

Audit Oversight Board Annual Inspection Report Findings and Insights



2018

Audit Oversight Board ANNUAL INSPECTION REPORT 2018

Findings and Insights

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INTRODUCTION

The Audit Oversight Board (AOB) was established under Part IIIA of the Securities Commission Malaysia Act 1993 (SCMA). Its mandate is to assist the Securities Commission (SC) in discharging its regulatory function by regulating auditors of public-interest entities (PIEs) and schedule funds to promote confidence in the quality and reliability of the audited financial statements. The AOB also exercises oversight over any person who prepares a report relating to financial information of PIEs and schedule funds, in relation to capital market activities.

This annual inspection report provides insights into the observations arising from the AOB's inspections at both Firm and Engagement levels in 2018, which is in line with its strategic themes relating to strengthening focus on risk-based inspection (Diagram 1).

Diagram 1
The AOB's Strategic Themes 2017-2020



To fulfil its mandate, the AOB conducts regular and special inspections on registered audit firms and individual auditors of PIEs and schedule funds. Inspections involve an assessment of the degree of compliance by auditors with auditing and ethical standards applicable in Malaysia and the quality of the auditor's reports prepared by the auditors relating to the audited financial statements of PIEs and schedule funds.

The AOB adopts a risk-based approach in its inspections and takes into consideration, among others, public-listed companies' (PLCs) market capitalisation and specific areas of concern in its selection of audit engagements to be inspected. In addition, the AOB incorporates annual thematic reviews on certain areas of audits where there are particular market interest or concern.

Part I of this report sets out snapshots of the current audit landscape in Malaysia relating to PIEs and schedule funds. During the year, the AOB continued with its annual Statistics Gathering and Analysis (SGA) exercise using statistical submissions by the Top 10 Audit Firms based on their PLC audit clients' market capitalisation in Malaysia (Top 10 Audit Firms). The Top 10 Audit Firms in Malaysia collectively audited PLCs that constituted 98% of the total market capitalisation of PLCs, and hence can be taken to be a close reflection of the audit firms under the AOB's purview. Acknowledging the challenges faced by the auditing profession in building capacity, the AOB placed greater emphasis on the analysis relating to capacity building efforts of audit firms during the year. Hence, the results from the SGA exercise relating to talent development are also presented in Part I. In addition, Part I presents the results of an analytical exercise performed by the AOB, to link past audit quality-related trends at the engagement level to its inspection results.

Part II and Part III set out the inspection findings and observations arising from Firm and Engagement level reviews respectively. Recognising the continuing volatility of local and global economic conditions, the AOB conducted thematic reviews on audits of PIEs with potential going concern issues. The AOB's thematic reviews in 2018 also included the extent of the audit firms' use of data analytics (DA) in their financial statement audits and extended its scope of inspections to cover the communication of Key Audit Matters (KAMs) by Other Audit Firms as well.

Part IV covers the remediation progress of inspected audit firms to address the AOB's inspection findings.

WHAT THE AOB DOES WITH FINDINGS?

At the conclusion of each inspection, the AOB issues a draft inspection report to provide details on findings observed during the inspection. Audit firms are expected to provide their responses within the specific timeframes prescribed by the AOB. The AOB finalises the inspection reports after taking into account representations made by the audit firms. All findings are expected to be remediated by the audit firms within a timeline agreed with the AOB.

Findings identified in relation to firm reviews generally relate to compliance with the requirements of the International Standard on Quality Control (ISQC) 1. For engagement reviews, findings are either deficiencies that are individually critical which may have an impact on the basis of audit opinion or those that relate to a pervasive issue where the impact cannot be easily quantified. Findings do not necessarily suggest that the affected PIEs' financial statements contain a material accounting error or its internal controls in respect of financial reporting are materially weak.

For engagements where significant improvements are required, actions can be taken on both individual partners involved as well as the audit firms. As part of its normal process, the AOB also assesses whether findings relate to a lack of audit procedures, a potential

material accounting error, or a combination of the two. The result of the AOB's assessment might require the following actions to be taken:

- (i) Imposing specific remediation measures on audit firms to rectify the findings raised.
 - The audit firms are required to incorporate or revise the relevant audit procedures in their audits of the PIEs for the ensuing financial year to evaluate the areas relating to the findings raised. The audit firms are also 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;
- (ii) Following the inspection of audit engagements, the related PIEs are referred to the SC's Corporate Surveillance Department for consideration of further action to be taken on the PIEs, where relevant;
- (iii) Sharing findings with PIEs relating to inspected audit engagements.
 - In 2018, the AOB had for the first time shared inspection findings with the Audit Committee members of a PIE. This was in relation to concerns arising from the AOB's inspection on

WHAT SHOULD PIE DIRECTORS DO WITH FINDINGS?

Given the AOB's targeted and risk-based udit approach to inspection, the AOB's inspection reports should not be taken to provide an assurance that the quality control of the audit 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 are responsible for overseeing the PIEs' financial reporting process. This oversight function can be enhanced through increased engagement with their auditors. In 2018, the AOB issued its inaugural AOB Annual Inspection Report which was distributed to all PLCs. This is to facilitate and enhance the communication and engagement between the Boards of Directors and/or the Audit Committees and their auditors.

The AOB strongly encourages directors and Audit Committee members to understand and discuss the findings and firm-level statistics shared in this report with their auditors to ensure that risk areas specific to their entities are adequately addressed and to gauge the audit firms' commitment and approach to audit quality. Common inspection finding themes from the report should be considered by Audit Committees in conducting their oversight responsibilities.

an audit engagement of the PIE, including relevant matters for the Audit Committee's consideration in their appointment of their auditors; and

(iv) Imposing additional registration conditions on audit firms.

In yet another first step for the AOB, while enforcement proceedings were ongoing, additional registration conditions were imposed on individual auditors and the audit firm to curb the auditors from signing the auditor's reports of its PIE clients. This was due to the severity and pervasiveness of findings on several inspected audit engagements. Such action on registration conditions were imposed with a view to safeguard the interest of the capital market.

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



As at 31 December 2018, there were 49 audit firms and 338 individual auditors registered with the AOB. Foreign incorporated companies listed on Bursa Malaysia were audited by 3 recognised foreign audit firms with 9 recognised foreign individual auditors.

Table 1
Registered and recognised auditors as at 31 December 2018

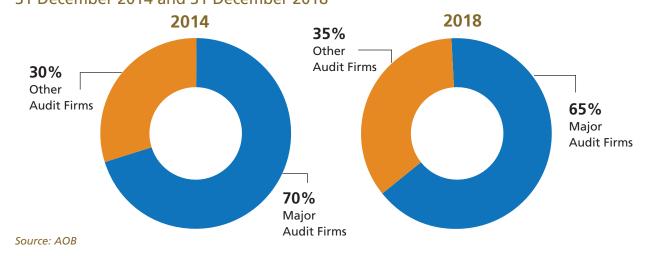
	No. of audit firms	No. of individual auditors	No. of PIEs	% of total PLCs' market capitalisation	No. of schedule funds	% of total NAV
Registered						
Major Audit Firms	6	183	762	93.49	1,004	98.06
Other Audit Firms	43	155	402	6.47	38	1.94
Recognised						
Foreign Audit Firms	3	9	7	0.04	-	-
TOTAL	52	347	1,171	100.00	1,042	100.00

Source: AOB

AUDIT CLIENTS' MOVEMENT

Audits of PIEs and schedule funds remained concentrated with the Major Audit Firms. However, the number of PIEs audited by Major Audit Firms continued to decline. As of 2018, there was a decline of 5% in the number of PIEs audited by Major Audit Firms over the last five years, although the total PLCs' market capitalisation of these Major Audit Firms' clients remained above 93%.

