	
Common Findings for Major Audit Firms and Other Audit Firms	27
• Sampling	
• Accounting Estimates	
• Group Audits	
Thematic Reviews	36
• Key Audit Matters – A Thematic Review	
• Oil and Gas Sector – A Thematic Review	
Remediation	41
• Recurring Findings	
• Root Cause Analysis	
Impact from the AOB’s Regulatory Activities	44
PART IV	46
Recent Initiatives Undertaken by the Big-Four Audit Firms to Enhance Audit Quality	
CONCLUSION	50
ACRONYMS AND ABBREVIATIONS	52
DEFINITIONS	53

INTRODUCTION

The AOB Inspection Report is issued for the first time separately from the AOB Annual Report. It aims to provide greater focus on common inspection findings, trend analysis and an assessment of remediation efforts taken by inspected audit firms.

In fulfilling the AOB's mission to foster high quality independent auditing on the financial statements of public-interest entities (PIEs) and schedule funds in Malaysia, the AOB conducts inspections on registered audit firms and auditors of the entities. An inspection includes an assessment of the degree of compliance by auditors with auditing, ethical and other assurance standards applicable in Malaysia, including *International Standard on Quality Control (ISQC)1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*, and the quality of the audit reports prepared by the auditors relating to the audited financial statements of PIEs and schedule funds.

The selection of audit engagements for inspection takes into consideration, among others, market capitalisation, specific industries, and areas of concern for the PIEs. In addition, the AOB also incorporated a series of thematic reviews on certain areas of audits with particular market concerns.

To provide context to the findings, Part I of this report highlights snapshots of the current audit profession landscape and key trends relating to audit quality. This includes results from the AOB's monitoring programme on the Top 10 Audit Firms based on their statistical submissions. The Top 10 Audit Firms in Malaysia collectively audited public-listed companies (PLCs) that constituted 98% of the market capitalisation of PLCs as at 31 December 2017.

Part II and Part III set out the inspection findings and observations arising from firm and engagement level reviews respectively. Part III also includes inspection findings relating to thematic reviews conducted during the year, as well as the remediation efforts of the firms.

Findings identified in relation to engagement reviews are deficiencies that are individually critical which may have an impact on the basis of audit opinion. These are usually in relation to the sufficiency and appropriateness of audit procedures performed and audit evidence obtained, or the basis of judgements in relation to key aspects of an audit. However, findings identified do not necessarily indicate that there is a breach in laws and regulations and that the audited financial statements of the PIEs are not reliable.

Part IV summarises recent initiatives undertaken by firms to enhance audit quality.

What AOB does with Findings?

Following an inspection, all findings highlighted are expected to be remediated by firms within a timeline agreed with the AOB. For engagements where significant improvements are required, the AOB does not restrict actions to the individual partners involved but will also consider the need for further measures to be imposed on firms, if necessary.

It should be noted that findings do not necessarily suggest that the affected PIEs' financial statements contain a material accounting error or that its controls in respect of financial reporting are weak.

The AOB assesses whether findings relate to a lack of audit procedures or relate to a potential material accounting error. The result of the AOB's assessment might require the following actions to be further taken:

- (i) Imposing specific remediation measures on firms to rectify the findings raised. Firms will be required to incorporate or revise the relevant audit procedures in their audit of the PIEs for the ensuing financial year to evaluate the areas relating to the findings raised. Firms will also be required to evaluate the impact of these audit procedures to the audited financial statements for the financial year inspected. In certain instances, this has resulted in Prior Year Adjustments (PYA) being made in cases where accounting errors were discovered; and
- (ii) Referring the PIEs relating to the inspected audit engagements to the Corporate Surveillance Department within the SC for consideration of further action to be taken on the PIEs, where relevant. In addition to outgoing referrals, the AOB also receives incoming referrals from other departments within the SC.

In instances where there are breaches of laws and regulations, the AOB will not hesitate to take action against auditors and audit firms which can range from issuing public reprimands to revoking the registration of audit firms and its partners.

What should PIE Directors do with Findings?

The AOB adopts a targeted and risk-based approach to inspection. As a result of this approach, the AOB's inspection reports should not be taken to provide an assurance that the quality control of the firm inspected, its audits or its audit clients' financial statements are free from any deficiencies not specifically raised by the AOB.

Directors and in particular Audit Committees play a key role in the PIEs' governance structure and are responsible for overseeing the PIEs' financial reporting process. This oversight function can be enhanced through increased engagement with their auditors; discussing, among others, common findings raised by the AOB and whether the auditors are aware of and are acting upon the relevant findings accordingly.

AOB'S Strategic Themes

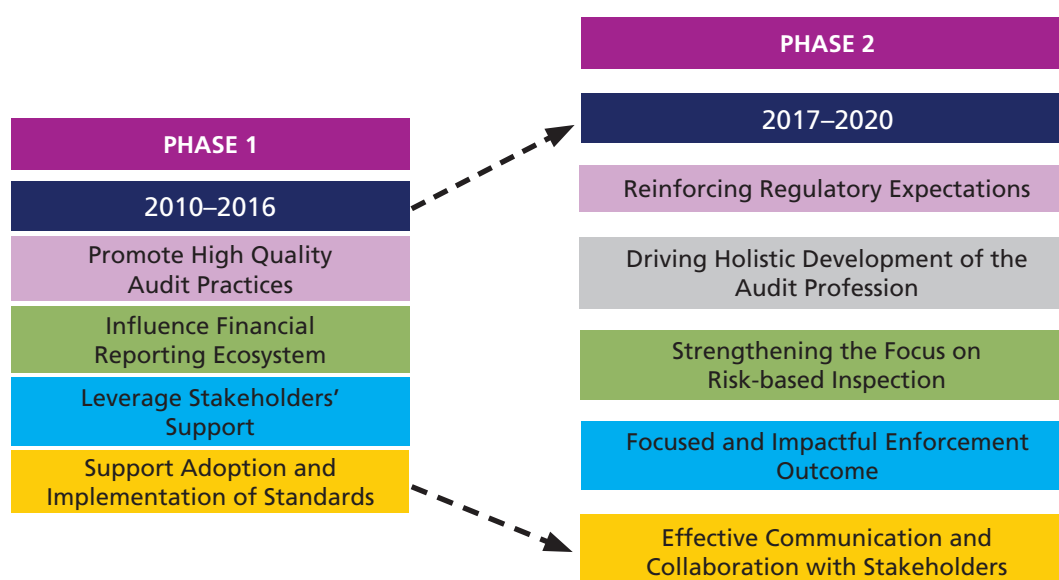
The AOB is always mindful of its regulatory responsibilities and takes conscious steps to constantly review its registration, research, inspection and enforcement activities to address new challenges which may arise.

The AOB's Strategic Plan 2017–2020 is reflective of its goals to move towards Phase 2 of its development (Diagram 1). In Phase 1, the focus was to promote high quality audit practices through the AOB's oversight activities, influence stakeholders to ensure that audit quality remains high on their agenda, leverage stakeholders' support and support adoption and implementation of standards.

The focus areas for Phase 2 were developed after careful consideration of emerging trends, risks and current financial reporting requirements that affect the auditing landscape. The Strategic Plan is designed to be responsive to the dynamic and evolving capital market, and it will be assessed on a regular basis to ensure that the AOB's focus is current and relevant.

Diagram 1

The AOB's Strategic Themes



Source: AOB



PART I

Insights into the Audit Profession

As at 31 December 2017, there were 49 audit firms and 334 individual auditors registered with the AOB. The AOB also recognised foreign audit firms and individual auditors who audit foreign incorporated companies listed on Bursa Malaysia. In this respect, five foreign audit firms and 17 foreign individual auditors were recognised by the AOB as at 31 December 2017.

The audits of PIEs and schedule funds remain concentrated with the Major Audit Firms, which represent 11% of total number of audit firms but collectively audited PLCs and schedule funds covering 92.97% of the total market capitalisation of PLCs and 99.22% of the aggregate net asset value (NAV) of schedule funds (Table 1).

Table 1
Registered and recognised auditors as at 31 December 2017

	No. of audit firms	No. of individual auditors	No. of PIEs	% of total market capitalisation	No. of schedule funds	% of total NAV
Registered						
Major Audit Firms	6	178	764	92.97	985	99.22
Other Audit Firms	43	156	384	6.97	38	0.78
Recognised						
Foreign Audit Firms	5	17	7	0.06	–	–
TOTAL	54	351	1,155	100.00	1,023	100.00

Source: AOB

In addition to the inspection programme, the AOB has put in place a monitoring programme that involves the Top 10 Audit Firms' annual statistical submissions. The Top 10 Audit Firms in Malaysia collectively audited PLCs that constituted 98% of the total market capitalisation of PLCs. The monitoring programme enables the AOB to share statistical information about the audit industry in Malaysia with the aim for firms to set individual audit quality indicators which will eventually improve their audit quality.

The annual data gathering initiative carried out since 2015 enabled the AOB to gain meaningful insights into the current state of the larger firms as well as to establish key trends relating to audit quality. Results of the AOB's analysis on the data gathered from the Top 10 Audit Firms as at 30 June 2017 are presented within each of the six pillars of ISQC 1:

- Leadership Responsibilities for Quality within the Firm;
- Relevant Ethical Requirements;
- Acceptance and Continuance of Client Relationship and Specific Engagements;
- Human Resources;
- Engagement Performance; and
- Monitoring.

Element 1

Leadership Responsibilities for Quality within the Firm

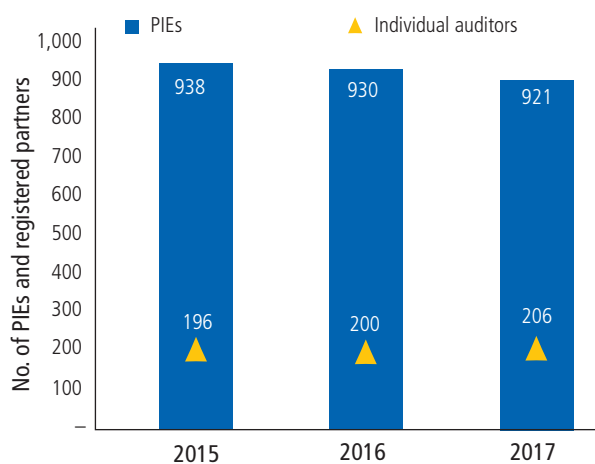
Sufficient and timely involvement of partners is one of the key drivers of audit quality. The leadership of the Top 10 Audit Firms continues to ensure that the workload of their partners is manageable, in order to allow them to effectively direct, supervise and review their audit engagements by:

- Increasing the number of partners;
- Rebalancing the partners' portfolio of clients annually; and
- Reviewing the firm's audit client portfolio to ensure that the firm has sufficient capacity and competence to perform the audit.

