Suruhanjaya Sekuriti
Securities Commission
Malaysia

Audit Oversight Board
Annual Inspection Report
2019

Audit Oversight Board

ANNUAL INSPECTION REPORT 2019

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

Telephone
+603 6204 8900

Websites
http://www.sc.com.my/aob   www.investsmartsc.my

Fax
+603 6201 1888

The cut-off date for the data included in this report is 31 December 2019

CONTENTS

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 Malaysia (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 the 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 2019, as well as several recent developments and key messages.

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.

As part of the AOB's strategic theme to strengthen the focus on risk-based inspection, the AOB takes into consideration, amongst others, its risk assessment of audit firms, public-listed companies' (PLCs) market capitalisation and specific areas of concern in its selection of audit engagements to be inspected. The AOB also assesses industry sectors and any prevailing market concerns that should be given priority in its inspection programme. Additional focus is applied to assess more recent significant accounting or auditing developments via the AOB's annual thematic reviews.

Part 1 of this report presents highlights of the current audit landscape in Malaysia relating to the audits of PIEs and schedule funds. In 2019, the AOB continued its annual data gathering exercise from the Top 8 Audit Firms in Malaysia to develop more objective insights into the respective firms' commitment towards audit quality. Observations on the common trends of firm and engagement levels audit quality indicators of these firms are included in Part 1 of this report. The Top 8 Audit Firms collectively audited PLCs that constituted 71.4% of the total number of PLCs in Malaysia and 96.9% of the total market capitalisation of PLCs, and hence can be taken to be a close approximation of the audit firms under the AOB's purview. Further, Part 1 features the AOB's newly introduced requirements for Annual Transparency Reporting applicable to audit firms as well as the results of thematic reviews on the appointment of Engagement Quality Control Reviewer (EQCR) by audit firms.

Parts 2 and 3 set out an analysis of the AOB's inspection results at firm and engagement levels. Its approach to the inspection and assessment of quality of audits are also presented to assist the understanding and interpretation of these findings. The inspection results and case studies in Part 3 also include those arising from thematic reviews conducted in relation to the implementation of new accounting standards, namely MFRS 9 *Financial Instruments* and MFRS 15 *Revenue from Contracts with Customers.*

Part 4 covers the remediation progress of inspected audit firms to address the AOB's inspection findings including analysis of recurring findings. The report concludes with a summary on the trends of inspection results as well as the areas that auditors need to focus on in the year ahead and measures taken by the SC/AOB in view of the COVID-19 pandemic.

WHAT DOES THE AOB DO WITH FINDINGS?

The AOB's process upon the conclusion of each inspection is depicted below:

DIAGRAM 1

The AOB's process after completion of inspection

01 Conclusion of inspection

02 The AOB issues Draft Inspection Report to audit firm on details of findings

03 Written responses by the audit firm within timeframes prescribed by the AOB

04 Analysis of audit firm's response and presentation of findings to the AOB Board

05 The AOB Board's approval and decision

06 Issuance of Final Inspection Report to audit firm

07 Remediation by audit firm within timeline agreed with the AOB

Source: AOB

DIAGRAM 2

Definition of an engagement finding

WHAT IS A FINDING?

Firm reviews

Relates to compliance with the requirements of the *International Standard on Quality Control 1* (ISQC 1).

Engagement reviews

- Relates to compliance with *International Standards on Auditing* (ISA).
- Individually critical deficiency which may have an impact on the basis of audit opinion.
- Pervasive issue where the impact cannot be easily quantified.

Findings do not necessarily suggest that the affected PIE's financial statements contain a material accounting error or its controls in respect of financial reporting are weak.

Source: AOB

For engagements where significant improvements are required, actions can be taken on both audit firms and individual partners involved. As part of its 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 (Diagram 3).

DIAGRAM 3

Actions that could be taken by the AOB

1 IMPOSITION OF SPECIFIC REMEDIATION MEASURES

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. Audit firms are also required to evaluate the impact of these audit procedures to the audited financial statements for the financial year inspected.

2 REFERRALS

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.

3 SHARING OF FINDINGS WITH PIEs

As provided under Section 31ZD(3) of the SCMA, the AOB may share findings with PIEs relating to inspected audit engagements. The AOB has exercised this power on several occasions. Depending on the severity of the concerns arising from the AOB's inspections, the AOB will not hesitate to continue doing so when the need arises.

4 ENFORCEMENT

In instances where there are breaches of laws and regulations, the AOB will take enforcement action against audit firms and individual auditors, which can range from issuing public reprimands to revoking the registration of audit firms and its individual auditors with the AOB.

5 IMPOSITION OF ADDITIONAL REGISTRATION CONDITIONS

Depending on the severity and pervasiveness of the findings while enforcement proceedings are ongoing, additional registration conditions could be imposed on audit firms and individual auditors as interim measures to safeguard audit quality and to protect public interest.

Source: AOB

WHAT SHOULD PIE DIRECTORS DO WITH FINDINGS?

In view of the AOB's targeted and risk-based approach to inspection, the AOB's inspection reports should not be taken as 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 Audit Committees are ultimately responsible for overseeing the PIEs' financial reporting process. Audit Committees in particular have an essential role to promote improvements in audit quality given their oversight of the audit process.

As highlighted in the *International Organization of Securities Commissions (IOSCO) Report on Good Practices for Audit Committees in Supporting Audit Quality* published in January 2019, Audit Committees can promote and support audit quality by following various good practices in relation to assessing audit quality. Audit Committees should consider findings from regulatory audit inspections and surveillances. This includes thematic findings from a regulator's inspections or surveillances that are common across many audit engagements.

In 2019, the AOB continued to distribute the *AOB Annual Inspection Report* to all PLCs. Two separate sessions of the 'Conversation with Audit Committees' were also held to present the common findings arising from the AOB's inspection programme. The information shared in these sessions **provided Audit Committees with sufficient information 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 their Audit Committees to understand and discuss the findings and firm-level statistics shared in the report with their respective auditors. This is to ensure that the risk areas specific to their entities are adequately addressed and enables them to gauge the audit firms' commitment and approach to audit quality. Common inspection finding themes from the report should be considered by the Audit Committees in conducting their oversight responsibilities.

PART 1

INSIGHTS INTO THE AUDIT PROFESSION

REGISTRATION AND RECOGNITION STATISTICS

While the Major Audit Firms have a larger share of the market for the audits of PIE as depicted in Table 1, there are still opportunities for growth for the Other Audit Firms as shown in Chart 1. This is a positive indication that the level of competition among audit firms remains healthy in serving Malaysian PIEs of various sizes.

TABLE 1

Registered and recognised auditors as at 31 December 2019

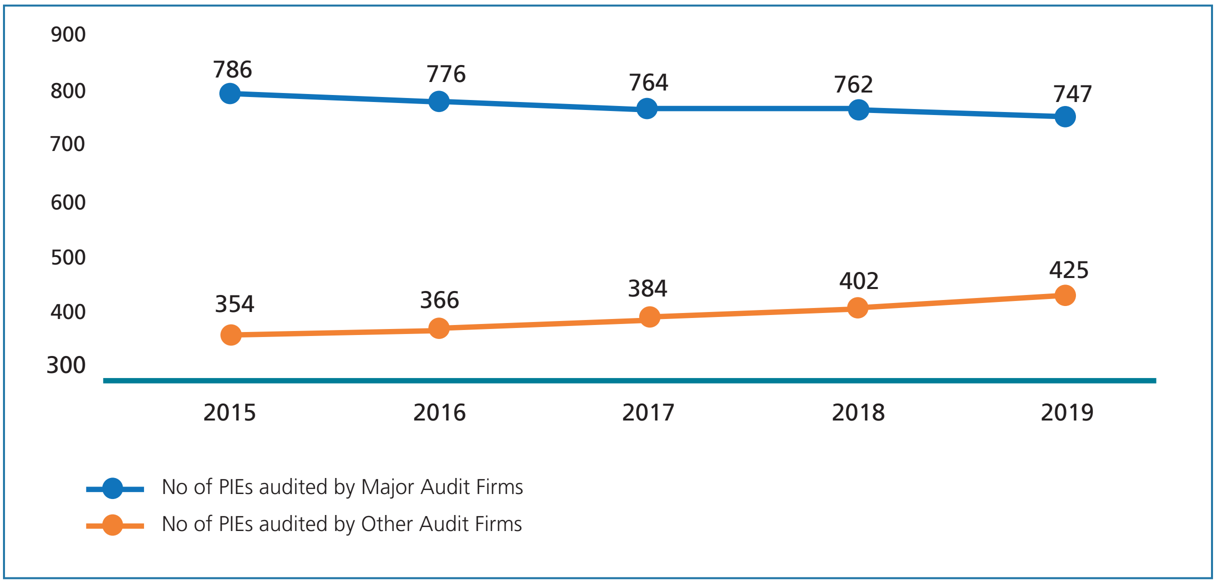
	No. of audit firms	No. of individual auditors	% of total no. of PIEs	% of total PLC's market capitalisation	No. of schedule funds	% of total NAV
Registered						
Major Audit Firms	6	182	63.4	94.5	1,063	98.2
Other Audit Firms	33	143	36.0	5.4	37	1.8
Recognised						
Foreign Audit Firms*	4	12	0.6	0.1	-	-
TOTAL	**43**	**337**	**100.0**	**100.0**	**1,100**	**100.0**

Source: AOB

* *As at 31 December 2019, 4 foreign audit firms and 12 foreign individual auditors who audit foreign incorporated companies listed on Bursa Malaysia were recognised by the AOB.*

CHART 1

Number of PIEs audited by Major and Other Audit Firms



Source: AOB

NEW CRITERIA FOR REGISTRATION WITH THE AOB

To encourage audit firms to increase capacity at the partner level and to strengthen governance over their audit partners, the new criteria for registration with the AOB are as follows:

The audit firm must have a minimum of three audit partners in the audit firm to be registered with the AOB for the audits of PIEs and schedule funds

The engagement quality control reviews of PIE and schedule fund audits must be carried out by an AOB-registered partner of the same audit firm appointed as the auditor of the PIE or schedule fund

The continuing registration of an audit firm with the AOB is subject to the said audit firm having at least one PIE or schedule fund audit client within the last 24 months. If an audit firm registered with the AOB has not been involved in the audit of a PIE or schedule fund for a consecutive period of 24 months, the audit firm shall withdraw its registration immediately

A person who applies for registration with the AOB must be an audit partner attached only to one audit firm, unless the criteria below are met:

- All the audit firms where the auditor is a partner are member firms of the same network, which are governed by a common partnership agreement and common policies and procedures addressing, at a minimum, audit methodology, risk management and quality control;
- All the related audit firms are registered with the AOB; and
- All AOB registered partners are common to each of the related audit firms.