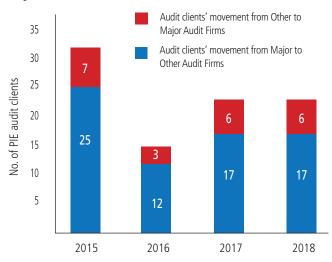
Chart 1
Percentage of PIEs audited by Major Audit Firms and Other Audit Firms as at 31 December 2014 and 31 December 2018



The AOB observed that there was a continuing trend of PIEs that opted for smaller audit firms to serve their needs, moving from the Major Audit Firms to Other Audit Firms as well as from larger to smaller Other Audit Firms.

With the increasing complexity of PIE audits and global nature of the business environment as well as strengthened requirements in auditing and ethical standards, sufficient capacity of the audit firms is of paramount importance in upholding audit quality. Thus, the AOB embarked on an in-depth review of its existing registration criteria in 2018, focusing on registered audit firms' capacity building efforts over the last eight years and their current level of capacity to carry out audits of PIEs and schedule funds.

Chart 2 4-year movement of PIE audit clients



Source: AOB

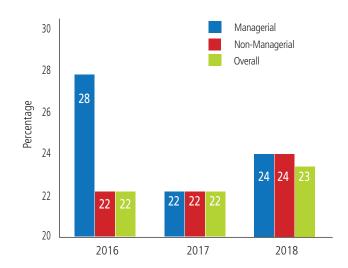
Key findings were shared with the audit profession who discussed and agreed on the best way forward towards improving audit quality in Malaysia. Their views were incorporated into the New Criteria for Registration with the AOB which are detailed in the AOB's *Annual Report 2018*.

CAPACITY BUILDING EFFORTS

Talent retention especially experienced audit personnel, remains the main challenge faced by the audit profession in recent years. Audit firms continue to execute measures and initiatives to retain their audit personnel by offering competitive remuneration, improving staff benefits, developing coaching cultures to encourage closer working relationship between management and staff as well as enhancing resource planning for better management of the staff's workload.

The overall staff turnover rate increased in 2018 as compared to 2017. Given that high staff turnover is commonplace in the audit profession, the AOB is cognisant that such a challenge could compromise the auditors' ability to maintain audit quality.

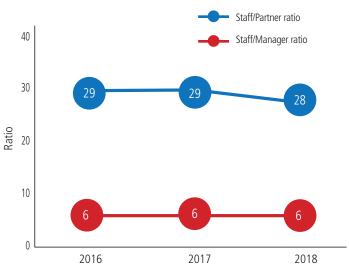
Chart 3 Audit Staff Turnover Rate



Source: AOB Analysis – Top 10 Audit Firms in Malaysia

The AOB notes that the Top 10 Audit Firms continued to manage the increase in attrition rates over the years by intensifying recruitment activities. As illustrated in Chart 4, the Staff to Partner (Managerial) ratios remained fairly constant over the past three years. This is a key mitigating point as it shows that supervision of staff is not compromised despite the attrition challenge faced.



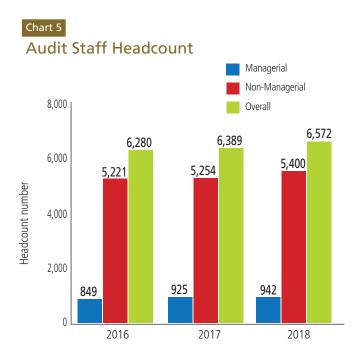


Source: AOB Analysis – Top 10 Audit Firms in Malaysia

Further illustrated in Chart 5 is the increasing trend of the overall staff headcount from 2016 to 2018 in anticipation of future attrition challenges.

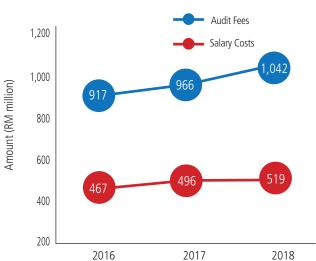
Given the continuous increase in headcount from the recent years, salary costs have also increased as illustrated in Chart 6.

Based on the analysis of growth in audit fees as compared to growth in salary costs in Chart 6, audit fees appeared to increase over the years in tandem with the increase in salary costs.



Source: AOB Analysis - Top 10 Audit Firms in Malaysia

Growth in Audit Fees vs Growth in Salary Costs

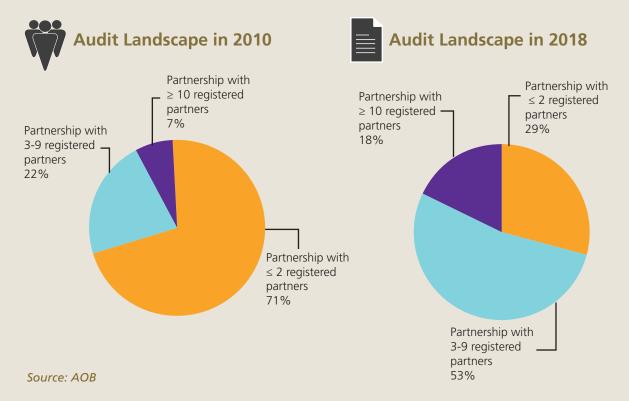


Source: AOB Analysis - Top 10 Audit Firms in Malaysia

GROWING FOR A BETTER FUTURE



Audit Landscape in 2010 vs 2018



When the AOB was first established in 2010, PIE auditors in Malaysia predominantly comprised partnerships with 2 or fewer **registered partners**. The AOB has continuously advocated for audit firms in Malaysia to grow and build their capacity, either via mergers and acquisitions or through organic growth.

By 2018, a significant change in the composition can be seen in terms of the size of audit firms in Malaysia auditing PIEs. The proportion of audit firms with 2 or fewer **registered partners** has reduced from 71% of the audit market in 2010 to only 29% in 2018.

In August 2018, the New Criteria for Registration with the AOB was introduced, whereby one of the criteria for audit firms is to have a minimum of 3 registered audit partners. This is impetus for smaller audit firms to grow their capacity to audit PIEs and schedule funds.

ENGAGEMENT LEVEL TREND ANALYSIS OF AUDIT QUALITY INDICATORS

In 2018, the AOB continued with its engagement level analysis involving audit engagements that were inspected in 2017 and 2018 to identify common trends relating to audit quality. Through this analysis, the AOB aims to provide greater insights into key indicators for audit quality.

PIE workload of the audit partner



- The workload of an audit partner can affect the amount of attention that he or she can spend on each of his or her audit engagement.
- For the inspected engagements with satisfactory inspection results, it was noted that audit engagement partners generally had no more than 4 PIE audit clients with the same financial year-end as the selected audit engagements being inspected.