Based on the data gathered on the Top 10 Audit Firms, the number of PIE audit clients has decreased since 2015 while the number of the AOB-registered partners has increased.

Chart 1

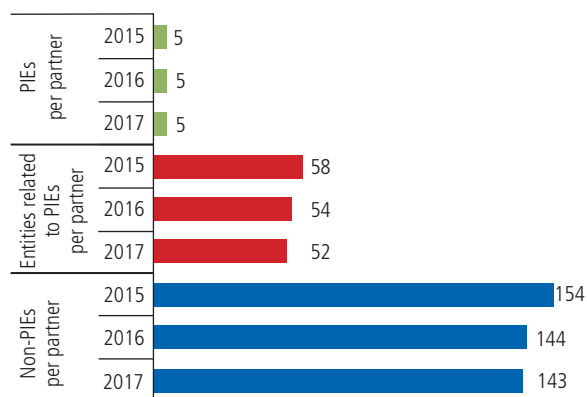
Number of PIEs vs number of registered partners of Top 10 Audit Firms as at 31 December



Source: AOB

Chart 2

Average number of clients per partner



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Further analysis of the data provided by the Top 10 Audit Firms revealed the following:

- Overall, the total average number of audit clients per partner has reduced by 7.8% from 217 audit clients in 2015 to 200 audit clients in 2017; and
- While the average number of PIE audit clients per partner has remained constant at five, the average number of non-PIE audit clients per partner has been reducing over the last three years.

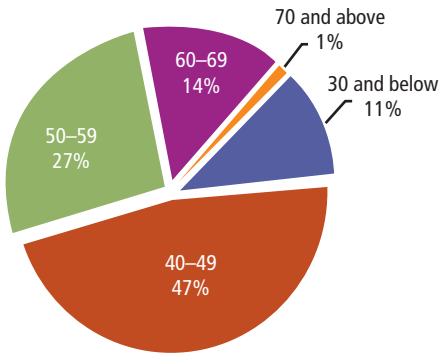
A lower number of audit clients per partner would allow for greater partner involvement.

Practice Continuity and Sustainability

In Malaysia, 42% of registered individual auditors are of the age of 50 years and above.

Chart 3
Age profile of registered individual auditors as at 31 December 2017

Within this group, 36% are of the age of 60 years and above, and are concentrated in audit firms with fewer than 10 partners.

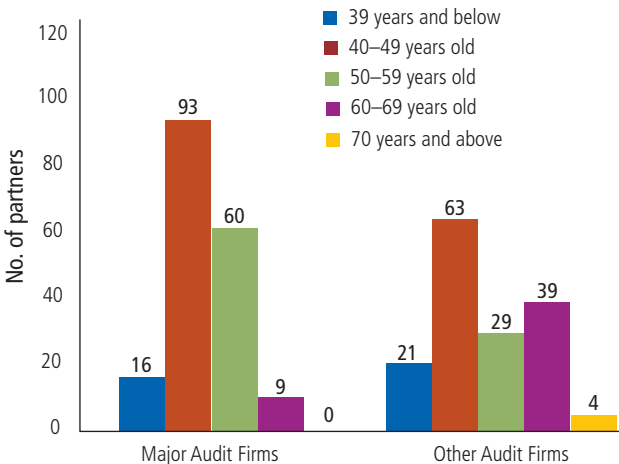


Source: AOB

As the auditing profession ages, it is increasingly evident that succession planning is an important process that audit firms should seek to establish as early as possible.

Chart 4
Breakdown of age profile as at 31 December 2017

A formal succession plan, along with a reassessment of existing partnership arrangements, would allow for the eventual orderly exit of older audit partners, while ensuring continuity and sustainability of the audit practice, hence minimising any potential disruption in the market. Audit firms need to continuously recruit, develop, mentor and groom their team members for future leadership roles. Good succession planning also includes constantly developing audit systems and programmes to ensure continuity and sustainability of the audit practice.



Source: AOB

Element 2

Relevant Ethical Requirements

On 14 March 2018, the Malaysian Institute of Accountants (MIA) announced the changes to the partner rotation requirements as follows:

- ▶ Audit partner rotation period applicable for audits of financial statements of PIEs for periods beginning on or after 15 December 2018 but prior to 15 December 2023:

Key Audit Partners	Stay-on Period	Cooling-off Period
Engagement Partners	7 cumulative years	3 consecutive years
Engagement Quality Control Reviewer (EQCR)	7 cumulative years	3 consecutive years
Other Audit Partners*	7 cumulative years	2 consecutive years

- ▶ Audit partner rotation period applicable for audits of financial statements of PIEs for periods beginning on or after 15 December 2023:

Key Audit Partners	Stay-on Period	Cooling-off Period
Engagement Partners	7 cumulative years	5 consecutive years
EQCR	7 cumulative years	3 consecutive years
Other Audit Partners*	7 cumulative years	2 consecutive years

* Partners who are not playing the role of engagement partner or EQCR but who will make key decisions or judgements on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.

Audit firms are reminded to ensure that audit partner rotation requirements are complied with at all times. As audit partner rotation is a fundamental provision under the By-Laws (on Professional Ethics, Conduct and Practice) of the MIA, instances of non-compliance would result in the AOB taking relevant enforcement actions on the firm. In 2018, the AOB will be monitoring audit firms' compliance with the new audit partner rotation requirements.

Element 3

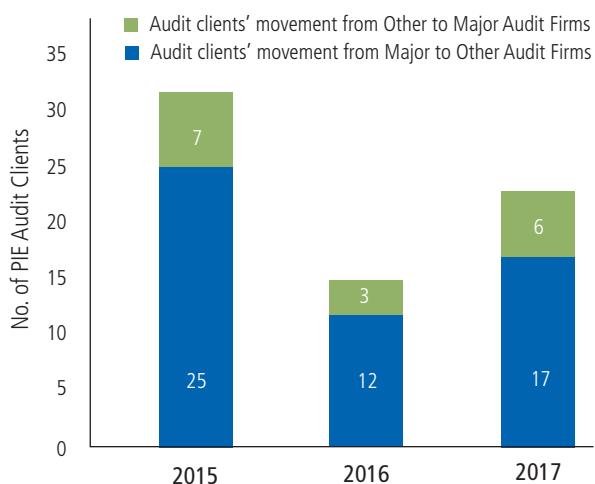
Acceptance and Continuance of Client Relationship and Specific Engagements

Major Audit Firms collectively audited PLCs and schedule funds representing 93% of the total market capitalisation of PLCs and 99% of the total NAV of schedule funds. In 2017, there was continued movement of PIE audit clients from Major Audit Firms to Other Audit Firms, as depicted in Chart 5. This trend is consistent with the initiative among the Major Audit Firms to reduce the number of PIE audit clients in order to manage the workload of their audit partners.

In 2017, the AOB continued to observe shortcomings in the evaluation process for the acceptance of new audit clients and audit engagements during its inspections. Details of these shortcomings are detailed in Part II – Table 1.

Chart 5

3-year movement of PIE audit clients



Source: AOB

Element 4

Human Resources

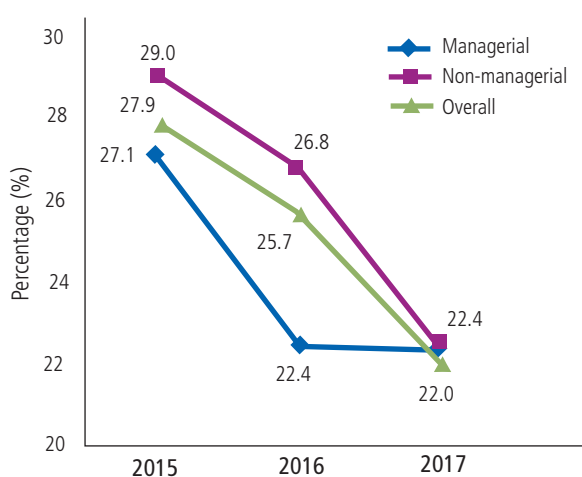
Talent retention has often been cited by audit firms as one of the key challenges faced and retention of experienced audit personnel are widely recognised as a key driver to better audit quality. Over the years, the audit firms have taken various initiatives to retain their talent by offering competitive remuneration, improving staff benefits, organising social events to build closer relationship between management and staff as well as improving resource planning to better manage workload.

Analysis of the data relating to talent retention among the Top 10 Audit Firms are as follows:

- ▶ Overall audit staff turnover rate has decreased since 2015 from 27.9% in 2015 to 22.0% in 2017;
- ▶ Turnover rate among managerial level audit staff has stabilised at around 22.0% within the last two years; and
- ▶ Growth of staff costs and increasing proportion of managerial audit staff within the last two years.

Similar to the prior year, there is a close correlation between growth in audit fees and staff costs. In 2017, audit fees increased by 5.3% while salary costs increased by 6.1%.

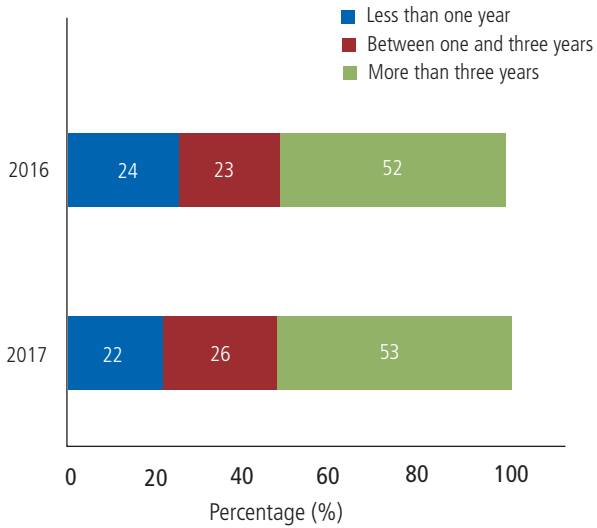
Chart 6
Average audit staff turnover rate



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Chart 7

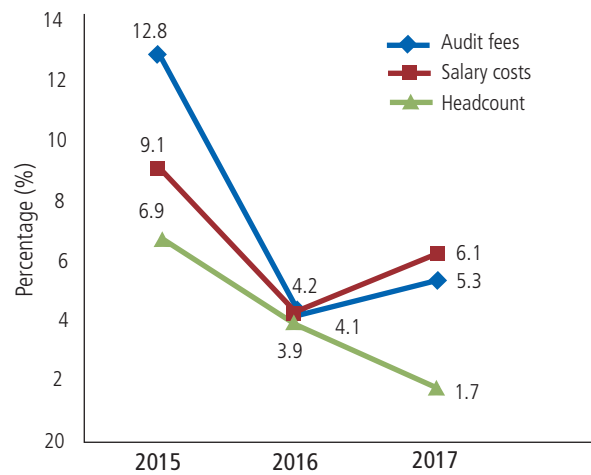
Composition of managerial audit staff by number of years of experience in the managerial role