All audit firms are reminded to ensure continued compliance with the new criteria for registration with the AOB.

INTRODUCTION OF ANNUAL TRANSPARENCY REPORTING FOR AUDIT FIRMS

To promote greater transparency and stronger accountability for audit quality among audit firms, the AOB introduced the requirements for the issuance of Annual Transparency Report by certain audit firms registered with the AOB on 14 August 2019.

It is envisioned that the information shared via the Annual Transparency Report would enable stakeholders to make better comparison between audit firms based on audit quality considerations rather than to focus merely on fees.

Audit Committees who are responsible for the appointment of the company's auditors are strongly encouraged to engage in discussions with the audit firms on the information disclosed in the Annual Transparency Reports when deciding on the selection and reappointment of auditors.

Audit firms registered with the AOB that meet the following criteria at the end of the calendar year for two consecutive years are required to issue an Annual Transparency Report based on the audit firm's fiscal year end:

- Audit firms with more than 50 PIE audit clients; and
- The total market capitalisation of the audit firm's PIE clients is above RM10 billion.

For the other AOB-registered audit firms that do not meet the above criteria, they are encouraged to issue an Annual Transparency Report.

The information required to be disclosed in the Annual Transparency Report encompasses the following:

- The audit firm's legal and governance structure;
- Measures taken by the firm to uphold audit quality and manage risks; and
- Information on the firm's measurement of indicators for audit quality.

The AOB is mindful that although the introduction of Annual Transparency Reporting is key to further improve the financial reporting ecosystem in Malaysia, the world is facing unprecedented circumstances due to the COVID-19 pandemic in 2020. The respective audit firms' immediate focus should be to maintain high standards of audit quality particularly in view of the various challenges that auditors face as a result of the pandemic.

Thus, the AOB decided to defer the implementation of the Annual Transparency Reporting for firms that meet the aforementioned stipulated criteria from 2020 to 2021.

In 2021, the Annual Transparency Report will be shared by the respective audit firms with the Audit Committees of their PIE audit clients. For the following years, the Annual Transparency Report would be made public on the respective firms' websites.

Notwithstanding the deferment, firms are encouraged to adopt Annual Transparency Reporting early.

DIAGRAM 1

Implementation timeline of Annual Transparency Reporting

April 2019	August 2019	January to December 2021	January 2022 onwards
▶ Engaged selected firms for feedback on Annual Transparency Reporting for audit firms in Malaysia.	▶ Framework for Annual Transparency Reporting was introduced during the AOB's Conversation with the Top 8 Audit Firms in Malaysia. ▶ Officially announced to all AOB-registered audit firms on the reporting requirements for Annual Transparency Report. ▶ Inaugural Annual Transparency Report targeted to be issued in 2020.	▶ Due to COVID-19 pandemic in 2020, the 'Soft Launch' of the Annual Transparency Report has been deferred to the year 2021. ▶ The Annual Transparency Report would be shared by the respective audit firms with the Audit Committees of their PIE audit clients.	▶ For the second year of reporting onwards, the Annual Transparency Report would be made public on the respective firms' websites.

Source: AOB

AUDIT QUALITY INDICATORS

Since 2015, the AOB has embarked on an annual data gathering exercise involving the larger audit firms in Malaysia to gain deeper insights into the respective firms' commitment towards audit quality. As part of this exercise, the current trends relating to indicators that could contribute to the overall audit quality have been analysed by the AOB. In addition, the AOB also collects data at the engagement level to facilitate deeper analysis on causal factors that can lead to better audit quality.

It is important to note that the audit quality indicators shared in this report are not an exhaustive list and are not intended to set performance benchmarks. The indicators should not be read in isolation as levels of audit quality can be impacted by a combination of quantitative and qualitative factors. The sharing of audit quality indicators in this report intends to encourage meaningful discussions among stakeholders on audit quality matters and to drive continued focus and improvements among audit firms.

Stakeholders are strongly encouraged to consider the results of the AOB's analysis when evaluating the audit quality indicators that would be disclosed by audit firms in their upcoming Annual Transparency Reports. The information shared in this section would enable stakeholders to compare the current state of the respective audit firms *vis-à-vis* industry average.

The trends observed by the AOB from the analysis at firm level for the Top 8 Audit Firms in Malaysia have been outlined below:

FIRM LEVEL TREND ANALYSIS

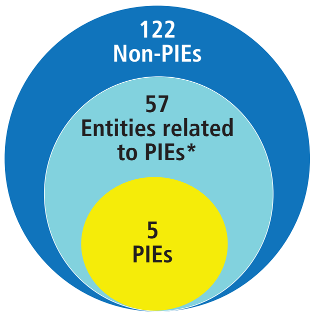
Audit partner capacity

- The average number of clients per audit partner who undertakes the role of engagement partner (EP) may provide an indication of an audit partner's workload within a firm^.
- The workload of an EP can affect the amount of time that he/she will be able to spend on each of his/her audit engagements.
- On average, an EP has about 5 PIE audit clients per annum.

^ There are instances of audit partners who are registered with the AOB who, for various reasons, do not play the role of an EP. They may solely undertake the role of an EQCR.

CHART 2

Average number of clients per AOB-registered audit EP



Source: AOB Analysis – Top 8 Audit Firms in Malaysia

* Relate to non-PIEs within the PIE Group which are audited by the Malaysian audit firms. Examples include, but are not limited to, subsidiaries, associates and joint ventures of PIEs.

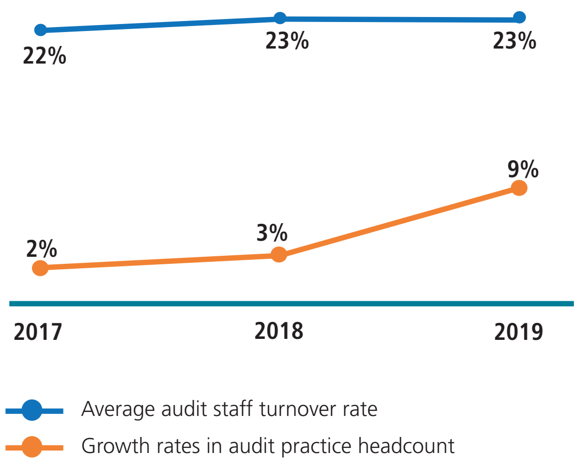
FIRM LEVEL TREND ANALYSIS

Audit staff capacity

- Talent retention is important to ensure that an audit firm has sufficient resources to undertake an audit.
- While there was no improvement in the overall audit staff turnover rate in 2019 from the prior year, the audit firms have been actively addressing this issue by intensifying recruitment activities.
- In 2019, the total audit staff headcount had collectively increased by 9%.

CHART 3

Average audit staff turnover rate and growth rates in the headcount of the audit practice



Source: AOB Analysis – Top 8 Audit Firms in Malaysia

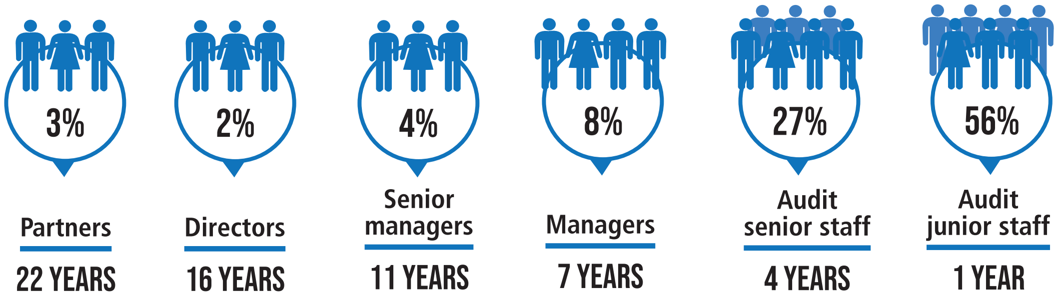
FIRM LEVEL TREND ANALYSIS

Experience of non-managerial audit staff

- In 2019, 83% of the audit personnel of the Top 8 Audit Firms comprise mainly non-managerial audit staff with average years of experience ranging from 1 to 4 years.

DIAGRAM 2

Audit practice staff by level to total headcount and average years of experience

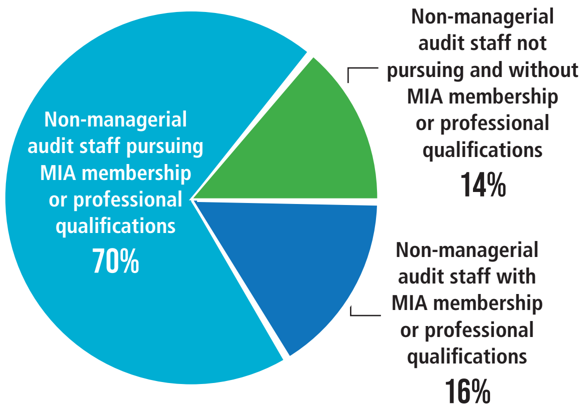


Source: AOB Analysis – Top 8 Audit Firms in Malaysia

- A majority of the non-managerial audit staff are currently pursuing MIA membership or professional qualifications while about 16% of the non-managerial staff are already professionally qualified (Chart 4).