Experience of EQCR



- For an engagement quality control review (EQCR) to be effective, the assigned EQCR partner must have relevant PIE audit experience.
- For the inspected engagements with satisfactory inspection results, the majority of the audit engagements had assigned experienced EQCR partners. These partners had at least eight years of experience as audit partners.
- For the inspected engagements with unsatisfactory inspection results, some of the EQCR partners had no prior or recent experience being audit engagement partners of PIEs.

Profile of Engagements Selected for Analysis

- Engagements inspected in 2017 and 2018 with no significant findings (i.e. satisfactory results).
- Engagements inspected in 2017 and 2018 referred to the Enforcement Department due to severity of findings.

Training and development



- Training conducted by an audit firm is an important mechanism to develop and maintain continued competence of the audit engagement team.
- For a majority of the inspected audit engagements with satisfactory inspection results, the average training hours attended by the audit staff were above 70 hours per year.

Partners' and managers' collective involvement



- The involvement of audit engagement partners to lead and supervise the performance of audit engagements with the support of audit managers is a key factor that affects audit quality.
- For the inspected engagements with satisfactory inspection results, the collective time spent by the audit engagement partner and the managerial level staff as a percentage of total engagement hours were noted to range from 11% to 37%.

Professional qualification of managerial level staff

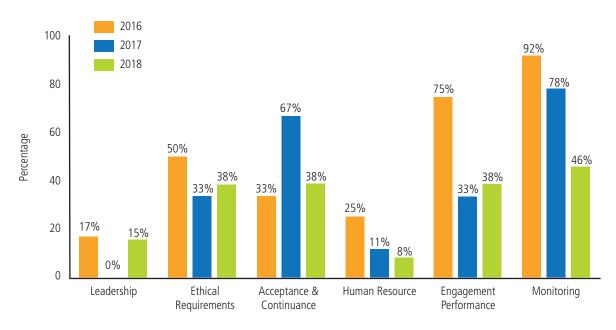


- A professional qualification is an indication that a
 person has acquired the relevant knowledge and skills
 to perform the duties required of the role. In view of the
 important role played by the managers and directors
 in supporting the audit partner in the review and
 supervision of an audit, it is important for them to be
 professionally qualified.
- For the inspected engagements with satisfactory inspection results, all audit managers and directors on the audit engagement team have obtained their professional qualifications.



In 2018, no shortcomings were noted by the AOB for 2 inspected audit firms. This was a positive development from the prior year where the AOB observed at least 1 shortcoming in the systems of quality controls for all inspected audit firms.

Chart 1
Percentage of audit firms inspected during the year with findings from 2016 to 2018



Source: AOB

Chart 1 depicts the percentage of inspected audit firms with findings from 2016 to 2018 where improvements were noted in the ISQC 1 elements of:

- Acceptance and Continuance of Client Relationships and Specific Engagements;
- Human Resource; and
- Monitoring.

In 2018, the AOB observed an increased year-on-year percentage of inspected audit firms with findings in the ISQC 1 elements of:

- Leadership Responsibilities for Quality within the Firm;
- Relevant Ethical Requirements; and
- Engagement Performance.

COMMON FINDINGS FOR MAJOR AND OTHER AUDIT FIRMS

The common findings observed from the AOB's inspections of the Major and Other Audit Firms in 2018 are listed in Table 1 below:

Table 1

Common findings identified by the AOB during the 2018 inspections

Common findings	Key concerns / risks	AOB reminders
Leadership Responsibilities for Quality within the Firm		
Certain audit firms outsourced the function of EQCR partner. These firms had also outsourced the audit work to audit staff from non-AOB registered firms. The following shortcomings were identified by the AOB: • The affected audit firms did not evaluate the competence of the outsourced EQCR partners and audit staff that were contracted to perform audit work for their PIE audit clients; and • Some of the outsourced EQCR partners and audit staff did not attend training on accounting and auditing standards which were relevant for the audit of a PIE within the last one or two years.	Audit quality would be compromised if the audit work were carried out by audit engagement team members who are not sufficiently competent. Further, an audit firm might not be able to exercise effective oversight and governance over outsourced audit partners.	Audit firms should only undertake an audit engagement when they have sufficient internal resources and capabilities to execute a quality audit. Effective from 16 August 2018, the New Criteria for Registration with the AOB requires the functions of the EQCR partner to be carried out by AOB-registered partners of the same audit firm appointed as the auditor of the PIE or schedule fund. For audit firms and individual auditors who are registered with the AOB as at 16 August 2018, they would be given until 1 January 2020 to ensure compliance with the new requirements.
Relevant Ethical Requirements Based on our selection of audit engagements for inspection, it was noted that certain engagement team members did not confirm their independence prior to their involvement in the audit engagements.	The failure to monitor audit engagement team members' independence declarations posed the risk that independence issues, if any, may not be detected and addressed in a timely manner.	Audit engagement partners are ultimately responsible for ensuring that the audit engagement team is independent of the audit client. They must therefore give due attention to ensure that the independence declarations by the audit engagement team members are timely and complete.

Table 1

Common findings identified by the AOB during the 2018 inspections (Continued)

Common findings	Key concerns / risks	AOB reminders
Engagement performance		
Some audit firms have not established control procedures to address alterations made to audit engagement files subsequent to assembly of final audit files.	The lack of controls over the assembled audit engagement files posed the risks that documentation and audit evidence could be altered, added or deleted without the audit firm's knowledge.	Audit firms are required to implement effective controls to safeguard confidentiality, safe custody and integrity of audit engagement documentation. Stern actions will be taken on audit firms found to have serious lapses in this area.
Monitoring		
The operating effectiveness of the system of quality control of certain audit firms was not evaluated due to lack of resources. This is a recurring observation from prior year.	In the absence of a robust monitoring process, weaknesses in a firm's system of quality controls could not be identified and rectified on a timely basis.	Audit firms have a duty to ensure that its monitoring functions are adequately staffed and led by a partner who has the appropriate experience and authority.

AUDITOR INDEPENDENCE

The AOB is cognisant of developments on the international front where there have been public concern whether the provision of non-audit services by audit firms to its audit clients could undermine auditors' independence, especially when the proportion of fees derived from the offering of non-audit services is high. Some of the measures taken by other jurisdictions to address these concerns for PIE audit clients were:

- Imposing restrictions on the range of non-audit services that may be provided by an audit firm;
- Imposing a fee cap on permissible non-audit services that may be provided; and
- Mandating audit firms to seek pre-approval from audit committees to provide certain non-audit services.

In Malaysia, the following were observed:

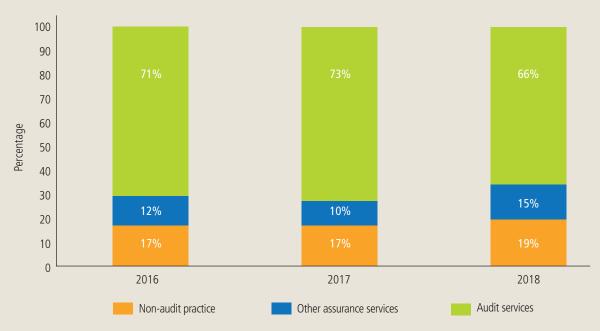
- As at 30 June 2018, the combined fee income of the Major Audit Firms from the audit practice and non-audit practice involving PIE audit clients amounted to RM420.8 million. As depicted in Chart 2, fees from statutory audits amounted to 66% while fees from other assurance services and non-audit services amounted to 34%.
- Chart 2 indicated that the composition of audit fees has decreased from 71% in 2016 to 66% in 2018 while the composition of fee income from other assurance services and non-audit practice have collectively increased by 7% over the last three years.