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Chart 8

Growth rates in audit fees, salary costs and audit practice headcount



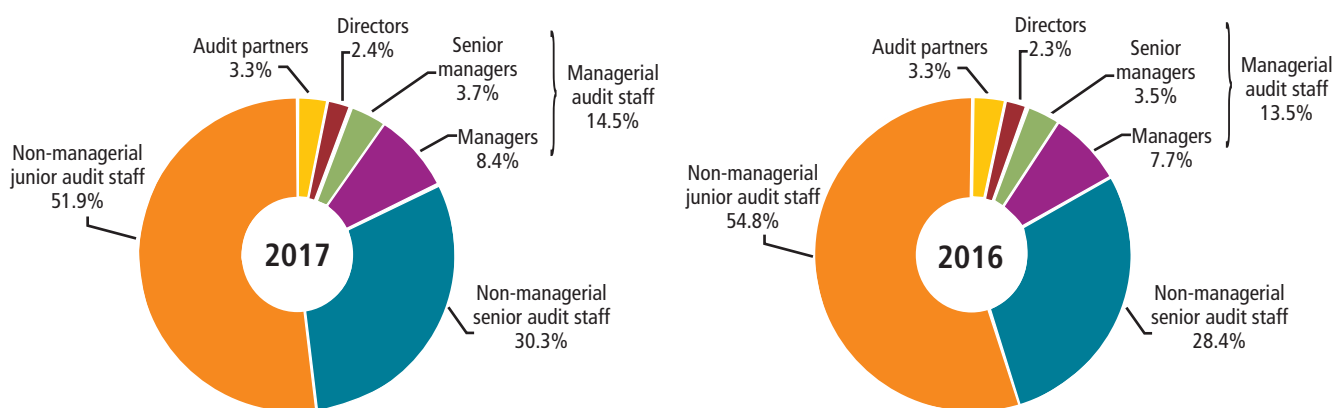
Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Element 5

Engagement Performance

Similar to prior years, the composition of audit personnel for the Top 10 Audit Firms in Malaysia comprises mainly of junior level audit staff whose level of experience averages about 1.2 years. Hence, it is important for firms to ensure that these audit staff are adequately trained and supervised.

Chart 9
Audit practice staff by level to total headcount



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Diagram 1
Average years of experience for audit practice staff for 2017



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

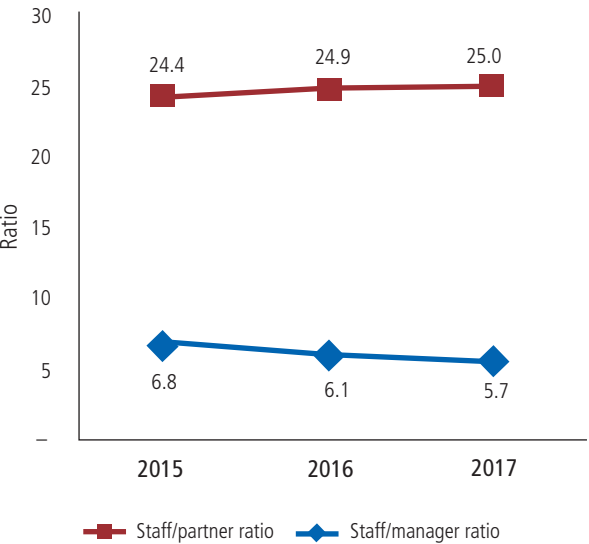
Based on the data submitted by the Top 10 Audit Firms, the AOB observed the following:

- ▶ Increase in the ratio of staff per partner from 24.4 in 2015 to 25.0 in 2017; and
- ▶ Decrease in the ratio of staff per manager from 6.8 in 2015 to 5.7 in 2017.

A decrease in staff per manager ratio indicates that the senior members of the audit team have higher capacity to supervise the junior audit team members on audit engagements.

Findings raised by the AOB in relation to the Engagement Performance are set out in Part III of this report.

Chart 10
Staff to partner and staff to manager ratios



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Element 6

Monitoring

The strength of a firm's system of quality controls is dependent on whether a firm has sufficient resources to support audit engagement teams in the areas of technical, training and risk management matters. As such, the AOB has been monitoring the ratio of total headcount in quality control functions vis-à-vis total headcount in the audit practice of the Top 10 Audit Firms.

The AOB observed that the ratio has improved from 1:59 in 2016 to 1:54 in 2017. Firms should continue to revisit the needs of the audit engagement teams and invest in the quality control functions of the firm due to the important role played by the quality control functions towards better audit quality.

Table 2

Total headcount in quality control vs total headcount in audit practice

	2015	2016	2017
Total headcount in quality control	106	106	119
Total headcount in audit practice	6,045	6,280	6,389
RATIO	1:57	1:59	1:54

Source: AOB Analysis – Top 10 Audit Firms in Malaysia

The role of the firm's monitoring function is important and should be performed by persons with sufficient and appropriate experience as well as authority. In recent years, the AOB observed that some firms have expanded their internal monitoring to include hot reviews. Certain firms have attributed better inspection results to hot reviews that have been carried out during the periods under review.

In 2017, the AOB observed certain shortcomings with the monitoring process of the Major and Other Audit Firms. These shortcomings are detailed in Part II – Table 1.

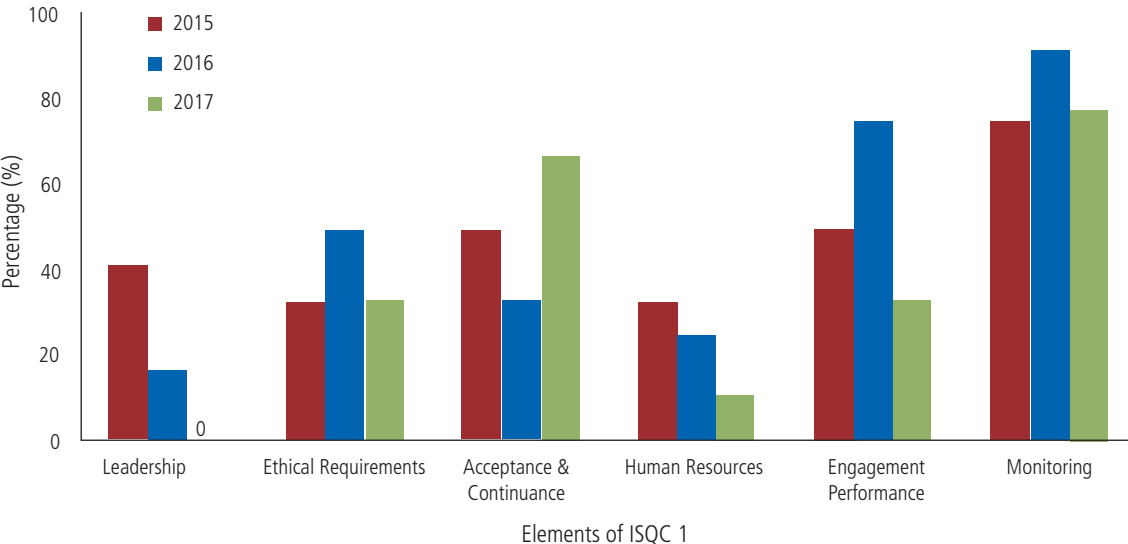


PART II

Inspection Findings and Observations from Firm Level Review

Over the last three years, the AOB observed improvements in the system of quality controls for inspected firms relating to three out of the six elements of ISQC 1 as illustrated in Chart 1.

Chart 1
Percentage of audit firms inspected with findings in the six elements of ISQC 1 from 2015 to 2017



Source: AOB

Chart 1 above depicts the percentage of inspected audit firms with findings in each of the six elements of ISQC 1 from 2015 to 2017. Improvements were noted in the ISQC 1 elements of Leadership Responsibilities for Quality within the Firm, Human Resources, and Engagement Performance. The AOB continues to observe a higher percentage of inspected firms with findings on the ISQC 1 element of Acceptance and Continuance of Client Relationships and Specific Engagements.

Table 1

Common findings identified by the AOB during the 2017 inspection

Common findings in 2017	Key concerns / risks	AOB reminders
<p>Acceptance and Continuance of Client Relationship and Specific Engagements</p> <ul style="list-style-type: none"> It was noted that certain audit firms consented to accept nominations to be the auditor of a PIE before completing the evaluations for the acceptance of new audit clients and audit engagements. 	<p>In the event that new audit clients and engagement assessments are incomplete or not sufficiently robust, the firm may not be able to identify the relevant client and audit engagement risks that should be addressed.</p>	<p>Firms are reminded not to treat the client and engagement acceptance evaluation as a mere administrative process. These processes serve as primary safeguards to prevent firms from accepting—</p> <ul style="list-style-type: none"> engagements that may present independence issues; audit engagements that are beyond the capacity or competency of the firm; and clients with issues over their integrity.
<p>Engagement Performance</p> <ul style="list-style-type: none"> Audit engagement files were not assembled within 60 days from the date of the audit report as required by ISQC 1. 	<p>Audit documentation and evidence may be misplaced when not assembled in a timely manner. The lack of controls over the assembly of audit engagement files poses the risk that documentation and audit evidence could be altered, added or deleted without the firm’s knowledge.</p>	<p>The AOB continues to observe findings relating to timeliness of audit files assembly. Closer monitoring and discipline by the firms on their audit engagement teams are required.</p> <p>The AOB would not hesitate to take stern action on firms with serious failures on file assembly and maintenance of confidentiality, safe custody and integrity of audit engagement documentation.</p>
<p>Monitoring</p> <ul style="list-style-type: none"> Recurring engagement review findings observed for firms that were re-inspected. Engagement reviews performed for some firms were not effective in view of observed failure to identify audit quality issues. 	<p>Failure to adequately remediate engagement review findings poses the risk of future audit failure.</p> <p>In the absence of a robust monitoring process, weaknesses in its system of quality controls would not be identified and rectified on a timely basis.</p>	<p>Firms should evaluate why past remedial measures failed to prevent recurring findings. Where relevant, new or additional measures may be required to address these findings.</p> <p>Firms should implement a robust internal monitoring programme to identify areas for improvement. It is important that the role of the monitoring function is assigned to personnel with the appropriate experience and authority.</p>

Source: AOB

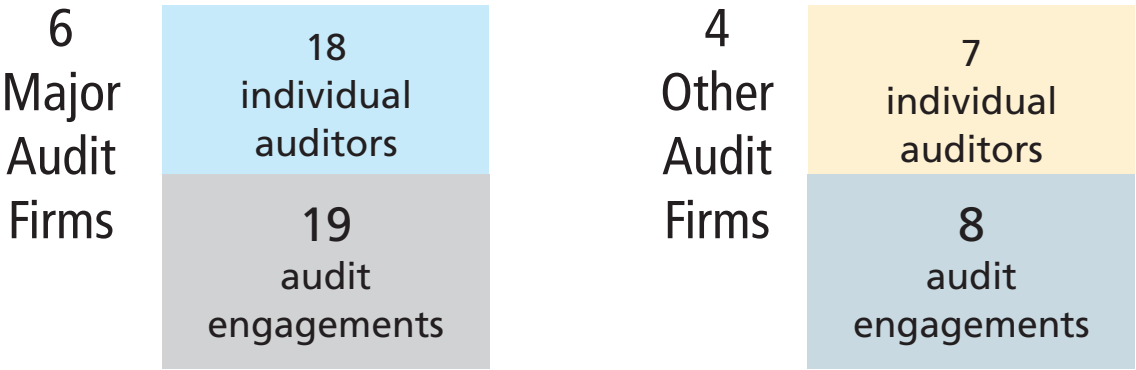


PART III

Inspection Findings and Observations from Engagement Level Review

In 2017, the AOB conducted regular inspections on six Major Audit Firms and four Other Audit Firms that collectively audited PLCs and schedule funds representing approximately 93% of the total market capitalisation of PLCs, 99% of the total NAV of schedule funds and over 63% of the total number of PIEs.