CHART 4

Professional qualifications of non-managerial audit staff



Source: AOB Analysis – Top 8 Audit Firms in Malaysia

Note:
Audit staff with professional qualifications are staff who are members of any of the recognised bodies specified in Part II of the First Schedule of the *Accountants Act 1967* such as The Malaysian Institute of Certified Public Accountants (MICPA), Institute of Chartered Accountants in England and Wales (ICAEW), Association of Chartered Certified Accountants (ACCA), Certified Practising Accountants (CPA) Australia ,Chartered Accountants Australia and New Zealand (CAANZ), Canadian Institute of Chartered Accountants, Institute of Chartered Accountants of India and Chartered Institute of Management Accountants (United Kingdom) (CIMA).

FIRM LEVEL TREND ANALYSIS

Engagement supervision

- The managerial staff comprising audit directors and managers support the audit partners in the review and supervision of audit engagements.

- A significant majority of the managerial staff of the Top 8 Audit Firms are professionally qualified (Chart 5).

- In certain firms, professional qualification is not a prerequisite for promotion to managerial level. Criteria are based on work experience and job performance.

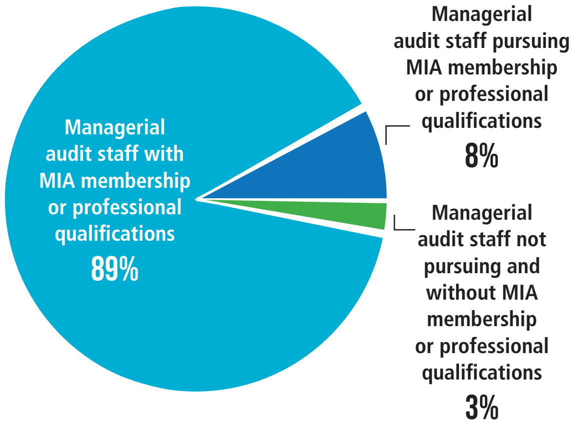
  Due to the vital role played by managerial staff, the AOB encourages audit firms to set policies to ensure that all managerial staff are professionally qualified. A person with a professional qualification is publicly recognised to have met the level of competence to carry out and manage audits.

- The average staff to partner and staff to manager ratios present an indication on the capacity of partners and managerial staff to supervise the junior audit team members. A lower ratio indicates that a partner or manager can accord greater attention to supervise an audit engagement team.

- Over the last 3 years, there have been no major changes to the ratios. This is an indication that resources for supervision of audit staff is not compromised in spite of the attrition within the firms.

CHART 5

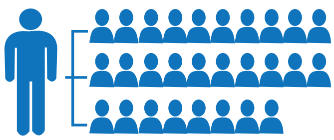
Professional qualifications of managerial audit staff



Source: AOB Analysis – Top 8 Audit Firms in Malaysia

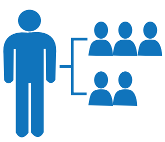
DIAGRAM 3

Average staff to partner ratio



1 partner to
2017: 28 audit staff
2018: 26 audit staff
2019: 28 audit staff

Average staff to manager ratio



1 manager to
2017: 5 audit staff
2018: 5 audit staff
2019: 5 audit staff

Source: AOB Analysis – Top 8 Audit Firms in Malaysia

FIRM LEVEL TREND ANALYSIS

Firms' investment to uphold audit quality

Training

DIAGRAM 4

Average number of training hours conducted by the Top 8 Audit Firms

Partners	71 hours
Directors, Senior managers and Managers	70 hours
Assistant managers	78 hours
Non-managerial audit staff	88 hours

Source: AOB Analysis – Top 8 Audit Firms in Malaysia

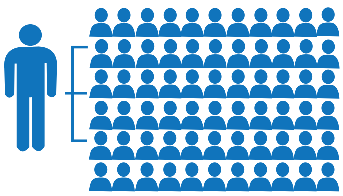
- In 2019, the average training hours provided by the Top 8 Audit Firms exceeded the minimum 40 hours of continuing professional education prescribed by the MIA.

Headcount in quality control functions

- The support provided by the quality control (QC) functions in an audit firm comprises staff training, quality assurance, technical consultations, risk management and monitoring of independence.
- A lower ratio of staff to QC headcount would indicate greater commitment by the audit firms to put in place dedicated resources to support audit quality.

DIAGRAM 5

Average staff to QC headcount



1 QC staff to
2017: 81 audit staff
2018: 90 audit staff
2019: 66 audit staff

Source: AOB Analysis – Top 8 Audit Firms in Malaysia

- In 2019, there was marked improvement in the ratio of staff to QC headcount from the prior years.

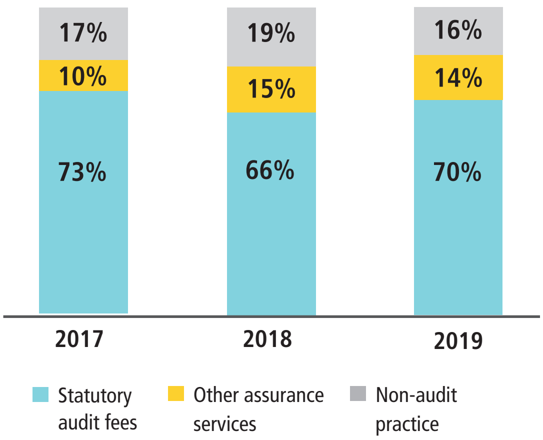
FIRM LEVEL TREND ANALYSIS

Auditor independence

- The provision of non-audit services by audit firms to its audit clients could undermine the perception of auditors' independence, especially when the proportion of fees derived from the offering of non-audit services is high.
- Over the last 3 years, the fee income from audit services continue to be the major contributor to the combined fee income derived from the firms' PIE audit clients as shown in Chart 6.

CHART 6

Collective composition of fee income between statutory audit, other assurance services and services provided by the non-audit practice of the Top 8 Audit Firms to PIE audit clients

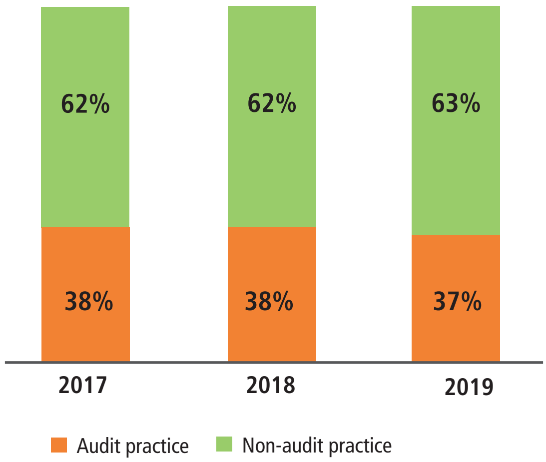


Source: AOB Analysis – Top 8 Audit Firms in Malaysia

- In comparison, more than half of the fee income of the global Big-Four Audit Firms are derived from their non-audit practices (Chart 7).

CHART 7

Collective composition of fee income between audit practice and non-audit practice of global Big-Four Audit Firms



Sources: EY Global Review Report for the year 2017 to 2019, Deloitte Global Impact Report for the year 2017 to 2019, KPMG International Annual Review Report for the year 2017 to 2019, PwC Global Annual Review for the year 2017 to 2019

ENGAGEMENT LEVEL TREND ANALYSIS

The AOB has continued its engagement level trend analysis involving audit engagements that have been inspected to identify common trends relating to audit quality since 2018. This analysis focused on engagements with satisfactory inspection results from 2017 to 2019. The AOB will continue to collect relevant data in the coming years in its efforts to fine-tune the analysis.

PIE WORKLOAD OF THE AUDIT PARTNER

- An engagement partner had **less than 4 PIE audit clients** with the same financial year-end.

EXPERIENCE OF THE EQCR PARTNER

- An EQCR partner had at least **8 years** of experience in the role of audit engagement partner of PIEs.

TRAINING AND DEVELOPMENT

- On average, the team members attended **40 to 90 hours** of training during the year.

PARTNERS' AND MANAGERS' COLLECTIVE INVOLVEMENT

>15%

- Partners' and managers' collective time spent on the audit engagements was **above 15%** of total engagement hours.