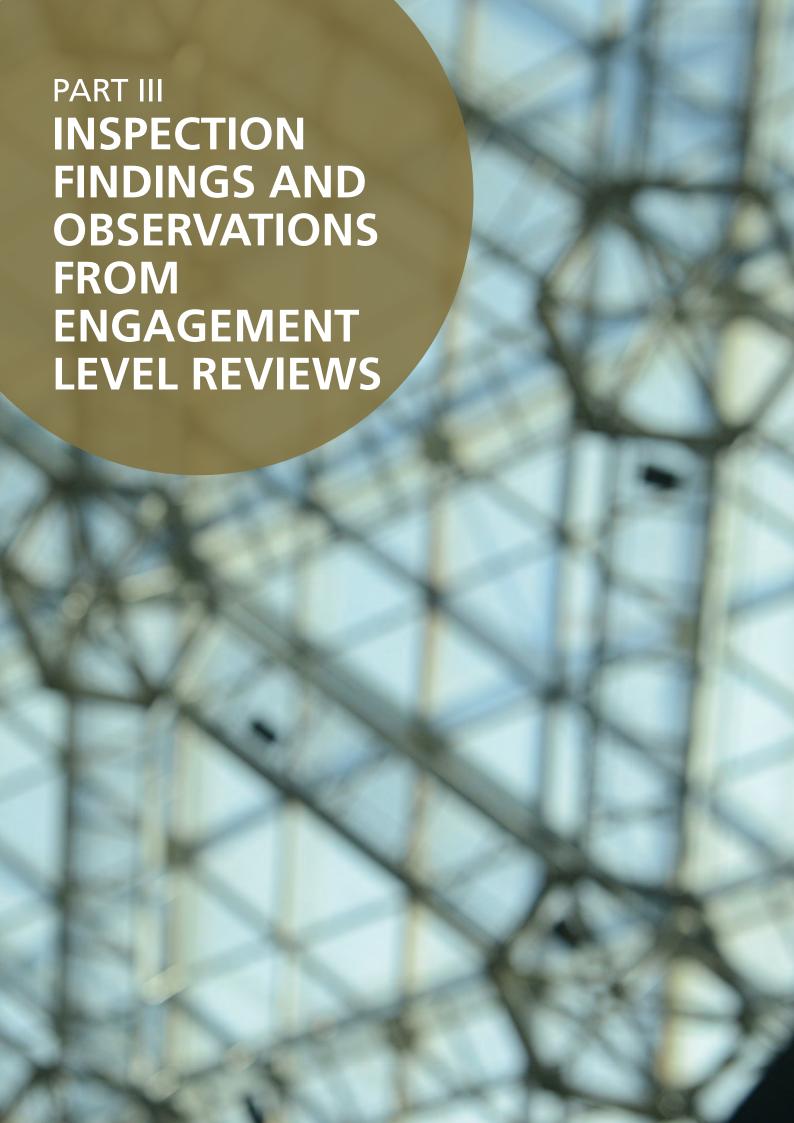
All audit firms in Malaysia are required to comply with the relevant provisions under the *MIA By-Laws* (on *Professional Ethics, Conduct and Practice*) with respect to the provision of non-audit services. As part of the firm level review on AOB-registered audit firms, audit firms' compliance with these provisions is an area of focus. In 2018, the AOB did not encounter exceptions relating to this area of review.

In view of the increasing trend in the composition of fees earned by the non-audit practice of the Major Audit Firms relative to the audit practice over the years, the AOB will closely monitor the development and evaluate whether further actions would be required to ensure that auditors' independence, both in mind and in appearance, are not compromised.

Chart 2

Composition of fee income between statutory audit, other assurance services and services provided by the non-audit practice of the Major Audit Firms





The AOB may inspect a registered auditor either through a regular or special inspection. A regular inspection is conducted with a focus on high-risk areas and generally considers the possible impact that audit firm or individual auditor's quality have on the overall confidence of the market and investors. Regular inspections are carried out based on an inspection plan developed via an annual risk assessment process.

A special inspection is usually driven by specific concerns, either by events or industry issues that may pose a risk to investor protection or raise concerns over the quality and reliability of the audited financial statements.

In 2018, the AOB conducted regular inspections on 6 Major Audit Firms and 7 Other Audit Firms that collectively audited PLCs and schedule funds representing approximately 94% of the total market capitalisation of PLCs, 96.60% of the total NAV of schedule funds and over 65% of the total number of PIEs.

The AOB inspected 16 and 13 audit engagements respectively across these 6 Major Audit Firms and 7 Other Audit Firms. Of the 13 audit engagements inspected under Other Audit Firms, 2 were in relation to special inspections which mainly arose as a result of close co-operation with the SC's Corporate Surveillance department.

Diagram 1

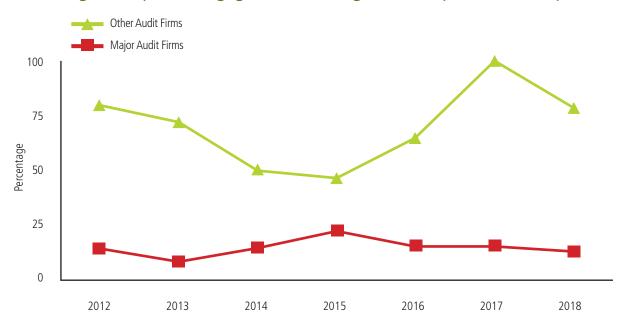
Number of audit firms, individual auditors and engagements inspected by the AOB in 2018



ENGAGEMENTS WITH SIGNIFICANT IMPROVEMENTS REQUIRED

Chart 1

Percentage of inspected engagements with significant improvements required



Source: AOB

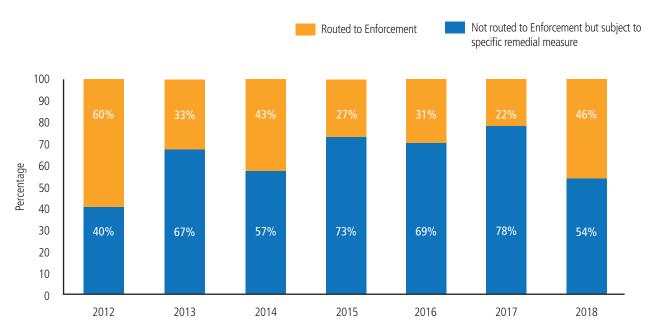
Inspected engagements with significant improvements required were those that were either imposed with specific remediation measures or routed to Enforcement. In Chart 1, the AOB observed a decrease to the percentage of inspected engagements with significant improvements required for Other Audit Firms in 2018.