Diagram 1
Number of audit firms, individual auditors and engagements inspected by the AOB in 2017

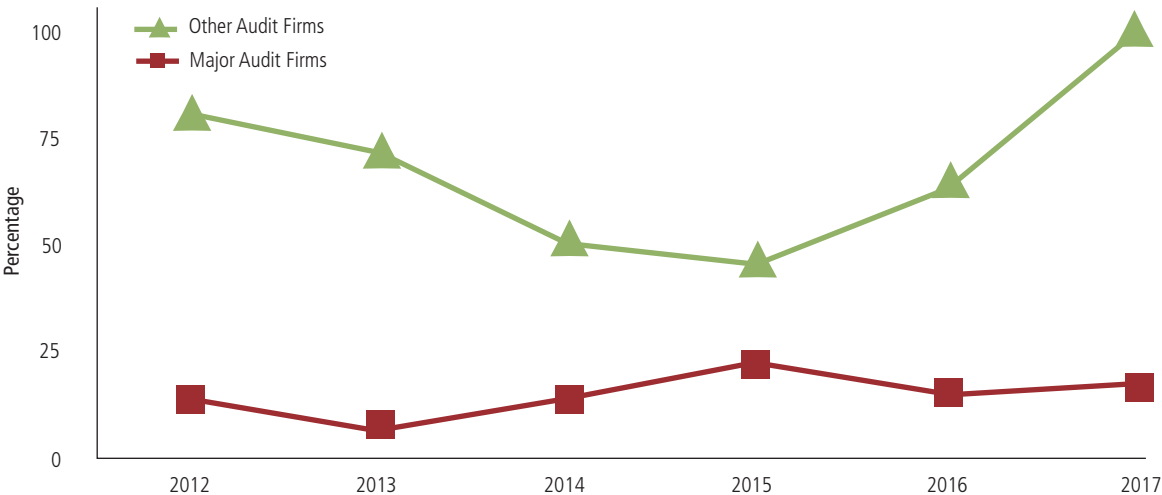


Source: AOB

Engagements with significant improvement required

As shown in Chart 1, while there were no significant changes in the number of engagements with significant improvements required for Major Audit Firms, the AOB continues to observe an increasing trend in relation to the number of significant improvements required for Other Audit Firms inspected within the last three years.

Chart 1
Percentage of inspected engagements with significant improvement required



Source: AOB

100% of inspected engagements in 2017 which were audited by Other Audit Firms require significant improvements, which resulted in a widening gap in the overall performance of Other Audit Firms as compared to Major Audit Firms over the six-year period since 2012.

In an effort to improve the quality for all of the AOB's registrants, the AOB will be introducing additional registration criteria to be imposed on audit firms and individual auditors seeking registration with the AOB or registered with the AOB. These additional criteria aim to, among others–

- (i) compel existing and future registrants to develop internal capacity;
- (ii) strengthen accountability over the engagement quality control review process; and
- (iii) strengthen accountability over the role of the audit partner.

From the audit firms' perspective, in order to reduce the number of engagements with significant improvements required, it is important for the firms' leadership to set the appropriate tone from the top and to take immediate and relevant measures to promote audit quality culture within their organisations. This includes making the necessary investments in the firms' infrastructure and technical competencies.

It was observed that firms which have made significant investments in resources to support audit engagement teams in the areas of technical, training and risk management have significantly less inspection findings. For these firms, the continuous challenge remains in ensuring consistency of performance across the engagement partners.

Common Findings for Major Audit Firms and Other Audit Firms

In comparing the common findings over a three-year period since 2015, the AOB observed that the top three findings in 2017 were also common findings over the same period.

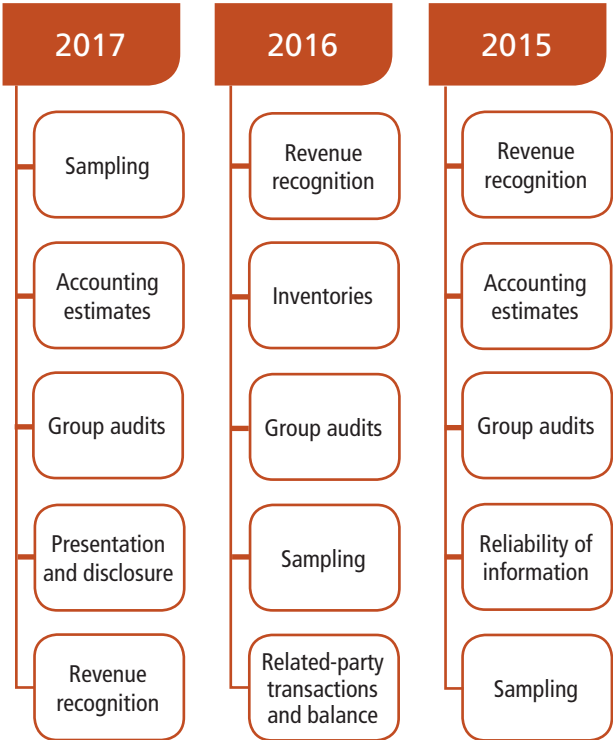
As in previous years, sampling remains one of the common findings observed by the AOB. Besides sampling, the AOB also observed an increase in the number of findings relating to the presentation and disclosure in the audited financial statements.

Both of the above areas of findings are observed to be prevalent across Major Audit Firms and Other Audit Firms. Heightened attention should be accorded by the firms to ensure that similar findings on basic and fundamental audit procedures do not recur.

An increase in the number of findings was also noted in the audit of accounting estimates which included complex calculations and judgement of the auditors. These findings were in relation to property development and contract costs, asset impairment and the fair valuation of assets.

Further details of the top three findings observed are explained and illustrated in the following case studies.

Diagram 2
Top five common findings by audit quality theme

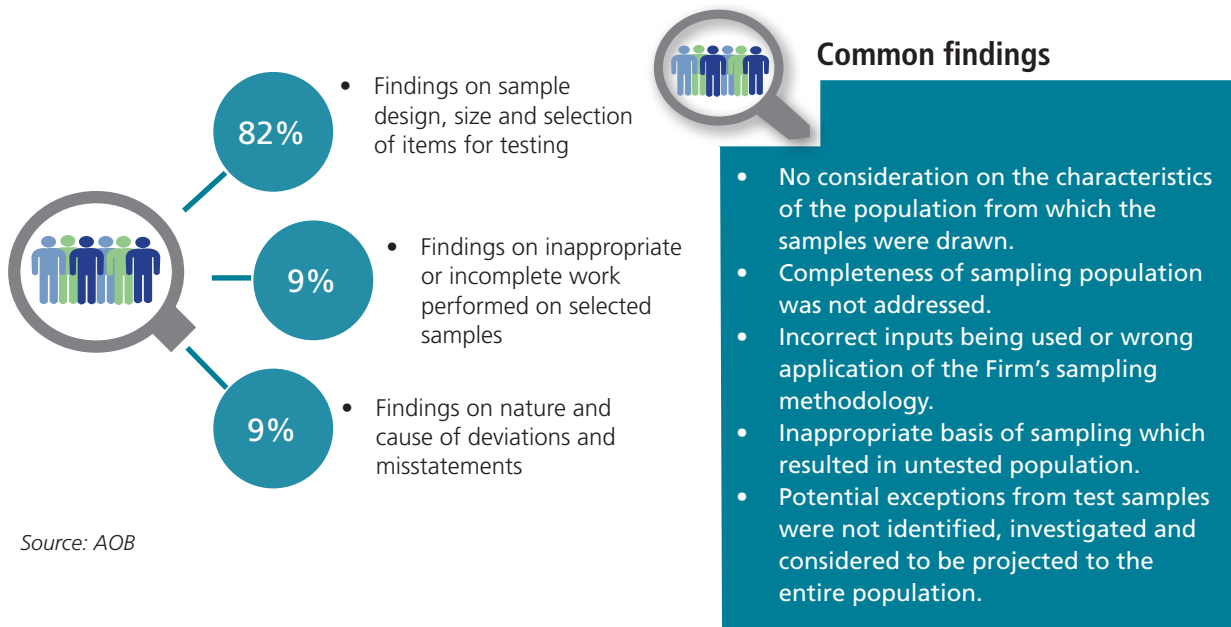


Source: AOB

Sampling

The continued observations of findings relating to sampling raises concerns on the effectiveness of firms' designed audit procedures to minimise its sampling risk. Common findings observed from the AOB's 2017 inspections in relation to sampling are shown in Diagram 3.

Diagram 3
Common findings on sampling



Source: AOB

One of the more prevalent findings observed is in relation to a selection of samples based on a monetary threshold using the materiality set for the audit engagement. The basis of selection is not representative, hence does not provide audit evidence for the remainder of the population. In the absence of other related audit procedures, this gives rise to an untested population issue.

The AOB also continues to observe findings where the completeness of the population from which samples were selected was not ascertained.

In applying audit sampling, an auditor has to determine a sample size that is sufficient to reduce its sampling risk to an acceptably low level. Sample items are to be selected in a way that each sampling unit has a chance of selection.