PIE WORKLOAD OF THE AUDIT MANAGERS (NEW TREND ANALYSED IN 2019)

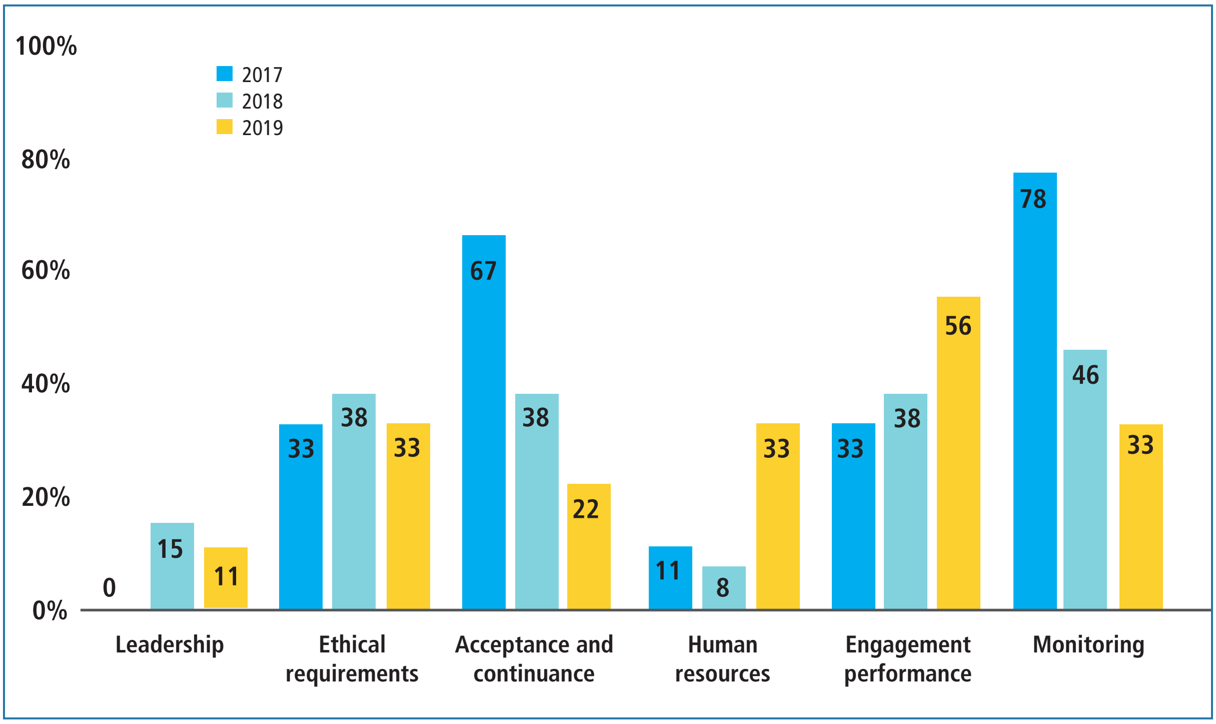
- Managers were involved in not more than 2 PIE audits with the same financial year-end.

PART 2

INSPECTION FINDINGS AND OBSERVATIONS FROM FIRM LEVEL REVIEW

CHART 1

Percentage of audit firms inspected during the year with findings from 2017 to 2019



Source: AOB

As depicted in Chart 1, improvements have been noted in the percentage of inspected audit firms with findings in 2019 from the prior year in the ISQC 1 elements of:

- Acceptance and Continuance of Client Relationships and Specific Engagements;
- Monitoring;
- Relevant ethical requirements; and
- Leadership responsibility for quality.

However, in the same period, there have been increases noted in the percentage of inspected firms with findings in the ISQC 1 elements of:

- Human Resources; 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 2019 are listed in Diagram 1.

DIAGRAM 1

Common findings identified by the AOB during the 2019 inspections

COMMON FINDINGS IN 2019	KEY CONCERNS / RISKS	AOB REMINDERS
Relevant Ethical Requirements		
Based on our selection of audit engagements for inspection, it was noted that certain audit engagement team members did not confirm their independence prior to their involvement on the audit engagements.	The failure to monitor engagement team members' independence poses the risk that independence issues, if any, may not be detected and addressed in a timely manner.	The independence of the team members on an audit engagement is the responsibility of the audit partner. Hence, audit partners are reminded to ensure that the independence declarations by the audit engagement team members as well as other specialists on the audit engagements, such as Information Technology (IT) as well as tax and valuation experts, are timely and complete.
Acceptance and Continuance of Client Relationships and Specific Engagements		
Some audit firms did not establish procedures that would require the prospective engagement team to obtain consent from the audit partner before accepting non-audit service engagements involving audit clients of the firm.	Audit partners who are ultimately responsible for ensuring auditor independence may not be aware of circumstances and relationships undertaken by the firm or its related entities that may pose threats to independence.	Firms are reminded to enhance the acceptance process for non-audit service engagements in order to ensure compliance with the *MIA By-Laws on Professional Ethics, Conduct and Practice and the International Standards on Auditing*. The AOB will not hesitate to take stern actions such as imposing prohibitions or revoking a firm's registration with the AOB for failures to comply with relevant ethical requirements.

COMMON FINDINGS IN 2019	KEY CONCERNS / RISKS	AOB REMINDERS
Human Resources		
In relation to the training of audit personnel, the following shortcomings were noted: • Some firms did not conduct sufficient training on accounting and auditing standards; and • Follow-up by some firms on audit personnel that were absent from training were inadequate.	Audit quality can be compromised if the audit work were carried out by audit engagement team members who are not sufficiently competent.	The conduct of training is particularly important for audit firms in view of the high staff turnover rate faced by the audit profession. Training helps to equip new hires with relevant knowledge and skills to perform a quality audit while maintaining continued competence for more experienced audit partners and managers. Audit firms should therefore invest in training to strengthen the capabilities of their audit workforce.
Monitoring		
The following shortcomings were noted during the inspections: • Some firms have not established a structured monitoring programme to evaluate the effectiveness of their system of quality controls; and • Engagement reviews performed by some firms were not effective in view of the observed failure to identify audit quality issues.	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.	Firms should implement a robust internal monitoring programme to identify areas for improvement. The designated partner-in-charge to lead the monitoring functions in the firm should have the appropriate experience and authority. In addition, the partner-in-charge of the monitoring functions should also be adequately supported with sufficient resources to ensure that his/her responsibilities are effectively discharged.
Some firms have not established a framework to investigate the root causes (root cause analysis) of deficiencies found during internal and external monitoring reviews.	The absence of a root cause analysis may result in the failure to identify appropriate measures to remediate any deficiencies found.	Firms are encouraged to establish a framework for the conduct of root cause analysis to facilitate effective identification of remedial measures to address weaknesses in the firm's systems of quality controls. In addition, firms should also monitor the effectiveness of the remedial actions that have been undertaken. Should a deficiency reoccur, it would be necessary to conduct a follow-up root cause analysis.

Source: AOB

Engagement Quality Control Review of Financial Audit Engagements

The EQCR who must be an audit partner registered with the AOB, is responsible to provide check and balance to the audit process through his or her independent evaluation of key judgement areas and significant matters.

In 2019, the AOB conducted a thematic review on the appointment of EQCR by audit firms. Some best practices observed by the AOB are:

a. Years of audit partner experience as an eligibility criterion

An individual is only considered for the role of EQCR after serving as an audit engagement partner for a minimum period ranging from two to four years. This is to ensure that the firms' EQCRs have obtained relevant experience before assuming the role of EQCR.

b. Authority and seniority of the EQCR

An EQCR with sufficient authority and seniority would be in a better position to effectively challenge the significant judgements made by an audit engagement partner as they would less likely to be intimidated by the audit engagement partner. Hence, some firms would not assign a junior partner to act as the EQCR on an audit engagement of a senior partner of the firm in order to safeguard the objectivity of the EQCR.

c. Workload of the EQCR

Heavy workload faced by an individual acting in the capacity of an EQCR can hamper the effectiveness of the review process. Consequently, some firms would consider the workload of the EQCRs during the allocation of audit engagements to ensure that they have sufficient time to perform a thorough review.

For some of the larger audit firms, procedures have also been formalised to monitor the timeliness of EQCR involvement throughout the various stages of the audit process. Audit engagement teams are required by these firms to plan ahead on the timing to submit the deliverables to the respective EQCRs to ensure that there is sufficient time for effective reviews to be carried out.

In recognising the importance of the engagement quality review process, the International Auditing and Assurance Standards Board (IAASB) will be introducing a separate standard known as the *International Standard on Quality Management 2* (ISQM 2). While the effective date of the proposed standard is yet to be determined, it is expected to address the specific requirements for the appointment and eligibility of the EQCR as well as the performance and documentation of the review.

Introduction of New Standard on Quality Management for Firms that Perform Audits or Reviews of Financial Statements

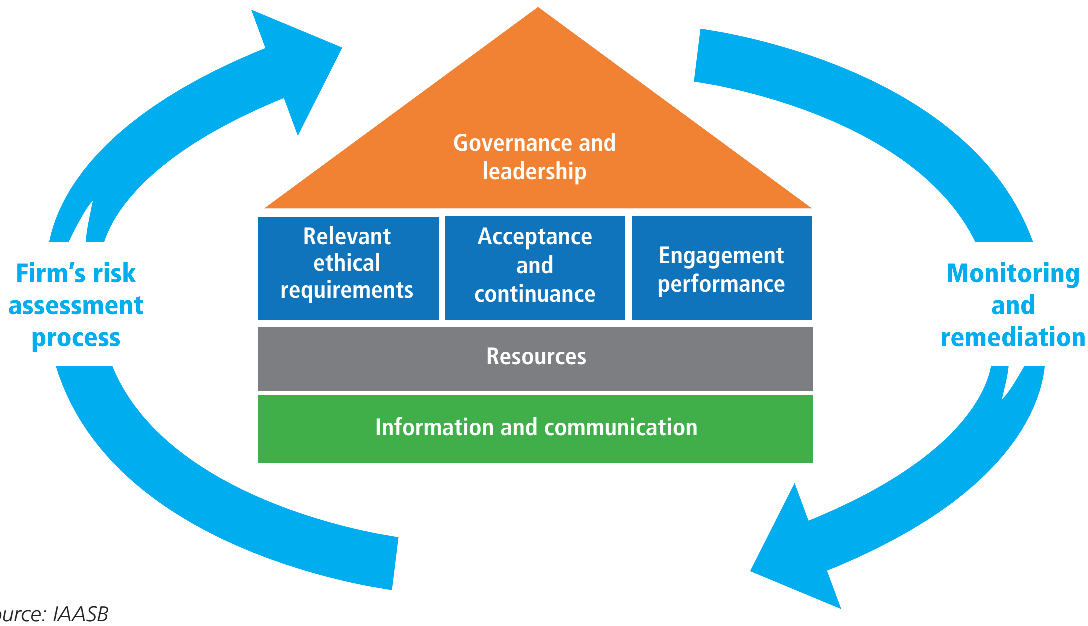
In recognising the need to enhance firms' management of engagement quality and to improve the scalability of the existing standard, the IAASB developed the *International Standard on Quality Management 1* (ISQM 1) to replace the current ISQC 1. The exposure draft on the proposed ISQM 1 was published in February 2019.