Although this is an improvement from the increasing trend between 2015 and 2017, the AOB still has concerns over the quality of the smaller Other Audit Firms where more than 75% of engagements inspected require significant levels of improvement.

In relation to Major Audit Firms, the AOB observed that there were no significant changes in the percentage of inspected engagements with significant improvements required. However, the AOB also observed variability of results within each inspected audit firm. In this regard, audit firms are advised to review their approach to audit quality and resources management to ensure consistent execution across each audit firm.

Chart 2

Actions taken on engagements with significant improvements required



Source: AOB

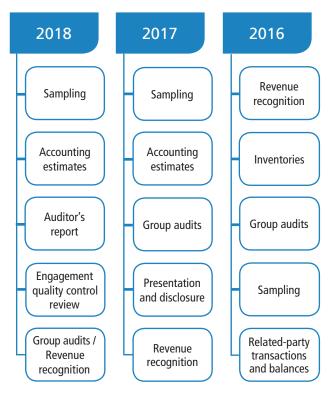
Chart 2 shows a breakdown of inspected engagements with significant improvements required by actions subsequently taken. The AOB observed that there was a reduction in the percentage of inspected engagements being routed to Enforcement from 2015 to 2017 as compared to the preceding 3 years. However, the percentage increased in 2018 where 46% of total inspected engagements with significant improvements required were routed to Enforcement.

These inspection results further revealed that Other Audit Firms with 2 and fewer AOB-registered partners did not have sufficient resources, infrastructure, systems and quality control processes to uphold audit quality. The lack of internal capacity needed to comply with required professional standards was one of the reasons for the AOB to introduce the New Criteria for Registration with the AOB. These new criteria require, among others, for an audit firm registered with the AOB to have a minimum of 3 audit partners in the audit firm for the audits of PIEs and schedule funds and to ensure that all its audit partners registered with the AOB are attached to only 1 audit firm at all times.

COMMON FINDINGS FOR MAJOR AND OTHER AUDIT FIRMS



Top five common findings by audit quality theme



Common findings observed from the AOB's inspections on audit engagements are illustrated in Diagram 2. Sampling remained the top area of findings in 2018. The AOB is concerned that findings continue to be observed in this basic and fundamental area across both Major and Other Audit Firms. For Major Audit Firms that had established sampling methodologies, common findings were related to inconsistent sampling application among the engagement teams. Findings observed for Other Audit Firms mainly arose from firms not having any specific sampling methodology or firms that applied self-developed sampling methodologies that did not meet the International Standards on Auditing (ISAs) requirements.

Source: AOB

Findings on auditor's report and EQCR common findings were observed in 2018.

Further details of the findings observed in the area of EQCR are elaborated on page 25. As for findings observed in relation to Auditor's Report, these relate to the communication of KAMs in the *Enhanced Auditors' Reports* (EARs). In 2015, the International Auditing and Assurance Standards Board (IAASB) issued its new and revised standard on EARs. This standard was adopted in Malaysia and became effective for audits of financial statements with financial periods ending on or after 15 December 2016, with the key change being the communication of KAMs.

Communication of KAMs was determined as one of the thematic areas of focus in 2018. Further details are presented in the Thematic Review section.

Engagement Quality Control Review

Although the AOB is cognisant that the engagement partner is the auditor responsible for the overall audit performance, the EQCR partner plays a key role in reviewing significant judgments and conclusions to formulate the audit opinion.

Under ISA 220 *Quality Control for an Audit of Financial Statements*, an appointment of EQCR is required for 'audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required'.

The EQCR partner should possess sufficient and appropriate experience to objectively evaluate the significant judgments and conclusions in formulating the auditor's report.

In 2018, the AOB inspection results for several engagements revealed material findings that have raised concern on the effectiveness of the EQCR.

The COMMON FINDING identified by the AOB during the 2018 inspection was that no or ineffective reviews performed by the EQCR partner over significant judgment and risk areas of the engagement and how the conclusions were reached.

KEY CONCERN/RISK

- Insufficient challenge process on significant areas and KAMs.
- Absence of a robust review by the EQCR partner affect the oversight and governance over the audit partners in carrying out audited financial statements of PIEs or schedule funds.

Diagram 3

Factors contributing to ineffective EQCR

External EQCR Arrangement	Timeliness	Competencies	Engagements
Inconsistency in performance and lack of accountability due to the following external arrangements: • EQCR partner was outsourced from an external firm • EQCR partner was not a full time partner of the firm	Timeliness of review by EQCR partner and involvement in the planning stage, project management and reporting to those charged with governance (TCWG)	 Insufficient experience Lack of technical competencies Lack of understanding of the role of EQCR partner 	 Inadequate meeting with engagement team due to differing locations Communication was only with team members and not with the engagement partner

Best practices

The AOB observed that appropriate resource allocation between the engagement partner and EQCR partner would yield an effective quality control review during the audit process.

In 2018, stern actions were taken by the AOB on ineffective EQCR partners for the first time which consisted of:

- Publicly reprimanding individual EQCR partners; and
- Prohibition of the EQCR partner in performing the audits of PIEs and schedule funds for a period of up to 12 months.

External EQCR arrangements

Certain audit firms engaged external EQCR partners through the following arrangements:

- Outsourced the function of the EQCR partner; and
- EQCR partner was not a full time partner of the audit firm whereby he was also a partner in a separate firm.

Results since 2011 showed that when the external EQCR partner arrangements were outsourced on audits of PIEs, audit quality was more often than not, severely compromised. This is depicted in Diagram 4.

Diagram 4

Findings of 21 engagements with external EQCR arrangements inspected between 2011 and 2018



Source: AOB

Moving Forward ...

Having considered the external EQCR arrangements as well as other observations arising from the AOB's inspections and ongoing monitoring efforts, one of the New Criteria for Registration with the AOB was that the EQCR assigned for the audits of PIEs and schedule fund clients must be carried out by an AOB-registered partner of the **same audit firm** appointed as the PIE's or schedule fund's auditor.

The new criteria took effect on 16 August 2018 for new registrants while existing AOB registrants were given an extension up to 1 January 2020 to ensure full compliance.

THEMATIC REVIEWS

Key Audit Matters

KAMs in the EARs – the second year in review

Communication of KAMs by Major Audit Firms was determined as one of the thematic areas of focus in 2017. As highlighted in the report dated 25 January 2018 on the *Enhanced Auditors' Report: A Review of First-Year Implementation Experience in Malaysia* by the AOB, the Malaysian Institute of Accountants (MIA) and the Association of Chartered Certified Accountants (ACCA), 'most audit committee members (78%) and investors (73%) agreed that the EAR is an improvement over the old format of the auditors' report' and 'nearly two-thirds (64%) of surveyed audit committee members indicated that based on their experience, the process of considering KAMs and reviewing EAR had resulted in the board and management making improvements to disclosures in the financial statements'.

In view of the reinforced importance of KAMs to the audit committee and investors, the AOB's 2018 Inspection Programme extended its focus to include the review of communication of KAMs by Other Audit Firms in the EAR.