Case study
1

Basis of sampling in testing Property Development Costs

Total costs incurred during the year for a property development project undertaken by PIE A was RM167.3 million. Substantive procedures for the costs incurred during the year was performed by testing samples of preliminary expenses, main building and architectural work. The number of samples tested and results of the tests, together with the relevant findings raised, are illustrated below:

Project costs	Costs (RM mil)	
Preliminary expenses	42.8	<p>12 samples of preliminary expenses were selected for testing with no basis of the sample size. Finding: <u>No consideration of the characteristics of the population and the sufficiency of the sample size.</u></p>
Main building works	52.7	<p>Sample selection based on 'major contracts by total contract value'. Finding: <u>Basis of sample selection does not allow each sampling unit to have a chance of selection.</u></p>
Architectural works	35.6	<p>Significant variances between amounts recorded and amounts verified were identified for three out of five samples tested. Finding: <u>No investigation of the nature and cause of the deviations identified, and whether any misstatements should be projected to the population.</u></p>
Others	36.2	
Total costs incurred for the year	167.3	

Case study
2

Basis of sampling in testing Revenue

Revenue for PIE B was derived from sale of goods amounting to RM21.5 million. Substantive procedures were performed on revenue via a test of detail where items above 25% of materiality set for the audit engagement were selected for testing. Further details of the samples tested and the relevant findings raised are as illustrated below:

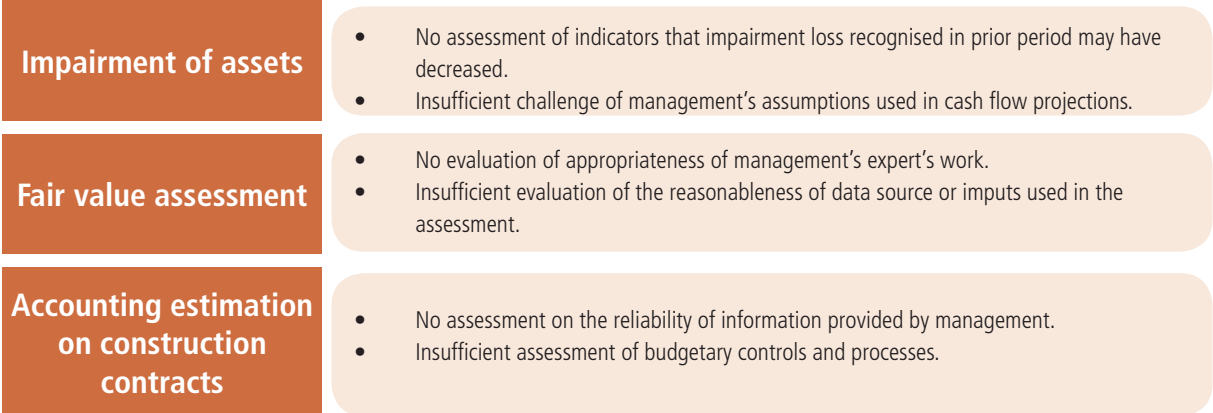
Revenue population needed RM mil	Performance materiality (PM) set by the auditor RM mil	Basis of sampling	No of samples selected	Total amount of samples selected RM mil
21.5	0.4	Items > RM0.1 mil	48	16.3

Auditors' common rebuttal	AOB's identified findings	What can auditors do differently to avoid these audit findings?
<p>Samples selected are material items.</p> <p>Sample coverage is already high, i.e. 76%. [RM16.3 mil/RM21.5 mil].</p>	<ul style="list-style-type: none"> • Selective examination of specific items cannot be projected to the overall population [ISA 500.10 (A55)]. • Untested population of RM5.2 mil exceeds Performance Materiality. [RM21.5 mil – RM16.3 mil]. 	<ul style="list-style-type: none"> • Avoid selective or key items testing. • If selective or key items testing is used: <ul style="list-style-type: none"> ▶ Test the remaining population based on appropriate sampling methodology; or ▶ Selective or key items testing to be supplemented by: <ul style="list-style-type: none"> – Test of controls – must be relevant to assertions to be addressed; and – Substantive analytical review.

Accounting Estimates

Common findings observed from the AOB's 2017 inspection in relation to accounting estimates, categorised into three main areas, are detailed in Diagram 4.

Diagram 4
Common findings on accounting estimates



Source: AOB

The AOB observed that there was an increase in findings on the audit of impairment assessment of assets. These findings were particularly in relation to the assessment of cash flow forecasts and projections prepared by management which was used to determine the value-in-use (VIU). There were insufficient assessment and challenge by the auditors on the key assumptions used in the cash flow forecasts and projections.

It was also observed that some Major Audit Firms have made greater progress in addressing the findings raised on accounting estimates, with more robust assessment and improved documentation. The firm attributed the result to more targeted training in relation to accounting estimates and an effective monitoring review.

The AOB continues to emphasise the importance of challenging the key assumptions used by management in their cash flows forecasts and projections. This includes assessing the assumptions relating to forecasted sales volume, selling prices and discount rates applied, particularly in the context of the economic climate at that time and the PIE's historical trends.

Case study
3

Impairment Assessment of Goodwill

PIE C's goodwill of RM10.0 million was allocated to Subsidiary A (Sub A), a Cash Generating Unit (CGU). The total carrying amount of the CGU and the goodwill amounted to RM35.0 million. In measuring the recoverable amount to be used in the impairment assessment on goodwill, PIE C prepared cash flow forecast and projections as shown below. Upon verifying the cash flow forecast and projections, Firm X concurred with PIE C and concluded that no impairment was required since the recoverable amount exceeded the carrying amount.

	Actual	Forecast	Projection				
	2017	2018	2019	2020	2021	2022	2023
Net cash inflows (RM mil)	0.73	0.79	0.86	0.94	1.02	1.11	1.21
Period		1	2	3	4	5	6
Discount rate at 13%		0.88	0.78	0.69	0.61	0.54	0.48
Net Present Value (NPV) (RM mil)		0.70	0.67	0.65	0.62	0.60	0.58
Discounted cash flows (RM mil)		3.82					
Terminal value using growth rate to perpetuity of 9% (RM mil)		32.97					
Recoverable amount (RA) (RM mil)		36.79					
Carrying amount (CA) (RM mil)		35.00					
Variance (RM mil)		<u>1.79</u>	Thus, no impairment required				

However, the key assumptions used to derive to the cash flows were not reasonable and not sufficiently challenged. Had the assumptions been more reasonable, the revised RA could potentially be less than the CA. Hence, the firm's initial conclusion that no impairment was required to be made by the PIE could no longer be applicable as illustrated in the following page:

Key assumptions

- Growth rate for revenue of 9%
- Gross profit margin of 14.5%
- Discount rate Weighted Average Cost of Capital of 13%
- Terminal growth rate of 9%
- Six-year cash flow projection

Consideration

- Reasonableness of assumptions:
- Revenue projected based on average historical revenue for five years where there were significant fluctuations from year to year;
 - Verification of data on historical revenue;
 - Discount rate used not specific to the CGU; and
 - Justification of using growth rate of 9% to determine the terminal value.
- Appropriateness of using a six-year cash flow projection

Common finding

Insufficient audit procedures performed to evaluate and challenge the appropriateness and reasonableness of the key assumptions used to determine the RA of goodwill

Impact of changes to assumptions – RA potentially less than CA. Conclusion of impairment?

Group Audits

Group Audits remains one of the top three findings observed during the three-year period since 2015. It is also one of the top findings that continue to be identified in the International Forum of Independent Audit Regulators (IFIAR) Annual Inspection Survey.

The findings observed in this area are summarised in Diagram 6 and include those in relation to the direction, supervision and review of the component auditors' work. More effort should be expended by firms to ensure that their remediation action plans are effective enough to address the findings relating to Group Audits. Firms should also ensure consistent application of the International Standard on Auditing (ISA) 600, *Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)*.

Recognising the need to further improve the existing standard on this area, the International Auditing and Assurance Standards Board (IAASB) approved a *Project Proposal for the Revision of the IAASB's International Standards Relating to Quality Controls and Group Audits* (Project Proposal) in December 2016.

Diagram 5

Enhancing Audit Quality Focusing on Group Audits



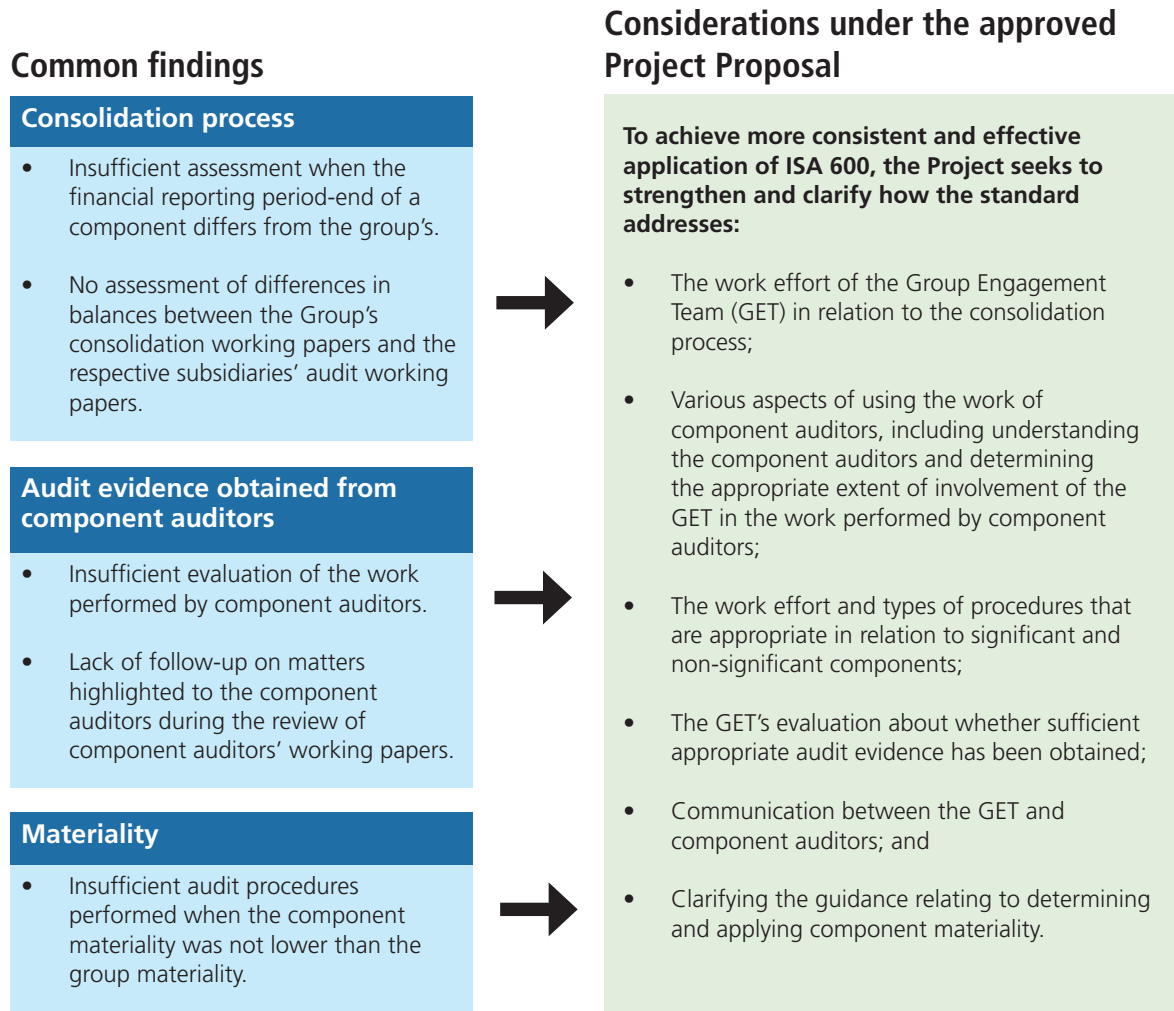
IAASB Project: Group Audits – ISA 600

- The IAASB recognises that various aspects of the auditing standards relating to Group Audits require further consideration, especially in light of ongoing implementation challenges in applying these standards. Issues were identified through the ISA post-implementation review, inspection findings of audit oversight bodies, and from ongoing stakeholder outreach;
- The IAASB subsequently consulted publicly about these topics through the *Invitation to Comment (ITC), Enhancing Audit Quality: A Focus on Professional Skepticism, Quality Control and Group Audits*, published in December 2015;
- Based on responses to the ITC and other input gathered during related outreach activities, the IAASB approved the *Enhancing Audit Quality: Project Proposal for the Revision of the IAASB's International Standards Relating to Quality Controls and Group Audits* in December 2016; and
- Under the project, the IAASB will be considering how specific requirements and application material in ISQC 1, ISA 220 *Quality Control for an Audit of Financial Statements* and ISA 600 *Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)* could be strengthened and clarified to address the specific challenges that have been identified and to achieve more consistent and effective application of the standards.