The proposed new standard incorporates a risk-based approach to an effective system of quality management.

Other notable enhancements include the following:

- Increased focus on the firm's leadership responsibilities, accountability and firm governance;
- Introduction of new standards to address the impact of technology, networks and the use of external service providers; and
- Increased emphasis on the monitoring of quality management system, and timely and effective remediation.

THE COMPONENTS OF A SYSTEM OF QUALITY MANAGEMENT



Source: IAASB

While the effective date of the proposed standard has yet to be determined, some of the larger audit firms in Malaysia, with the support from their respective networks, have started to assess their level of readiness to comply with the potential requirements of ISQM 1.

Similarly, all firms are advised to be proactive by keeping themselves updated with the latest developments mentioned above and to take the necessary steps to prepare for the requirements of the proposed new standard.

PART 3

INSPECTION FINDINGS AND OBSERVATIONS FROM ENGAGEMENT LEVEL REVIEW

The AOB may inspect a registered audit firm or individual auditor via a regular or special inspection. Regular inspections are carried out based on an inspection plan developed via the AOB's annual risk assessment process.

Special inspections are 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 related audited financial statements.

In 2019, the AOB conducted inspections on six Major Audit Firms and seven Other Audit Firms that collectively audited PLCs and schedule funds representing approximately 96.4% of the total market capitalisation of PLCs, 96.0% of the total net asset value (NAV) of schedule funds and over 72.6% of the total number of PIEs.

The AOB inspected 18 and 12 audit engagements respectively across these six Major Audit Firms and seven Other Audit Firms (Diagram 1).

DIAGRAM 1

2019 Inspection coverage

Major Audit Firms				Other Audit Firms			
2017	6	18	19	2017	4	7	8
2018	6	16	16	2018	7	11	13
2019	6	18	18	2019	7	12	12

Number of audit firms | Number of individual auditors | Number of audit engagements

Source: AOB

ENGAGEMENTS WITH SIGNIFICANT IMPROVEMENTS REQUIRED

Inspected engagements with significant improvements required are those that were either imposed with specific remediation measures or routed to Enforcement.

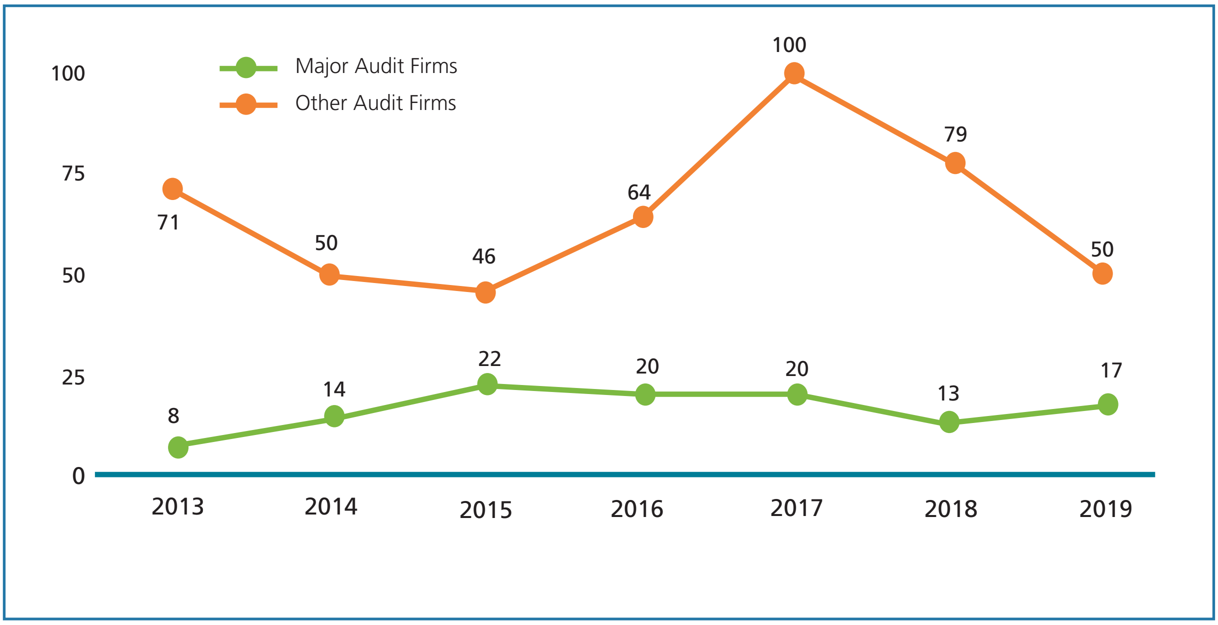
Despite the decreasing trend as illustrated in Chart 1, the AOB observed a stark difference in the audit quality between Other Audit Firms, where 50% of the engagements inspected require significant levels of improvements and the other half fared relatively well in the 2019 inspections. The AOB observed that firms that adopted appropriate audit quality measures proportionate to the firms' size and portfolio, combined with high quality culture within the workforce, resulted in an improved inspection outcome.

With 50% of the inspected engagements requiring significant improvements, the Other Audit Firms are well below the performance of the Major Audit Firms, where inspected engagements requiring significant improvements are lower than 25%.

The AOB observed that the performance of the Major Audit Firms has been relatively consistent at a certain level over the last three years of inspection. However, the AOB is concerned with the varying degree of results in the level of audit quality within each engagement inspected at Major Audit Firms. In view that these Major Audit Firms are responsible for the audit of PLCs which constitute 94.5% of the total market capitalisation of PLCs in Malaysia, the firms should not be complacent and should continue to ensure that high levels of audit quality is maintained at all times. It is therefore imperative for the firm's leadership to set the appropriate tone from the top and review their approach to audit quality and resource management to ensure consistency of performance across each engagement.

CHART 1

Percentage of inspected engagements with significant improvements required

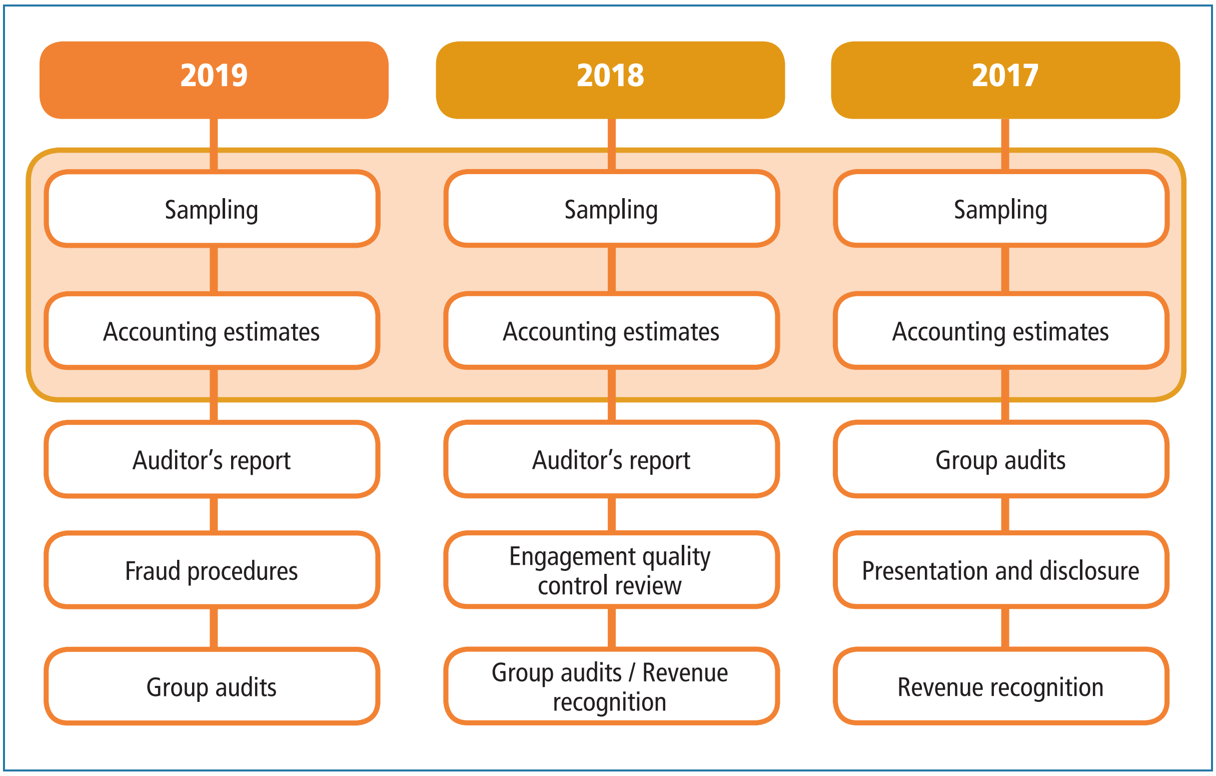


Source: AOB

COMMON FINDINGS FOR MAJOR AND OTHER AUDIT FIRMS

DIAGRAM 2

Top five common findings by audit quality theme[1]