Details of the Engagement reviews performed are provided as follows:

Diagram 5

Analysis of Engagements reviewed in 2018

AOB 2018 Inspection



29 engagements

67 KAM reported 2 engagements with 0 KAM



8 engagements with findings

40%

Insufficient audit evidence documented to support the Auditor's audit procedures performed to address KAMs communicated in the EAR

60%

Inadequate assessment to dispose significant areas communicated to TCWG but not disclosed as KAMs in the EAR

Best Practices

- Focused training sessions on the identification and communication of KAMs
- Development of guidelines and revised working papers to assist the application and assessment by the engagement team
- Earlier and meaningful communication from the Auditor to TCWG
- Reviews performed by technical functions on the drafting of KAMs reported and the disposal of significant areas not disclosed as KAMs by the engagement teams

The AOB observed that audit procedures to address the reported KAMs in the EAR were not performed or documented in the assembled audit working papers. The AOB will not tolerate such instances as it is a clear misrepresentation to the shareholders and taints the integrity of the profession.

Auditors should continue to be vigilant of the specific requirements of ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* where the rationale for the Auditor's determination as to whether or not each of these matters is a KAM should be documented in the assembled audit working papers.

Although 2 of 29 (7%) Engagements reviewed by the AOB had no KAMs communicated in the EAR, the occurrence of such instances was observed to be uncommon globally. Where such conclusions are made, auditors are required to sufficiently evaluate and document the rationale as to why there were no KAMs communicated in the EAR.



Progressing towards the third year of implementation where investors become even more familiar with, and are able to make better use of the EAR, the scrutiny and accountability of the work performed by auditors would magnify. The AOB continues to emphasise the importance of tailoring communication of KAMs and to avoid boilerplate reports, particularly to prevent misrepresentation in the audited financial statements.

Data Analytics

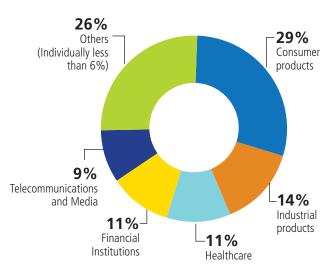
Application in Financial Statements Audits by the Big-Four Audit Firms

In 2018, the AOB compiled information from the Big-Four audit firms on the application of data analytics (DA) in financial statements audits of PIEs. The AOB noted that 3 of the Big-Four audit firms have applied DA in the financial statements audits of 35 PIEs. This number constituted approximately 6% of the total number of PIEs audited by the Big-Four audit firms.

As shown in Chart 3, a majority of the audit engagements where DA were applied involved PIE audit clients operating in the consumer and industrial products industry where the transactions were voluminous.

The AOB also noted that DA were commonly used to audit journal entries, revenue and receivables on audit engagements, as shown in Chart 4.





Source: AOB

Chart 4 Percentage of audit engagements that had applied DA by audit areas

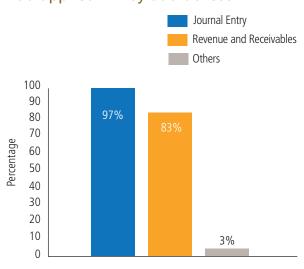


Chart 6

Common pitfalls and best practices in the application of DA



Common pitfalls

- Application of the DA tools did not satisfy the specific requirements of ISA 330 The Auditor's Responses to Assessed Risks, particularly whether substantive procedures were performed for each material class of transactions, account balance, and disclosure
- Exceptional or unusual transactions identified by DA were not sufficiently investigated
- Inconsistent application and understanding of the audit firm's DA tools and methodology, particularly where overlapping methodologies were noted



Best practices

- Involvement of the audit firm's information technology (IT) specialist to verify the integrity and reliability of the PIE's information system. The IT team were also involved in the data extraction from the PIE's information system to ensure completeness and accuracy of system information
- Extensive training sessions on the audit firm's DA resources and relevant application of such tools in the performance of audit
- Dedicated audit firm personnel as 'subject matter experts' on the implementation and use of DA



Moving forward

- As audit firms start to extend the usage of DA, in-depth scrutiny and evaluation over the audit firm's application of DA should be performed to ensure that all requirements of the auditing standards have been met;
- Enhancement to the audit firm's methodology and corresponding training sessions to provide clarity and consistency in the application of DA in the audit of financial statements; and
- Adoption and application of DA should be considered by Other Audit Firms especially where efficient use of technology can help bridge the gap arising from human resource constraints.

Going Concern

In light of the local and global economic volatility, one of the thematic areas of focus in the AOB's 2018 Inspection Programme was in relation to the auditors' assessment on Going Concern of their clients.

Diagram 7

Analysis of Engagements Reviewed under Going Concern Thematic Reviews in 2018



ISA 570 Going Concern requires auditors to consider whether events or conditions exist that may cast significant doubt on an entity's ability to continue as a going concern. Where events or conditions exists, giving rise to material uncertainties related to going concern (MUGC), the auditors would need to ascertain that sufficient disclosures have been made in the financial statements.

As shown in Diagram 7, out of 6 engagements selected for inspection in 2018, 2 had findings on going concern. Common findings noted from these 2 engagement files are:



Common Findings

- Insufficient audit procedures performed to evaluate the appropriateness of management's going concern assumption applied in the preparation of the financial statements as the auditors tend to accept management's representations without obtaining sufficient evidence to support such representations.
- No audit procedures performed to verify the overall cash flows, particularly the reliability of underlying data and reasonableness of assumptions used by management when preparing cash flow and other forecasts, which was used in the evaluation of the going concern assumption.
- No audit procedures performed to verify management's representation that financial support was available to support the going concern assumption.

In addition to the common findings, the AOB observed instances where Going Concern was included as a KAM. However, there was no disclosure on MUGC included in the auditor's report. Based on the AOB's engagements with the relevant auditors, it was noted that sufficient appropriate evidence were obtained from the management to support the going concern assumption, including but not limited to feasible business plans, positive projected cash flows and availability of financial support for the next business cycle. Auditors should avoid any ambiguity by tailoring their disclosures as specific as possible, particularly where a MUGC disclosure was deemed not required.

Although there are no specific requirements that mandates consultations, it is common to see audit firms requiring mandatory consultations in circumstances where there is a possibility of issuing modified opinions. In circumstances where the auditors decided to include Going Concern as a KAM without the inclusion of MUGC disclosures in the auditor's report, the AOB noted that certain auditors initiated consultation with the Firm's risk management team before issuing the audit opinion. The AOB views this as a best practice that should be considered by audit firms when faced with similar situations.