Source: IAASB's ISA 600 Project Update – Enhancing Audit Quality Focusing on Group Audits

Diagram 6

Common findings on Group Audits and areas for consideration under the Project Proposal



Source: AOB and IAASB's *Enhancing Audit Quality: Project Proposal for the Revision of the IAASB's International Standards Relating to Quality Control and Group Audits*

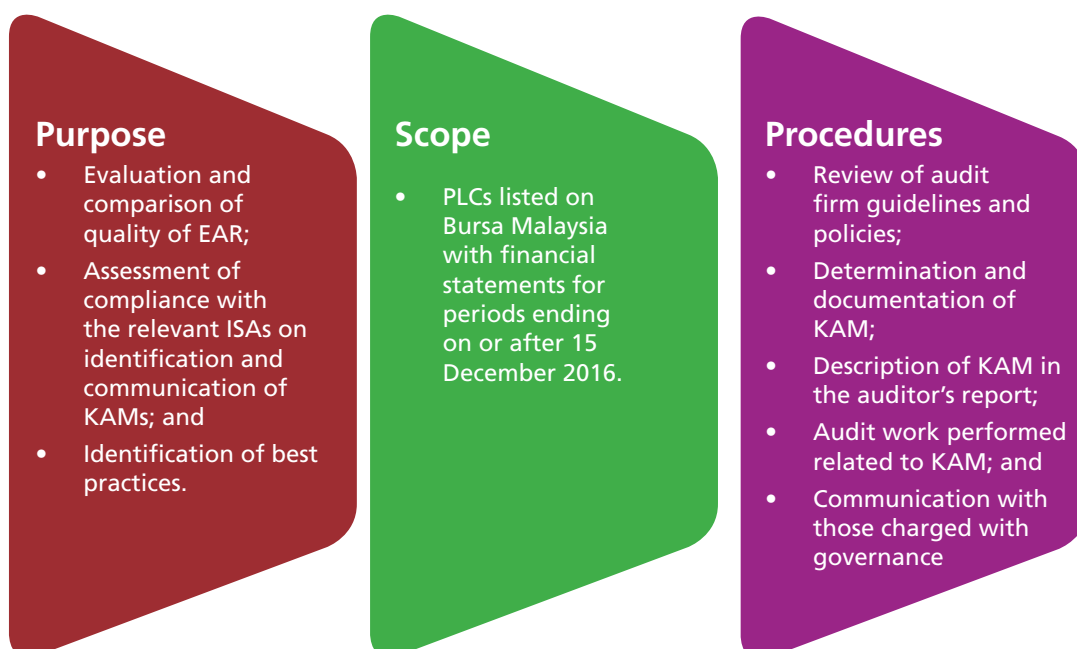
Thematic Reviews

Key Audit Matters – A Thematic Review

One of the thematic areas of focus in the AOB's 2017 Inspection Programme was in relation to the communication of Key Audit Matters (KAMs) in the *Enhanced Auditor's Reports* (EARs). In 2015, the IAASB issued its new and revised enhanced auditor reporting standards. These standards were adopted in Malaysia and are effective for audits of financial statements with financial periods ending on or after 15 December 2016.

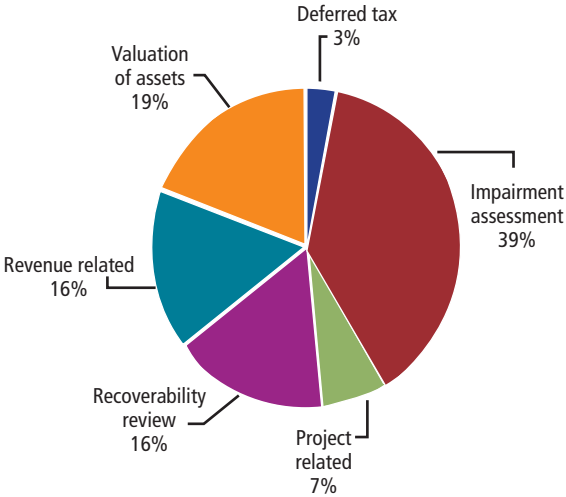
The key change in the EAR is the introduction of KAMs. *ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report* defines KAM as "Those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance".

Due to the importance of KAMs, these were the focus areas included in the AOB's Engagement Reviews for Major Audit Firms in 2017.



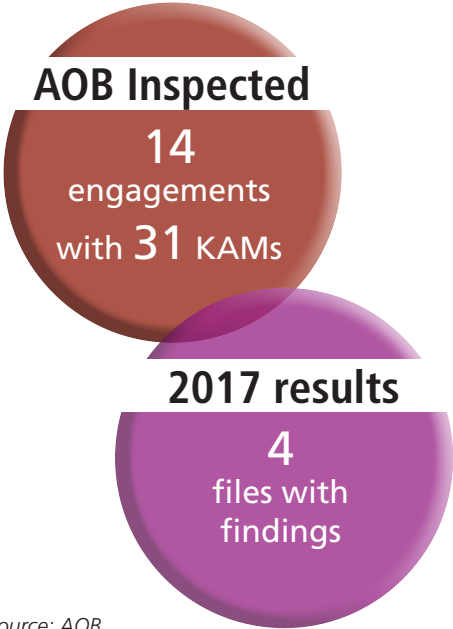
Details of the reviews performed are provided below.

Chart 2
Analysis of types of KAM reviewed in 2017



Source: AOB

Diagram 7
Analysis of Engagement review with KAM inspected in 2017



Source: AOB

Diagram 8
Common findings and best practices to address KAM

Common Findings

- Insufficient audit evidence in the working paper to support KAM communicated in the auditor’s report; and
- Documentation of the rationale to dispose significant areas identified but not disclosed as KAM in the annual report.

Best Practices

- Focused training sessions on KAMs;
- Additional working papers and guidance developed to assist engagement team;
- Early communication from the auditor to those charged with governance; and
- Additional reviews performed by technical function.

Source: AOB

In 2018, the AOB completed a joint study with MIA and the Association of Chartered Certified Accountants (ACCA) exploring the impact of the first generation of the EARs issued in Malaysia¹. The study focuses on auditors' communication with audit committees, as well as the perceptions and behaviours of investors. The annual reports of 190 PLCs in Malaysia with financial year ended 31 December 2016 were reviewed.

Moving Forward

The review on EAR, particularly on KAM, is expected to continue to be an area of interest in the future for Malaysia. This was established in the joint study where 86% of audit committee members surveyed reported that they had gained deeper insight into financial reporting risks of their companies through their reviews on the EARs including KAMs. Nearly two-thirds of audit committee members surveyed found that this also resulted in the directors and management making improvements to disclosure in the financial statements and other elements within the annual report. 67% of investors surveyed felt that they had gained deeper insight into the financial reporting risks of the companies that they have invested in, with over a third responding that KAMs have changed their approach towards analysing investment risks of companies.

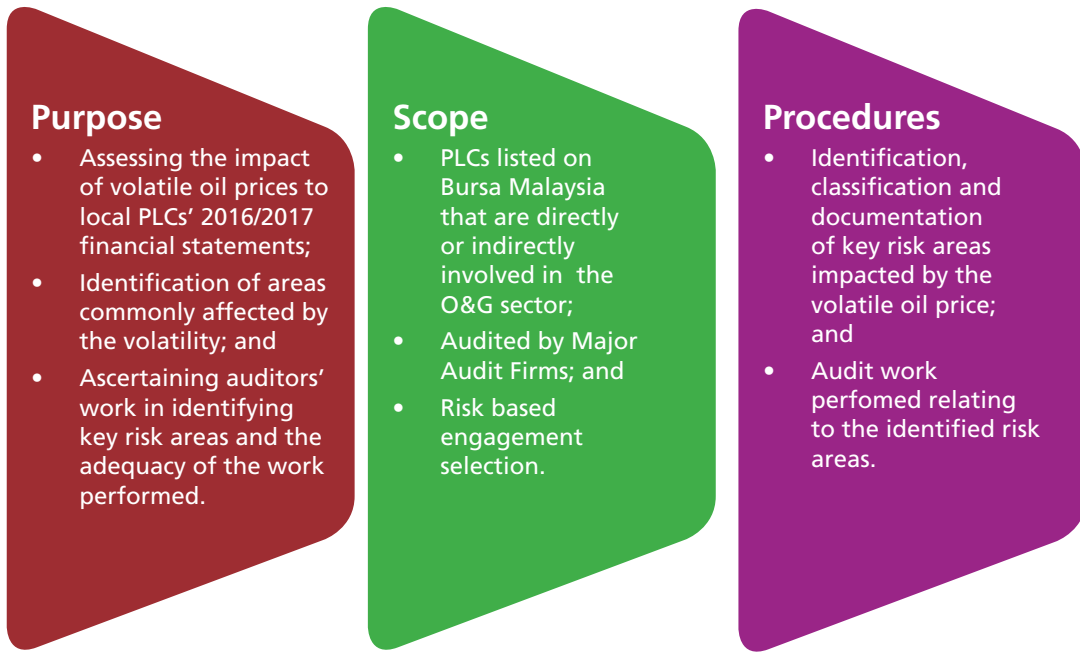
Moving towards the second year of implementation, the AOB would continue to review KAMs in detail to drive the delivery of valuable reports particularly in the area of going concern and critical judgements made. The focus of the review will also be extended to Other Audit Firms.