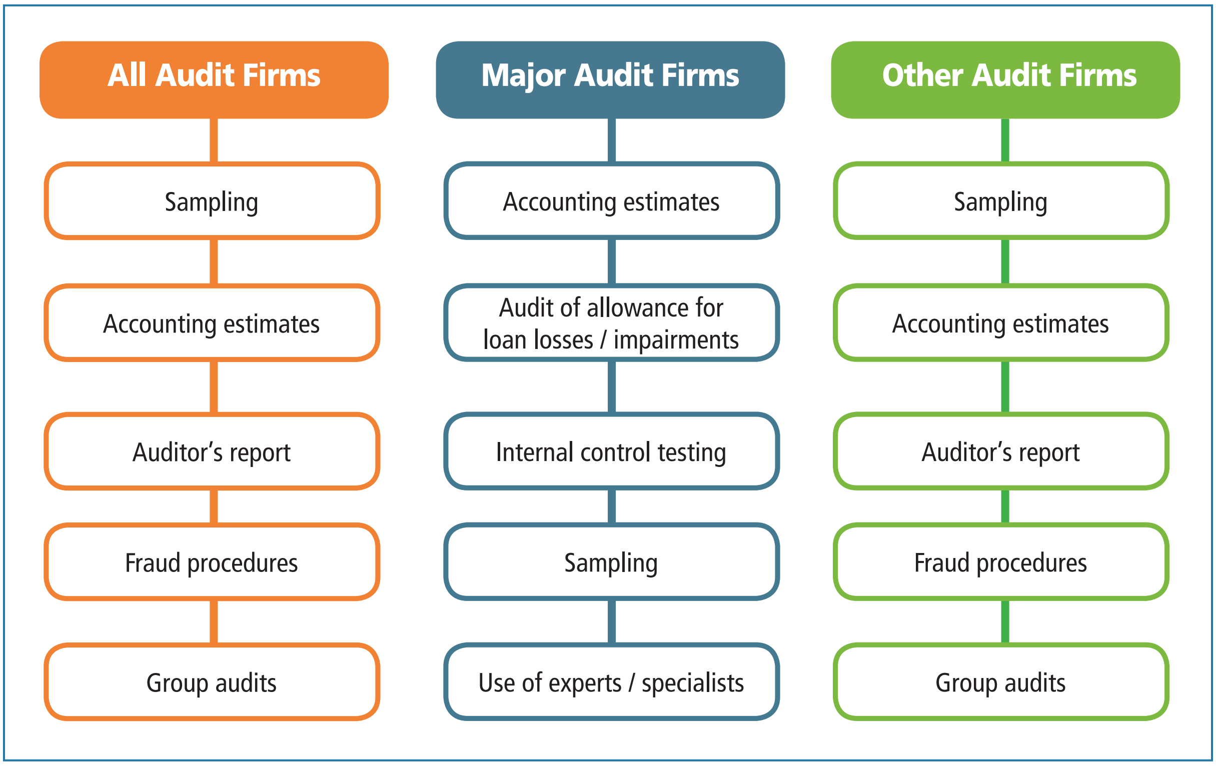
Source: AOB

Common findings observed from the AOB's inspections over a three-year period are illustrated in Diagram 2. These can be further analysed as follows (Diagram 3).

[1] The categorisation of common findings is consistent with the International Forum of Independent Audit Regulators' (IFIAR) Survey of Inspection Results for Audit Firms.

DIAGRAM 3

Top five common findings by category of audit firms



Source: AOB

As in previous years, sampling and accounting estimates remained the top areas of findings in 2019. Despite sampling being a basic and fundamental audit procedure, the AOB observed this finding to be more common across Other Audit Firms. This situation mainly arose from firms that applied sampling methodologies that do not meet the requirements of ISAs.

As for findings observed in relation to accounting estimates involving complex calculations and auditors' judgement, these were noted to be common across both Major Audit Firms and Other Audit Firms and were **prevalent in areas such as property development, contract costs and valuation of assets.**

Arising from the AOB's thematic inspection on changes in accounting standards, particularly MFRS 9 *Financial Instruments*, the common findings for Major Audit Firms evolved around the verification of internal controls and appropriateness of key assumptions applied in the impairment assessment of loans. The information on these common findings is featured in the **thematic reviews section**.

In addition to the above, the AOB continued to observe findings in relation to Auditor's Report, particularly on Key Audit Matters (KAM) in its third year of implementation. The findings were mainly in relation to inadequate assessment to dispose of significant areas communicated to Those Charged with Governance (TCWG) but not disclosed as KAM.

COMMON PITFALLS

Audit sampling

- Not verifying the completeness of the population used for sample selection.
- In some occasions, the population used for sample selection may not have been appropriate to achieve the objective of the audit procedures performed.
- No basis and rationale for sample size and sample selection. How then does the auditor gain comfort that the sampling risk has been reduced to an acceptably low level?
- No audit procedures performed on the samples selected by the auditors themselves and there were no other alternative procedures performed to make up for the shortfall in samples verified.
- Relying solely on client's own documentation or listings as audit evidence, without first verifying the reliability of those listings.
- No follow-up procedures when external confirmations were not received. In certain circumstances where confirmations were received with differences noted, these were not addressed or reconciled.

Accounting estimates

- Accounting treatment applied by client may not be appropriate for the assets recognised. For example, capitalising expenses which did not meet the requirements of MFRS 116 *Property, Plant and Equipment*, and recognising an investment as an associate without first assessing whether there was significant influence as at reporting date.
- Not verifying the accuracy of depreciation/amortisation recognised as at reporting date.
- Accepting the outcome of client's discounted cash flow projections used in asset impairment assessment without assessing or challenging the client's key assumptions and estimates used.
- Not ascertaining that disclosures in the audited financial statements are accurate and adequate in accordance with the requirements of the relevant accounting standards.

Fraud procedures

- No specific audit procedures performed to address heightened risk of management override of controls. Although risks were appropriately identified, the auditors persist with generic pre-existing procedures, which did not specifically address the risks.
- Auditors did not perform inquiries with the client to understand the processing of journal entries, especially in relation to inappropriate or unusual journal entries and adjustments.
- Journal entries were not tested. Where journal entries were tested, auditors did not verify whether the journals were appropriately supported, reviewed and approved.

The main root cause of the above common pitfalls on audit sampling, accounting estimates and fraud procedures appears to be due to the lack of professional scepticism by the audit engagement team and worsened by the lack of supervision by the engagement partners. The AOB would like to remind the auditors to maintain professional scepticism in assessing audit evidence particularly on the reliability of documents, responses to inquiries and other information obtained from management and TCWG throughout the audit as required by the ISAs. The ultimate responsibility of an audit falls with the engagement partners. Although tasks may be delegated to the other members of the engagement teams, sufficient review is required by the engagement partners, especially on high risk and judgemental areas involving estimates.

THEMATIC REVIEWS

Change in Accounting Standards

The AOB is cognisant that the financial reporting environment is dynamic and regularly updated to suit the requirements of stakeholders. Changes to accounting standards play a key role to provide more valuable insights and cater to the information needs of users of financial statements. In assessing the implementation of new accounting standards, the AOB performed thematic reviews on two new accounting standards.

MFRS 15 *Revenue from Contracts with Customers*

One of the thematic areas of focus in the AOB's 2019 Inspection Programme was in relation to the audit impact arising from the first year implementation of MFRS 15 *Revenue from Contracts with Customers* (MFRS 15).

QUICK FACT SHEET

- Issued by the MASB in 2014
- Effective for audit of financial statements with financial periods beginning on or after **1 January 2018**
- MFRS 15 supersedes **MFRS 111 *Construction Contracts*, MFRS 108 *Revenue*** and other revenue-related IC interpretations

Source: MASB and MIA

The focus of the thematic review was to assess the audit firms' responses to the PIE managements' adoption of MFRS 15. The following diagram depicts the 5-step model embedded within MFRS 15, which is commonly used as a guidance tool by company/client management in assessing their revenue recognition policy in relation to contract customers.

DIAGRAM 4

MFRS 15's 5-step model

- **STEP 1** Identify the contract(s) with customer
- **STEP 2** Identify the performance obligation(s) in the contract
- **STEP 3** Determine the transaction price
- **STEP 4** Allocate the transaction price to the performance obligation(s) in the contract
- **STEP 5** Recognise revenue when/ as the entity satisfies a performance obligation

Source: MASB and MIA

The following case studies provide a **non-exhaustive example** of circumstances where revenue recognition can be less straightforward and requires detailed assessments to assess the appropriateness, accuracy and completeness of revenue recognised in accordance with MFRS 15.

CASE STUDY 1 Revenue recognition for Property Development activities

PIE A is currently involved in the development of a 4-block condominium complex located in the heart of Kuala Lumpur. All units sold were entitled to free fittings such as built-in kitchen, air-conditioning, kitchen appliances and two parking bays. Owners of the units will also be entitled to free access to common facilities, which include swimming pool, gym and barbeque pits (hereafter referred to as "freebies").

As at the reporting date, the development's percentage of completion (POC) has reached 55% and the take-up rate of units sold was 80%. These units sold comprised cash buyers as well as units purchased via loans from panel financial institutions (loan buyers). A 10% deposit is required upon signing the sale and purchase agreement (SPA), which was recognised as revenue upon receipt. PIE A recognised revenue from cash buyers when POC and progress billing exceeds 50%, whereas revenue from loan buyers are recognised based on POC.