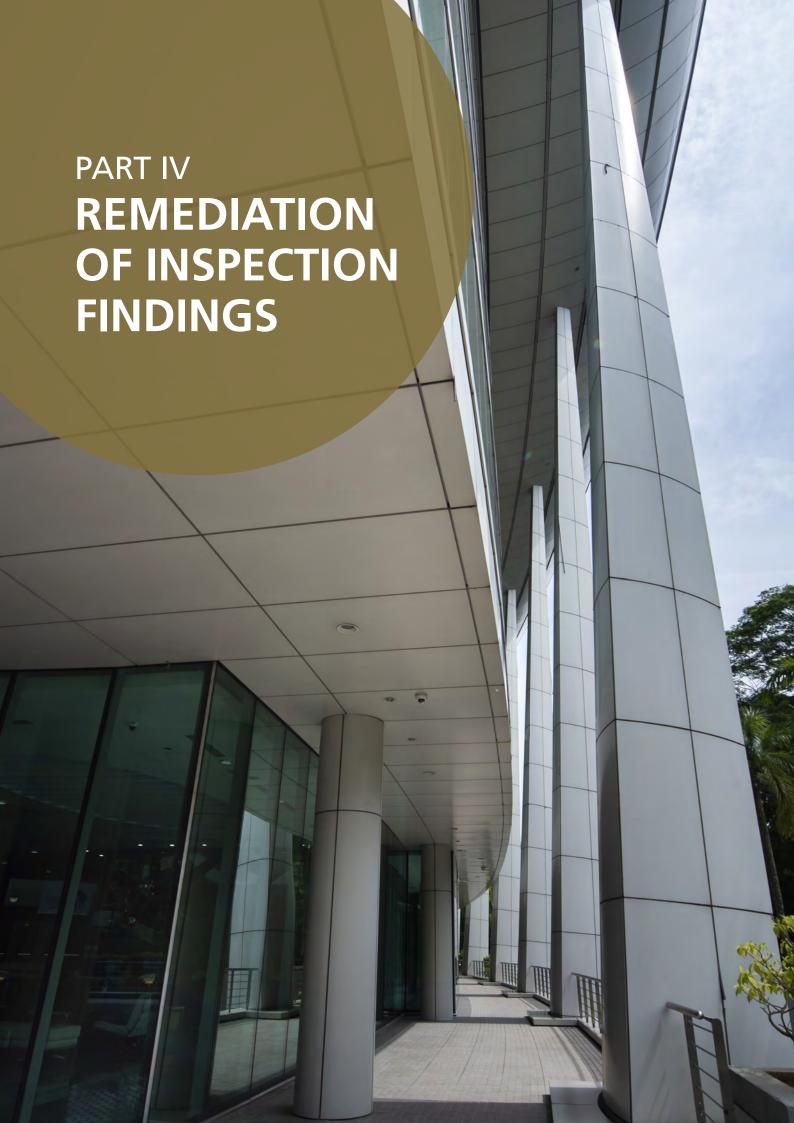
Further, as with other significant audit areas communicated with TCWG, it is also equally important for audit firms to communicate clearly and in a timely manner to TCWG on this area.

Moving Forward ...

In dealing with potential going concern issues, audit firms should take extra caution in ensuring sufficient audit procedures were performed towards finalising the audited financial statements and in issuing the audit opinion. This includes the following:

- Ensuring that sufficient disclosures have been made by management on the appropriateness of the going concern assumptions;
- Consulting with the audit firm's risk management team whenever Going Concern is a risk area regardless of whether it is disclosed as a KAM, MUGC or leads to a modification; and
- Timely communication with TCWG who are ultimately responsible for the financial statements of the entity.





OVERALL PROGRESS

As part of the final stage of an inspection, an audit firm will be issued a Final Inspection Report by the AOB. The inspected audit firm is subsequently required to submit its remediation plan detailing its proposed measures to be taken to address the findings raised in the Final Inspection Report.

The AOB will evaluate the proposed remediation plan as to its appropriateness before providing a written approval to the audit firm to proceed with the implementation of the said plan. The AOB acknowledges that there is no generic prescription to minimise the risks relating to audit quality and that remediation plans would differ from one audit firm to the other in accordance with the structure and size. However, it is vital that the remediation plan is holistic, relevant and sustainable enough to ensure that any shortfall or compromise of audit quality are appropriately and promptly rectified to ensure high quality and reliable audited financial statements of PIEs and schedule funds. Should the AOB disagrees with an audit firm's proposed remedial plan or any elements of the plan, the AOB would engage further with the audit firm which then will be required to submit revisions to the relevant areas or even to the extent of submitting a new and completely revised plan.

In cases where severe findings are identified, the AOB may specify measures to be taken and imposed on the audit firm and/or individual partners.

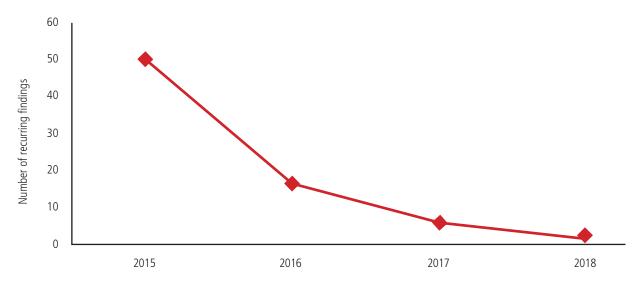
The remediation plan framework usually includes the identification of root causes and performance measures for remediation which focus on the outcome and effectiveness of the remediation plan. One of the key ways to measure the effectiveness of the remediation action is via the number of **recurring findings** raised in subsequent inspections. In this regard, it is encouraging to observe that the number of recurring findings for reinspected audit firms has been on a downward trend in the past four years. A positive development is also noted in the number of recurring findings where only 2 reinspected audit firms recorded a recurring finding each, out of 8 reinspected audit firms in 2018.

The marked progress made in relation to the reduction in the number of recurring findings indicated the effectiveness of remediation actions taken by audit firms to address the findings raised and the corresponding root causes. This could also be attributed to the Major Audit Firms' commitment in having a more structured and formalised Root Cause Analysis framework, ensuring in-depth and independent analysis and identification of the actual reasons behind the occurrence of a finding.

Notwithstanding the improvement as highlighted above, audit firms are reminded not to trivialise a recurring finding as merely a one-off and isolated incident attributable to a particular situation or individual.

Audit firms should assess and consider whether the finding is actually a symptom of a wider issue that needs to be addressed promptly and effectively.

Chart 1
Recurring findings by year (2015 – 2018)



Source: AOB

RECURRING FINDINGS

Out of the AOB's reinspection of 8 audit firms in 2018, it was observed that only 1 recurring finding each in 2 of the audit firms. These recurring findings were in relation to sampling and recoverability of trade receivables.

Recurring findings on sampling were consistently observed by the AOB over the years, particularly in relation to untested population arising from inappropriate basis of sample selection. Coupled with the fact that sampling is one of the top common findings observed in the past three years, there should be further enhancement to the audit firms' current remediation actions to appropriately identify the underlying root causes for these types of findings to avoid continuous recurrence.

Diagram 1

Number of Firms with recurring findings out of total reinspected Firms



6 Firms without recurring findings



2 Firms with recurring findings

ROOT CAUSE ANALYSIS PERFORMED BY THE MAJOR AUDIT FIRMS

In order to gain a better understanding of the underlying causes to audit findings, the Major Audit Firms performed root cause analysis on signficant findings arising from the firm's internal quality reviews and the AOB inspection.