Oil and Gas Sector – A Thematic Review

The AOB's inspections in 2017 continued to include a focus on certain high risk areas of the financial statements resulting from the volatility of local and global economic conditions. The O&G industry was identified as an area of thematic review in 2016. In view of the industry's high risk areas continuing to be prevalent in the economic climate, this remained as one of the thematic reviews for 2017. The focus of the thematic review was in the following areas:

- (i) The audit of fair value of assets (including impairment assessment);
- (ii) The nature and extent of the use of auditor's experts and specialists; and
- (iii) The approach to the audit of controls.

¹ The *Enhanced Auditors' Report – A review of first-year implementation experience in Malaysia* is publicly available on the SC website.



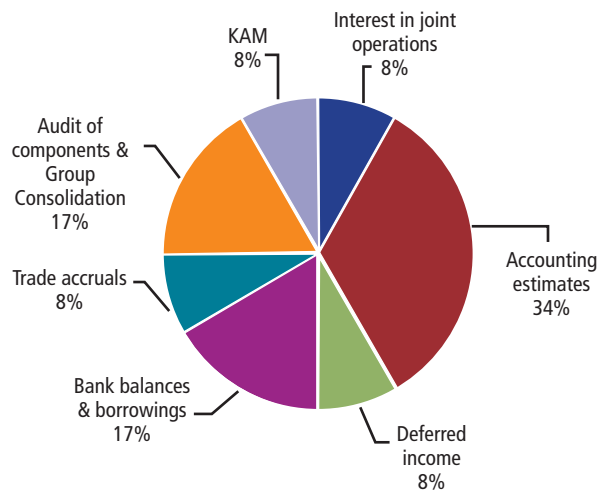
Details of the reviews performed are provided below.

Diagram 9
Analysis of Engagement review under O&G sector for Major Audit Firms in 2016 and 2017



Source: AOB

Chart 3
Analysis of Findings arising from Thematic Review on O&G sector



Source: AOB

Diagram 10

Findings raised in relation to Thematic Reviews on O&G Sector



Common Findings

- Insufficient audit procedures performed to challenge and assess the reasonableness of the assumptions used in cash flow forecast and projections for impairment assessment;
- Insufficient audit procedures performed to evaluate the appropriateness of valuer's work used in management's impairment assessment;
- No audit procedures performed to verify management's representation in order to support the assessments where there was no impairment indicator; and
- No audit procedures performed to verify deferred income balance.

Source: AOB

Based on Diagram 10 above, one of the common findings observed from the AOB'S 2017 and 2016 thematic reviews on the O&G sector was in relation to accounting estimates, including those derived from impairment assessments. This is in line with the expectation where issues on impairment are more prevalent in PIEs which are loss-making or which assets are idle or with low utilisation rate, resulting from economic changes and volatile oil prices.

In relation to findings on impairment assessments, the AOB observed shortcomings in the assessment of the reliability and appropriateness of the underlying assumptions, method and source data applied by the valuer where the valuation report was relied upon to determine the fair value of an asset for purposes of impairment assessments. The AOB also observed instances where the VIU determination of assets includes cash flows arising from potential new projects where relevant contracts have not been secured.

Moving Forward

In today's dynamic economic environment, it is even more important for auditors to be alert to changes in the economy and the market impact to corporate reporting and their audits. In such an environment, firms should ensure a higher level of alertness and professional scepticism when performing audits. This will enable firms to effectively tailor their audit procedures to respond to higher risks of material misstatements of financial statements of entities affected by their economic environment.

In particular, audit procedures need to be planned to respond to the increased risk of material misstatements relating to accounting estimates including fair value measurements, through increased professional scepticism and a focus on robust evaluation of the assumptions used by management.

The AOB would continue to conduct thematic reviews on industries with potential high risk areas affected by the prevailing economic condition in its inspections.

Remediation

Overall progress

Subsequent to an inspection, firms are given up to 12 months to implement remedial action plans that have been approved by the AOB. To date, the AOB has not encountered any instances where a firm has failed to execute the remedial action plan. The AOB recognises the firms' efforts and investments to drive and sustain audit quality throughout the years.

The firms' commitment in the implementation of remedial action plans is also reflected in the overall reduction in the total number of recurring findings observed in 2017 compared with those observed in 2016. Out of eight re-inspected firms in 2017, three firms recorded no recurring findings.

The above observations on recurring findings emphasise the importance of identifying the actual root causes and putting in place a remedial action plan that is more holistic, specific and targeted to address the identified root causes.

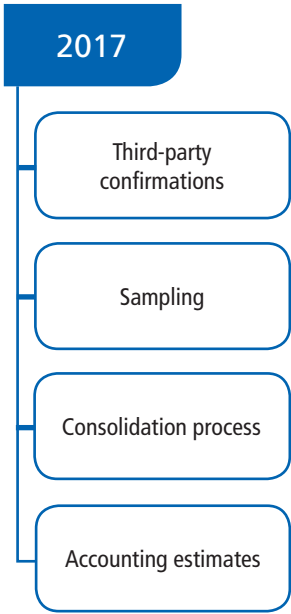
Recurring findings

The recurring findings observed during the year are detailed in Diagram 11.

Recurring findings in relation to sampling and third-party confirmations have been consistently observed by the AOB over the years. Findings in relation to these two areas include lack of investigation of exceptions noted from the external confirmations and inappropriate basis of sample selection that led to an untested population. These are considered to be basic and fundamental areas which should be addressed promptly by firms to avoid continuous recurrence.

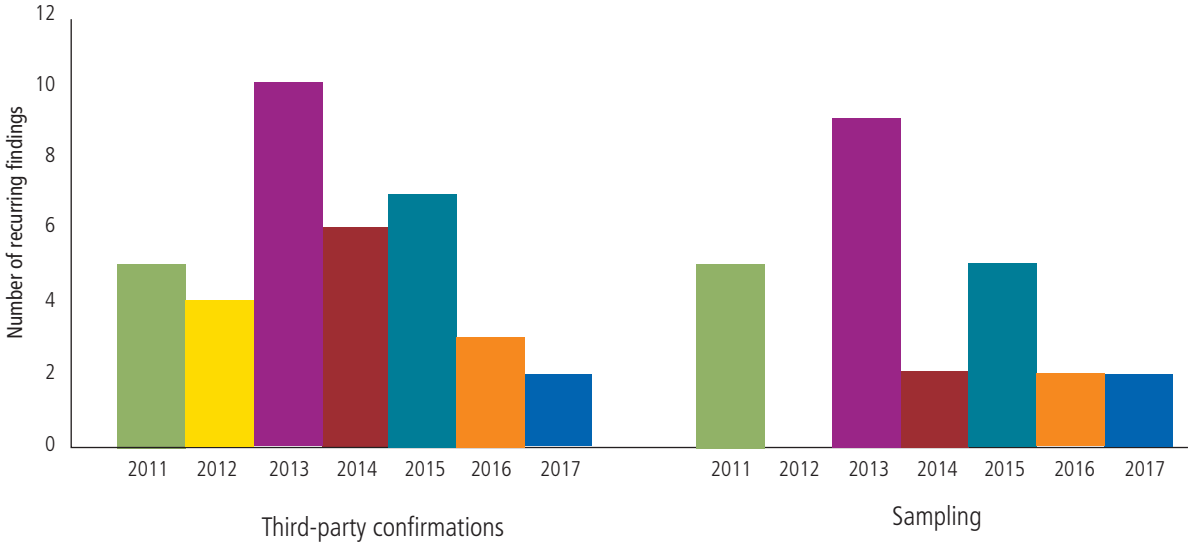
Findings in relation to consolidation process and accounting estimates were highlighted in the earlier case studies of this report.

Diagram 11
Recurring findings observed in 2017



Source: AOB

Chart 4
Top recurring findings by year (2011 to 2017) – Major Audit Firms and Other Audit Firms



Source: AOB

Root cause analysis

A root cause analysis (RCA) is a process where the underlying causes to inspection findings are identified so that targeted actions could be implemented to address them. In 2016, the AOB noted that the Big-Four Audit Firms were at various stages of formalising an RCA framework.

In 2017, the AOB conducted a thematic review to obtain an understanding on the approach undertaken by the Big-Four Audit Firms for the conduct of RCA. Discussions were held with the firms and relevant policies and procedures were reviewed. Key observations of the approach taken by these firms are detailed in Table 1 below.

The AOB encourages all audit firms to implement a structured approach for the conduct of RCA as it is an important step towards continuous audit improvement.

Table 1
Key observations on the RCA process undertaken by the Big-Four Audit Firms

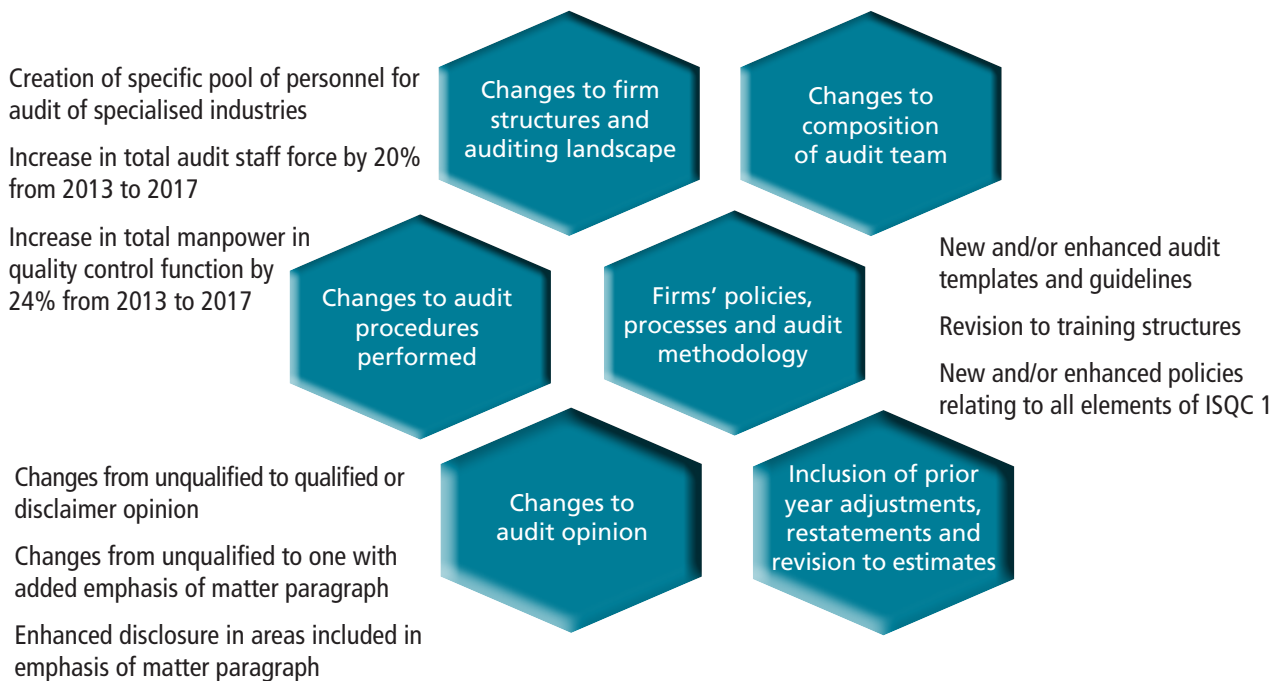
Areas	Key Observations
Scope of RCA	<p>The following are typically scoped in for RCA:</p> <ul style="list-style-type: none"> Monitoring review findings that affects firm-wide quality controls; Poor quality audit engagements arising from internal and external reviews; and Audit engagements that did not have any findings in order to identify best practices.
Timeframe of RCA	<ul style="list-style-type: none"> RCA are generally required to be completed within two months after the finalisation of quality review findings report.
Personnel responsible for the conduct of RCA	<ul style="list-style-type: none"> A team of independent RCA reviewers led by an independent partner.
RCA process and linkage to remediation efforts	<p>The typical steps in the conduct of RCA are as follows:</p> <ul style="list-style-type: none"> Findings or issues that are to be subject to RCA are identified and in-depth understanding obtained by RCA reviewers; Relevant engagement related data (e.g. nature and type of engagement, audit engagement hours) as well as data on engagement team members (e.g. level of experience, training attended and workload) are collected; Separate interviews are conducted with the relevant engagement team members to obtain their input on possible root causes. Where applicable, other personnel such as EQCR may be interviewed; Information obtained are analysed and root causes identified. The respective firms have developed a list of causal factors to serve as a guide as well as to promote consistency in the identification of root causes across member firms; Results of RCA are shared by the RCA team with the firm's leadership; Relevant remedial measures are developed and implemented to address identified root causes to findings or issues; and Effectiveness of remedial actions is monitored. The RCA process is revisited if the implemented remedial actions were subsequently found to be ineffective.