Potential issues	Audit considerations
The probability test required in paragraph 9(e) of MFRS 15 may have not been satisfied to recognise revenue in relation to: • 10% deposit upon signing of SPA; and • 50% threshold set for cash buyers	Challenge management's assumptions as to the appropriateness of recognising these as revenue, particularly whether these amounts have satisfied the related performance obligations
Freebies may have been bundled as one performance obligation with the residential unit	Whether the freebies should be considered as separate performance obligations, particularly where these could be purchased as standalone services and/or goods
Discounts, rebates and other variable considerations payable to unit buyer may not have been considered in determining the transaction price Transaction price may not have been accurately allocated to each performance obligation	Completeness and valuation of variable considerations included in determining the transaction price and verification on the reasonableness of allocation of transaction price to each performance obligation
Timing of revenue recognition may not have reflected the transfer of control (satisfaction of performance obligation)	Assessment on whether control has been transferred to verify the completion of each performance obligation for revenue recognition

CASE STUDY 2

Revenue recognition for manufacturing and after sale services

PIE B is a manufacturer of customised automated test equipment (ATE) for the semiconductor industry. A prospective customer will request for a quotation based on specific requirements and will place an order once agreed. A 20% down payment is required upon order and 60% of the selling price is due upon delivery of the ATE at the customer's designated premises. The remaining 20% is due once the equipment has been tested and the customer agrees to purchase the equipment. PIE B will issue an invoice for each payment stage followed by an official receipt upon settlement. The normal credit term is 60 days, but early payment discounts are offered to incentivise settlement within 30 days. PIE B also provides warranties for any defects up to 12 months from delivery date. Extended warranty is available at an additional cost.

Potential issues	Audit considerations
Identifying when a contract with customer exists – purchase order or issuance of invoices for each payment stage	Assessment on whether the requirements of paragraph 9 of MFRS 15 are met, specifically whether the contract exists
Down payment, testing services, warranty for defects and extended warranty may have been bundled with the delivery of ATE as a single performance obligation	Whether the down payment, testing services, warranty for defects and extended warranty should be considered as separate performance obligations in view that some of these are offered for purchase as standalone services
Early payment discounts and other variable considerations relevant to the contract may not have been considered in determining the transaction price	Completeness of valuation of variable considerations included in determining the transaction price and verification on the reasonableness of allocation of transaction price to each performance obligation
Early payment discounts may have been allocated to a specific performance obligation instead of all performance obligations	
Revenue is recognised upon issuance of invoices for each payment stage i.e. 20% down payment, 60% upon delivery and 20% for testing services	Verifying revenue cut-off and assessing the accuracy and completeness of deferred revenue recognised for unsatisfied performance obligations as at reporting date

CASE STUDY 3 Revenue recognition for hospitality services

PIE C is an operator of a 5-star resort chain across the Southeast Asia region, equipped with its very own themed parks. In conjunction with the holiday season, PIE C is offering rooms at 20% discount on the normal selling price for online reservations made via selected hotel-booking providers. Each room offered under the promotion comes with free Wi-Fi, breakfast for two persons, full minibar and complimentary welcome drinks. Reservations made for more than five nights are entitled to a complimentary all-park access for two individuals. Customers have the option to pay upon reservation or check-in at no additional cost. Cancellations less than 72 hours before the check-in dates are non-refundable and customers will be charged the full amount. A 5% refundable deposit is required upon check-in.

Potential issues	Audit considerations
Identifying when a contract with customer exists – upon online reservation, expiry of cancellation period, customer check-in or at the end of the booking period	Assessment on whether the requirements of paragraph 9 of MFRS 15 are met, specifically whether the contract exists
Free Wi-Fi, breakfast, full minibar, welcome drinks and all-park access tickets may be bundled with the hotel room as a single performance obligation	Whether Wi-Fi, breakfast, full minibar, welcome drinks and all-park access tickets should be considered separate performance obligations in view that some of these are offered for purchase as standalone services and/or goods
The refundable deposit and other variable considerations relevant to the contract may not have been included in determining the transaction price	Completeness of valuation of variable considerations included in determining the transaction price and verification on the reasonableness of allocation of transaction price to each performance obligation
The allocation of transaction price may not be in proportion to the standalone prices of each performance obligation	
Identifying the point in time when the performance obligations are satisfied: - daily basis; - upon transfer of goods/services; or - upon customer check-out	Assessment on whether control has been transferred for purposes of identifying whether each performance obligation has been satisfied for revenue recognition, as well as verification of revenue cut-off

The AOB had some initial concerns on the practical implementation of MFRS 15, particularly in relation to areas which required professional judgement. These turned out to have less of a material impact on the financial statements. Firms would need to reassess these areas on a regular basis, and ensure that such understanding and assessment are adequately documented and carried forward to future audits.

Based on the engagements inspected, the AOB observed that most of the audit firms as well as management and directors were well-prepared in embracing the implementation of MFRS 15. Further, audit firms had designed audit programmes in line with the 5-step model to better evaluate management's revenue recognition and organised substantial amounts of training to prepare their audit personnel to address potential concerns.

Moving Forward

In today's market environment, organisations are constantly introducing incentives and attractive goods and services packages to entice customers. Auditors need to continuously apply high levels of professional scepticism in looking at how management analysed individual contracts with customers to identify separate performance obligations, timing and completeness of revenue recognition as well as accuracy in the allocation of transaction prices. Moving towards the second year of implementation, the AOB will continue to focus on the auditor's assessment of the judgement applied by PIEs in relation to MFRS 15 requirements.

MFRS 9 *Financial Instruments*

In 2019, the AOB conducted a thematic review on the first year implementation of MFRS 9 *Financial Instruments* (MFRS 9) with a particular focus on how the new standard impacts the audits of financial institutions.

QUICK FACT SHEET

- Issued by the MASB in 2014
- Effective for audit of financial statements with financial periods beginning on or after **1 January 2018**
- MFRS 9 supersedes **MFRS 139 *Financial Instruments: Recognition and Measurement***

Source: MASB and MIA

The AOB's inspections scoped under this thematic review were predominantly focused on the following areas and the related-IT controls:

DIAGRAM 5

Areas of inspection focus

Classification and measurement of financial assets	Impairment
Auditors' assessment over the PIE's determination of the business model for managing financial assets and contractual cash flow characteristics of the financial assets	Auditor's evaluation over the appropriateness of the PIE's model and inputs applied in the measurement of expected credit losses (ECL)

Source: AOB

Common findings and best practices observed from the AOB's thematic review on the audit of MFRS 9 implementation are as follows:

DIAGRAM 6

Thematic review on audit of MFRS 9 implementation – Common findings

- Insufficient audit procedures performed to test the accuracy and completeness of the underlying data used in the ECL computation that were interfaced from other systems (see Case Study 4);
- Over-reliance on auditors' expert's work with insufficient assessment of the adequacy of the auditor's expert's work as audit evidence for the verification of ECL (see Case Study 5);
- Insufficient audit procedures performed to assess the appropriateness of the PIE's usage of 100% weightage for a single baseline scenario for the PIE's ECL estimates;
- No audit procedure performed to assess the appropriateness of proxy rates used for certain inputs in the ECL model; and
- Insufficient audit procedures performed to assess the appropriateness of applying loss given default (LGD) of only either 0% or 100% in the ECL computation, particularly for those balances with collateral that appeared to be less than the outstanding balances.

Source: AOB

DIAGRAM 7

Thematic review on audit of MFRS 9 implementation – Best practices

- Early engagement with the PIE to enable appropriately planned audit responses to risks of material misstatements arising from the estimation of ECL;
- Timely assessment of audit implication arising from issues raised by the audit firm's modelling specialists on the PIE's ECL model; and
- Effective communication with the audit firm's IT specialists, for their involvement in verifying the integrity of the PIE Group's information systems relating to the ECL model.

Source: AOB

CASE STUDY 4

Auditing the ECL model: Systems Test

MFRS 9 requires the ECL model to reflect an unbiased and probability-weighted amount based on reasonable and supportable information, taking into account the time value of money. Bank A's ECL model for its loan portfolio of RM15 billion is automated within System X, where the ECL is calculated based on several input parameters:

ECL = Exposure at Default (EAD) **X** Probability of Default (PD) **X** Loss Given Default (LGD) **X** Discount Factor

The above input parameters are determined using data interfaced from the core banking systems via Data Warehouse. Further, in discounting ECL to the reporting date, Bank A applies the loans' respective Effective Interest Rate (EIR) as the discount factor. EIR computation is performed automatically in System W and is also interfaced with System X to enable the computation of ECL.

The following were noted as part of Firm Z's assessment of Bank A's ECL model:

Inputs	Observations
EAD	The determination of EAD takes into account the undrawn loan commitments and credit conversion factor (CCF), where the CCF is the percentage of the currently undrawn limit that is expected to be drawn at the time of default. The undrawn balances and CCF are interfaced from the core banking system to System X via the Data Warehouse for the computation of EAD. In verifying the interface between the core banking system, Data Warehouse and System X, the data tested did not include undrawn balances and CCF. Hence, **the accuracy of the undrawn balances and CCF interfaced from the core banking system to System X was not verified.**
Discount factor	Firm Z's interfacing test did not include the interface between System W and System X, hence **there was no audit procedure performed to verify the accuracy of the EIR used by System X to compute the ECL.**
Staging of loans	The staging of loans based on changes in credit quality since initial recognition is automated within System X, taking into account various factors, including the *months-in-arrears* (MIA) of loans. While the logic and script of the staging were verified to ensure the accuracy of the staging, **there was no audit procedure performed to verify the accuracy of the MIA of loans interfaced from the core banking system to System X**.

CASE STUDY 5

Auditing the ECL model: Reliance on auditor's experts

Bank B is a member of an international banking group with its Head Office in Frankfurt. In auditing the ECL for Bank B's loan portfolio of RM8 billion, Firm Y partly relied on the work performed by its internal experts. The experts' scope of work included assessing the reasonableness of parameters being used as well as performing ECL recomputation.

Firm Y performed audit procedures to evaluate the appropriateness of the experts' work as audit evidence for the verification of ECL. However, the assessment did not include the following audit considerations:

Inputs	Audit considerations
ECL computation	• Appropriateness of Bank B's weightage of 100% for a single baseline scenario and how this would meet MFRS 9's requirements of an unbiased and probability-weighted ECL amount.
EAD	• Accuracy and completeness of undrawn amount, amortisation and repayment schedule used in the EAD computation. • Appropriateness of proxy CCF used based on Bank B's Head Office rates, including assessment of whether or not it is representative of the actual utilisation rate in Bank B.
PD	• Reasonableness of adjustments made to the PD rates leveraged on Bank B's Head Office.