Findings were commonly attributed by the Major Audit Firms to the following root causes:



Inadequate Supervision and Review

 Supervision and review by the audit partners and the managerial level staff were not sufficiently robust and in some instances, were untimely



Knowledge Gap

Certain audit engagement team members lacked industry or technical knowledge



Inadequate Resource Allocation

- Insufficient audit staff being allocated to the audit engagement
- Mismatch between skills and experience of the audit engagement team members with the requirements of the audit engagement



Lack of Documentation Discipline

 Lack of rigor in the documentation of the audit procedures performed and the results thereafter. In the absence of proper documentation, it was difficult for the audit engagement team to provide evidence that relevant audit procedures have been carried out during the audit



Time Pressure

- Some audit clients did not provide their deliverables on time
- Tight reporting deadlines imposed by the audit clients. This situation was worsened when there were issues with the quality of deliverables from their audit clients

The AOB encourages all audit firms to continue to assess the underlying cause to inspection findings as part of their efforts to reduce recurring findings and enhance audit quality. Audit firms should ensure that the root cause analyses are carried out with sufficient depth to ensure measures taken for quality improvements are effective and sustainable.



CONCLUSION

Results of the AOB's inspections in 2018 revealed that while there was a decrease in the percentage of inspected engagements with significant improvements required for Other Audit Firms, there was still a wide gap in the overall performance of Other Audit Firms as compared to Major Audit Firms. Further, the severity of findings noted from the first time inspections of several Other Audit Firms has necessitated the AOB to take stern actions against the audit firms and partners involved, including the imposition of certain additional registration conditions on an inspected audit firm and its individual auditors, pending the conclusion of enforcement proceedings. This severe action was taken for the first time by the AOB due to the severity of the inspection findings and to mitigate potential risks of future failure and potential impact to the capital market.

Also for the first time, actions were taken against EQCR partners involved in inspected engagements with severe findings. It is acknowledged that an engagement partner is ultimately responsible for the quality of an audit. However, individuals acting as the EQCR partner should also be fully aware of their roles in relation to significant matters and significant judgment areas in the financial statements.

The AOB noted that the less than desirable performance of some of the Other Audit Firms stemmed from design and implementation gaps within the audit firms' system of quality controls. The AOB also observed that inspected engagements with unsatisfactory inspection results tend to have issues with competence of the engagement partners, experience of the EQCR partner and training of engagement team members.

The AOB continues to remind the fundamental need of having the right infrastructure, training and technical competence to support audit quality.

On the other hand, it is encouraging to note that there has been a decreasing trend in recurring findings for reinspected audit firms. This demonstrates the reinspected audit firms' positive commitment towards improving and sustaining audit quality, including designing and implementing effective remediation plans and having a more robust root cause analysis. Notwithstanding this improvement, the AOB is concerned that it continues to observe engagement findings in certain basic and fundamental areas. Sampling in particular has been one of the top five findings observed from 2016 to 2018 and is one of the two recurring findings identified during the year. It is observed that findings on this area were identified even when established sampling methodologies were in place, indicating that the issue also lies with consistency of implementation. Audit firms should ensure that audit team members are provided with relevant and consistent training to avoid recurrence of these findings.

Moving Forward ...

In view of several new accounting standards becoming effective from 2019 onwards, the AOB will focus on the audit firms' continuous technical knowledge update in these areas and the effective application in audit execution. The AOB will also look into the audit firms' preparation towards the anticipated revised ISQC 1 requirements. Continuous engagement with audit firms and other stakeholders will be carried out to further promote efforts in enhancing audit quality.

ACRONYMS AND ABBREVIATIONS

ACCA Association of Chartered Certified Accountants

AOB Audit Oversight Board

CMSA Capital Markets and Services Act 2007

DA Data analytics

EAR Enhanced Auditors' Report

EQCR Engagement quality control review
ISA International Standards on Auditing
ISQC International Standards on Quality Control

KAM Key Audit Matter

MIA Malaysian Institute of Accountants

MUGC Material uncertainty related to going concern

NAV Net asset value
PIE Public-interest entity
PLC Public-listed company

SC Securities Commission Malaysia

SCMA Securities Commission Malaysia Act 1993

SGA Statistics Gathering and Analysis TCWG Those charged with governance

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 judgments on significant matters with respect to the

audit of the financial statements on which the firm will express an opinion.

Public-interest entity Entity specified in Part 1 of Schedule 1 of the SCMA:

(a) a PLC or a corporation listed on the stock exchange;

- (b) a bank licensed under the Financial Services Act 2013;
- (c) an insurer licensed under the *Financial Services Act 2013*;
- (d) a takaful operator licensed under the Islamic Financial Services Act 2013;
- (e) an Islamic bank licensed under the Islamic Financial Services Act 2013;
- (f) a person prescribed as a prescribed financial institution under section 212 of the *Financial Services Act 2013* or a person prescribed as a prescribed Islamic financial institution under section 223 of the *Islamic Financial Services Act 2013*;
- (g) a developmental financial institution prescribed under the *Development Financial Institutions Act 2002*;
- (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;
- 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*.

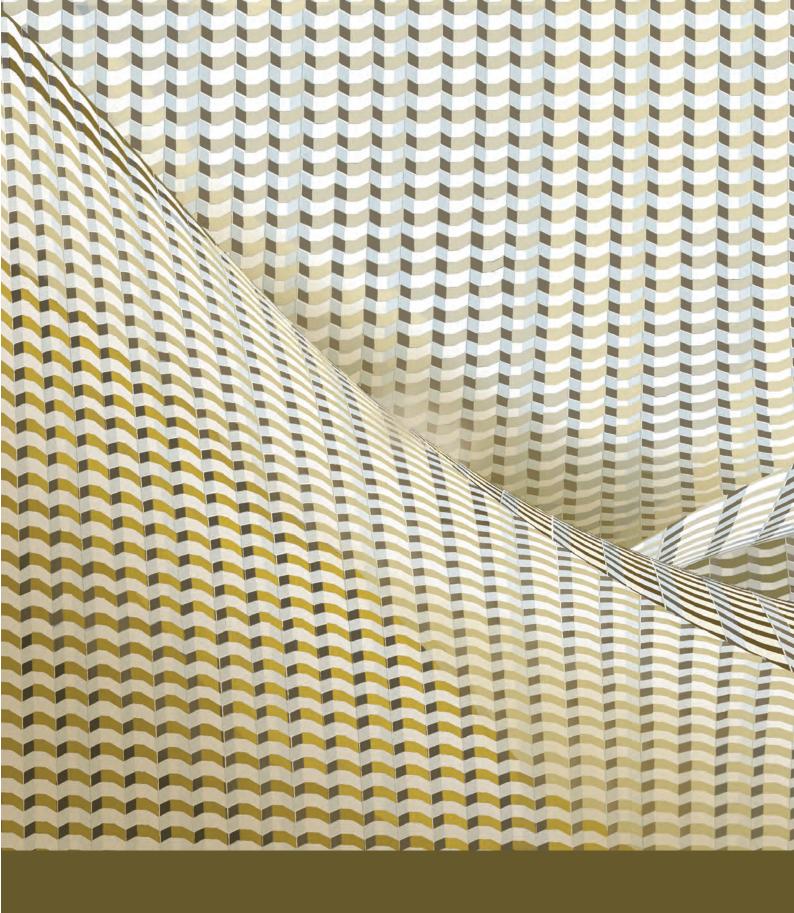
Schedule fund

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.



ANNUAL INSPECTION REPORT 2018

Audit Oversight Board

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