Source: AOB

Impact from the AOB's Regulatory Activities

Throughout the years, the AOB has been assessing the impact of our efforts through these dimensions:

Diagram 1
Impact from the AOB's Regulatory Activities



Source: AOB

The image shows a modern building's interior atrium. The space is characterized by large, curved glass columns that support a curved ceiling. The floor is made of light-colored tiles. The lighting is bright, creating a clean and open atmosphere. The overall design is contemporary and architectural.

PART IV

Recent Initiatives Undertaken by the Big-Four Audit Firms to Enhance Audit Quality

Application of Data Analytics in Financial Statements Audits

Data analytics (DA) refers to the use of IT tools and techniques to analyse and examine large amount of data. In keeping up with global developments, the Big-Four Audit Firms in Malaysia have commenced adoption of DA since 2016.

Imperatives for DA in audits



- DA can promote effectiveness, efficiency and consistency in audit execution:
 - Higher degree of comfort: entire population of data can be examined;
 - Better understanding of client's transactions: DA tools are capable to map out the flow of business transactions from the point of initiation in the system to subsequent general ledger postings; and
 - Risk based audit: visualisation capabilities of DA tools allows trends and anomalies to be identified with greater ease and enable auditors to focus on areas of higher risk.

Progress of implementation



- Progress differs due to readiness of IT infrastructure, availability of skilled resources and readiness for audit team to embrace the change;
- Implementation varies between firms from the second year of implementation to firms that have conducted pilot runs and in the early stage of implementation;
- A majority of the Big-Four Audit Firms have chosen to adopt data analytical tools developed by their network including relevant guidance, training materials and audit work programmes; and
- Champions for DA have been appointed to act as subject experts.

Areas of application in the audits of financial statements



- Common areas of application are testing of journal entries and audit of revenue.

Challenges faced by the auditors



- The process to extract and prepare the data for analysis can be time consuming especially if the data is large and complex. Involvement of IT specialists may be required;
- Quality of data can also impede data analysis if data within the client's systems is incomplete;
- Clients may not be supportive in providing data for analysis due to concerns over data confidentiality; and
- Auditing standards have yet to be updated to take into consideration the application of DA.

While the AOB is supportive of the efforts and investments undertaken by the Big-Four Audit Firms to enhance effectiveness and efficiency of audit through the use of DA, the AOB is cognisant that currently there is no specific auditing standard that addresses the use of DA in the conduct of audits.

In light of the above, firms are advised to consider the following as they embark on applying DA on their engagements:

- ▶ Ensure sufficient involvement of experienced audit personnel including other specialists in order to ensure that DA is appropriately applied and relevant responses to identified risks are properly carried out;
- ▶ Maintain proper documentation on relevant procedures performed to ensure integrity and completeness of client's data used for DA, data analytical procedures performed as well as the results obtained thereafter;
- ▶ While DA would enable audit teams to be more focused on unusual or exceptional transactions, auditors should be mindful not to omit audit procedures on routine transactions. This is to avoid a situation of remaining untested populations that may be material; and
- ▶ As DA often involve a large amount of client data that are analysed outside of the client's premises, it is important for firms to establish a strong data governance framework and practices that address data security, storage and the retention of client data.

Project Management

The Big-Four network firms are cognisant that poor project management of audit engagements can impair audit quality. Consequently, these firms have taken measures to strengthen project management skills of audit engagement team members. The recent key initiatives have been detailed below:

- (i) Reminders issued by the firm's leadership on the timely and sufficient involvement of partners;
- (ii) Mandating monitoring of milestones for audit planning and audit execution where key tasks have been identified and deadlines established for each milestone. This is to encourage upfront audit planning and execution;
- (iii) Tools have also been developed to facilitate monitoring of milestones by audit partner and firms; and
- (v) Training has been carried out to improve project management skills of audit personnel.



Conclusion

CONCLUSION

The AOB notes the firms' ongoing efforts in improving and sustaining audit quality, as reflected in the overall reduction in the number of recurring findings observed in 2017 compared with the previous year. However, the breadth and depth of measures taken still vary from one firm to another. The number of engagements requiring significant improvements for Other Audit Firms is on an increasing trend while there are no significant changes for Major Audit Firms.

The AOB acknowledges that firms of varying sizes face different sets of challenges ranging from the ability to make sufficient investments for the necessary infrastructure to support audit quality to consistency of engagement performance across partners. Regardless of these challenges, a vital element in efforts to improve audit quality is in having the right culture embraced by firms' personnel of all levels from audit partners to junior staff. Updating processes and methodologies alone would not achieve the desired improvements in audit quality if equal prominence is not given to improving the culture on quality and the corresponding behavioural aspects. In this regard, firms' leadership would need to set a strong tone at the top and continuously reinforce the messages on audit quality.

Firms are also constantly reminded to have a robust internal monitoring programme with sufficient depth. An effective RCA needs to be performed to help identify actual root causes to findings observed. As this is an important element in the remediation process, firms are encouraged to have a more structured and formalised RCA framework. Appropriate remedial measures then need to be implemented to address the root causes. Equally important is the need for timely follow-up and assessment on the effectiveness of implemented remedial plans.

Moving forward, the AOB will continue to engage with firms to discuss drivers of audit quality as well as their progress on the initiatives taken to improve audit quality.

ACRONYMS AND ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
AOB	Audit Oversight Board
CA	Carrying amount
CGU	Cash Generating Unit
CMSA	<i>Capital Markets and Services Act 2007</i>
DA	Data analytics
EQCR	Engagement quality control reviewer
IAASB	International Auditing and Assurance Standards Board
IFIAR	International Forum of Independent Audit Regulators
ISA	International Standard on Auditing
ISQC	International Standard on Quality Control
KAM	Key audit matter
MIA	Malaysian Institute of Accountants
NAV	Net asset value
O&G	Oil and Gas
PIE	Public-interest entity
PLC	Public-listed company
RA	Recoverable amount
RCA	Root cause analysis
SC	Securities Commission Malaysia
SCMA	<i>Securities Commission Malaysia Act 1993</i>
VIU	Value-in-use

DEFINITIONS

Auditor	An individual auditor or audit firm who is registered or recognised under section 310 of the SCMA as a registered auditor or recognised auditor of a PIE or schedule fund.
Big-Four Audit Firms	Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.
Major Audit Firms	Audit firms with more than 10 partners and audit more than 50 PIE clients with a total market capitalisation of above RM25 billion.
Other Audit Firms	Audit firms other than Major Audit Firms.
Other Audit Partners	Partners who are not playing the role of engagement partner or EQCR but who will make key decisions or judgements on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.
Project Proposal	Project Proposal for the Revision of IAASB's International Standards Relating to Quality Controls and Group Audits
Public-interest entity	Entity specified in Part 1 of Schedule 1 of the SCMA: <ul style="list-style-type: none">(a) a PLC or a corporation listed on the stock exchange;(b) a bank licensed under the <i>Financial Services Act 2013</i>;(c) an insurer licensed under the <i>Financial Services Act 2013</i>;(d) a takaful operator licensed under the <i>Islamic Financial Services Act 2013</i>;(e) an Islamic bank licensed under the <i>Islamic Financial Services Act 2013</i>;(f) a person prescribed as a prescribed financial institution under section 212 of the <i>Financial Services Act 2013</i> or a person prescribed as a prescribed Islamic financial institution under section 223 of the <i>Islamic Financial Services Act 2013</i>;(g) a developmental financial institution prescribed under the <i>Development Financial Institutions Act 2002</i>;(h) a holder of the Capital Markets Services Licence for the carrying on of the regulated activities of dealing in securities, dealing in derivatives or fund management;(i) an exchange holding company approved under the securities laws;(j) an exchange approved under the securities laws;(k) a central depository approved under the securities laws;(l) a clearing house approved under the securities laws;(m) a self-regulatory organisation recognised under the securities laws;(n) a private retirement scheme administrator approved under the securities laws;

- (o) a trade repository approved under the securities laws;
- (p) the Capital Market Compensation Fund Corporation; and
- (q) any other person as the Minister may prescribe by order published in the *Gazette*.

Schedule fund

Fund specified in Part 2 of Schedule 1 of the SCMA:

- (a) a private retirement scheme approved by the SC under the CMSA;
- (b) a unit trust scheme approved, authorised or recognised by the SC under the CMSA; and
- (c) any other capital market funds as may be specified by the SC.

Top 10 Audit Firms

Top 10 audit firms based on their PLC audit clients' market capitalisation in Malaysia.

This page is intentionally left blank

This page is intentionally left blank

No. 3 Persiaran Bukit Kiara, Bukit Kiara
50490 Kuala Lumpur, Malaysia

Tel: +603 6204 8900 Fax: +603 6201 1888

Websites: www.sc.com.my/audit-oversight-board www.investsmartsc.my