Moving Forward

Given the nature of the estimates and volume of computation, MFRS 9 implementation requires heavy reliance on information systems and automated controls that are configured within the systems. In such cases, involvement of audit firms' IT specialists is key to the audit. Audit firms must ensure that **effective and continuous communication** is in place to ensure that **all relevant systems and controls are sufficiently audited.**

Further, in view of the significant estimates and judgement applied by PIEs in relation to MFRS 9 requirements, audit firms must continue to exercise professional scepticism in scrutinising and challenging these estimates sufficiently.

PART 4 REMEDIATION OF INSPECTION FINDINGS

REMEDIATION PROCESS

As part of the final stage of an inspection, the AOB issues a *Final Inspection Report* to the inspected audit firm. 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 evaluates the appropriateness of the proposed remediation plan 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 another in accordance with the structure and size. However, it is vital that the remediation plan is holistic, relevant and sustainable to ensure that any shortfall or compromise of audit quality is appropriately and promptly rectified.”

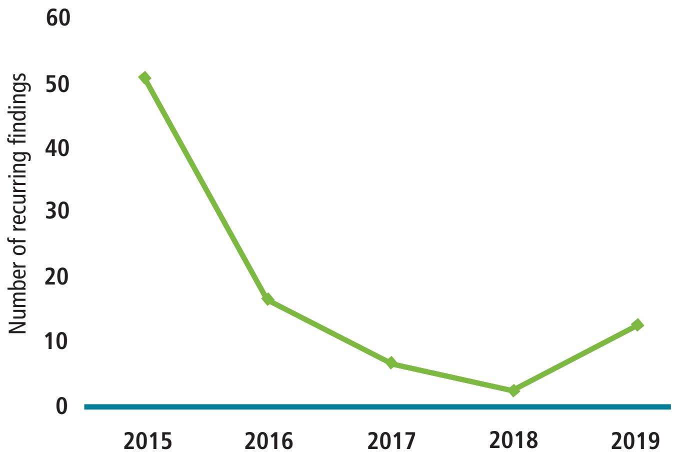
In the event that the AOB disagrees with an audit firm’s proposed remedial plan or any elements of the plan, it engages further with the audit firm, which will then be required to submit revisions to the relevant areas or even to the extent of submitting a new and completely revised plan.

The remediation plan framework usually includes the audit firm’s identification of root causes and performance measures for remediation, which focused on the outcome and effectiveness of the remediation 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.

RECURRING FINDINGS

CHART 1

Recurring findings by year (2015 – 2019)



Source: AOB

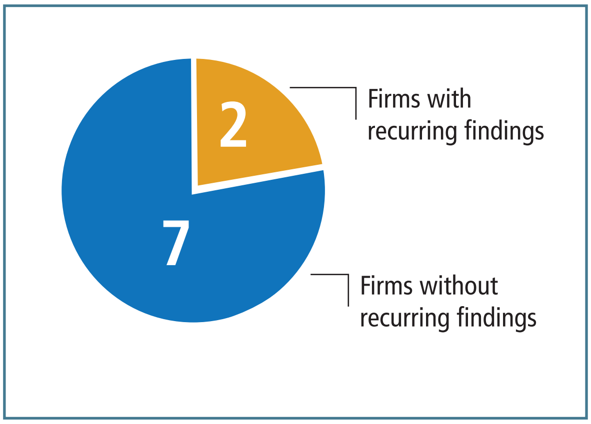
One of the key methods to measure the effectiveness of the remediation measures is via the number of recurring findings raised in subsequent inspections. The AOB reinspected nine audit firms in 2019. As depicted in Chart 1, while there were improvements in recent years (indicated by the downward trend in the number of recurring findings for reinspected audit firms in the four-year period between 2015 and 2018), there was a significant increase in the number of recurring findings in 2019. Twelve recurring findings were observed, all of which were in relation to two reinspected Other Audit Firms.

This observation raised questions on the effectiveness of remedial actions taken by these audit firms to address the findings raised and corresponding root causes. It also indicates that sustainable and consistent audit quality remain a challenge and reinforces the importance of audit firms' commitment for continuous improvement. Audit firms must strive to instil a culture of high and consistent audit quality delivery.

The absence of recurring findings in the other reinspected audit firms reflects these firms' commitment in the implementation of remediation plans, where remediation was seen as a continuous and ongoing exercise. There was also recognition of the importance of identifying the actual root causes and to put in place a remedial action plan that is more holistic, specific and targeted to address the identified root causes. Notwithstanding this positive observation, audit firms should be wary of being complacent in addressing issues that might easily recur.

CHART 2

Number of reinspected firms with and without recurring findings in 2019



Source: AOB

DIAGRAM 1

Areas of recurring findings

Source: AOB

CONCLUSION

CONCLUSION

Overall, the trends in inspection results and audit quality have improved for most firms over the past years. This is evidenced by the decreasing trend in relation to the number of significant improvements required for Other Audit Firms inspected within the last three years, the stable performance of Major Audit Firms in the same period and the overall reduction in the number of recurring findings in most of the reinspected audit firms. The above reflect the firms' commitment and ongoing efforts to improve and sustain audit quality.

However, the challenge remains for each Major Audit Firm to maintain consistently high audit quality across **all engagements**. For Other Audit Firms, the AOB is increasingly concerned with the performance of some of these firms. The severity and pervasiveness of findings observed, many of which relating to the execution of basic audit procedures, made it necessary for the AOB to take more stern actions including imposing additional registration conditions prior to the conclusion of enforcement proceedings to safeguard public interest.

The AOB reiterates that enforcement actions by the AOB are taken against audit firms and individual auditors based on the level of severity and impact of the inspection findings arising from its inspection program. The AOB does not differentiate on the size of the audit firms for its enforcement actions but assesses whether the findings are pervasive and significant to the auditors' work, which may have an impact on the audit opinion expressed by the auditors.

To maintain and further improve audit quality, auditors need heightened vigilance and increased responsiveness to emerging issues. This challenge intensifies with the COVID-19 pandemic and the Movement Control Order (MCO), which has been effective since 18 March 2020. The AOB closely monitors the impact of the COVID-19 pandemic and the MCO on the financial reporting of PIEs that operate in the Malaysian capital market and the related audited financial statements.

In April 2020, the AOB issued an AOB Alert to auditors and Audit Committees to communicate on the areas of focus that auditors and Audit Committees and/or TCWG may wish to pay particular attention to when discharging their responsibilities. Areas of focus for auditors to consider included the following:

DIAGRAM 1

Auditors' areas of focus due to the impact of COVID-19 and MCO

- To be cautious and highly sceptical when scrutinising areas such as going concern and assessing potential indicators of asset impairment;
- As group auditors, to plan and ensure that sufficient appropriate audit evidence regarding financial information of the components have been obtained in the event that there is a delay or inability to access the information of the components;
- To determine whether disclosures in annual reports relating to effects of the COVID-19 pandemic on the current operations and future prospects of the PIEs are sufficient; and
- To assess whether there are any events that occur between the dates of financial reporting and auditor's report that require additional audit procedures.

Source: AOB

The above matters should be thoroughly considered by the auditors in the performance of their audits with no compromise on audit quality. In these circumstances, continued adherence to relevant standards and adequate training for staff members are important as these are fundamental building blocks for high quality audits. To this end, the SC/AOB's relief measures introduced amidst the COVID-19 pandemic included a one-off training subsidy for existing registered audit firms of the AOB with less than 10 audit partners, of up to RM30,000 per firm for Approved Training Programmes conducted by MICPA.

Moving forward, the AOB's inspection will focus on how auditors obtain sufficient appropriate audit evidence faced by the challenges presented by the COVID-19 pandemic and the MCO, particularly their audit execution relating to the abovementioned areas of focus.

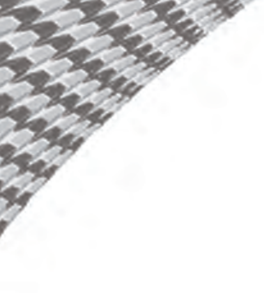
ACRONYMS AND ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
AOB	Audit Oversight Board
CCF	Credit conversion factor
CMSA	*Capital Markets and Services Act 2007*
EAD	Exposure at default
ECL	Expected credit losses
EIR	Effective interest rate
EP	Engagement partner
EQCR	Engagement quality control reviewer
IAASB	International Auditing and Assurance Standards Board
IOSCO	International Organization of Securities Commissions
ISA	*International Standards on Auditing*
ISQC	*International Standard on Quality Control*
ISQM	*International Standard on Quality Management*
IT	Information Technology
KAM	Key Audit Matters
LGD	Loss given default
MASB	Malaysian Accounting Standards Board
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
NAV	Net asset value
PD	Probability of default
PIE	Public-interest entity
PLC	Public-listed company
QC	Quality control
SC	Securities Commission Malaysia
SCMA	*Securities Commission Malaysia Act 1993*
TCWG	Those charged with governance

DEFINITIONS

Auditor	An individual auditor or audit firm who is registered or recognised under section 31O 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.
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;

	(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 8 Audit Firms	Top 8 audit firms based on their PLC audit clients' market capitalisation in Malaysia.



ANNUAL INSPECTION REPORT 2019
Audit Oversight Board
Securities Commission Malaysia
3 Persiaran Bukit Kiara   Bukit Kiara   50490 Kuala Lumpur
Tel +603 6204 8900   Fax +603 6201 1888
Websites   http://www.sc.com.my/aob   www.investsmartsc.my