

# PART ONE FOSTERING HIGH QUALITY INDEPENDENT AUDITING IN THE CAPITAL MARKET



## INTRODUCTION

Audit quality is key in safeguarding public trust and strengthening investor confidence in reliable corporate reporting. One of the vital elements of upholding audit quality is effective audit oversight.

Building on the foundation of its achievements in the past, the AOB remains focused on its mandate to foster high quality independent auditing in the capital market.

While the AOB continues with its core functions, namely registration and recognition, inspection and enforcement, it is mindful and attentive to the increasing complexity of the audit industry. Drivers such as global economic uncertainties, technological disruptions and complexities in developments of global financial reporting standards are regularly monitored to ensure that the AOB's focus is current and relevant.

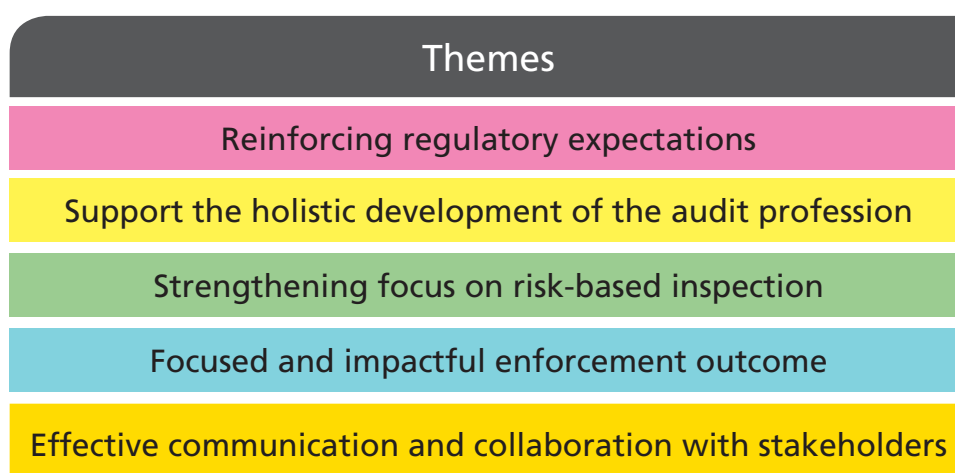
2018 marks the second year of the AOB's Strategic Plan 2017-2020. In an effort to provide more depth and breath to the implementation of the strategic initiatives, priority was given to the following strategic themes:

- Reinforcing regulatory expectations;
- Focused and impactful enforcement outcomes; and
- Strengthening the focus on risk-based inspection.

Highlights of activities in 2018 towards achieving the strategic themes are presented in the following sections.

### Diagram 1

#### The AOB's Strategic Plan 2017 - 2020



## Malaysia Ranked Top in the Area of Auditors and Audit Regulators in CG Watch 2018

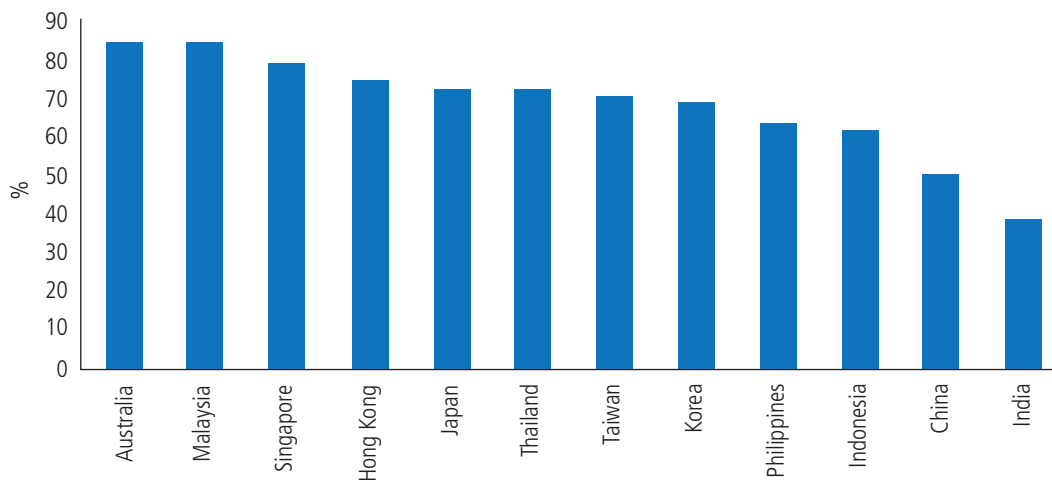
In the recently issued CG Watch 2018 by ACGA, Malaysia emerged as the biggest gainer moving from sixth place in 2016 to fourth in 2018, after Australia, Hong Kong and Singapore. This report is the result of a biennial survey by the ACGA and CLSA Limited (CLSA) of 12 Asian countries including Australia.

Malaysia scored above the regional average in several areas including the strength of its rules for corporate disclosure, governance and enforcement. Malaysia also scored the highest (tied with Australia) for the quality of accounting, auditing standards and practices, and the effectiveness of audit regulation.

The AOB was also recognised as one of the region’s most effective audit regulators and probably the best communicator.

Chart 1

### Auditors and audit regulators: scores by market



Source: ACGA




The ACGA commended the AOB on its inaugural *2017 AOB Annual Inspection Report* issued in March 2018, which provided details of its inspection programmes and insights into the structure and practices of the audit industry. The ACGA also noted that the issuance of the inspection report sets a good example for the region.

The AOB’s enforcement actions as well as New Registration Criteria for Registration with the AOB were identified as proactive.

This is the ninth edition of the CG Watch.

## REINFORCING REGULATORY EXPECTATIONS

The AOB continues to reinforce regulatory expectations through its three key functions – registration and recognition, inspection as well as enforcement. In 2018, this was achieved through the following key efforts:

- |  |   |   |
|--|---|---|
|  <div style="background-color: #4CAF50; color: white; padding: 5px; text-align: center; font-weight: bold;">Gatekeeping</div> <ul style="list-style-type: none"> <li>• <b>Strengthened existing registration pre-assessment and recognition processes</b>, reinforcing the regulatory expectations on the audit firms' system of quality control at point of registration and recognition for Malaysian and foreign audit firms respectively.</li> <li>• <b>Introduced New Criteria for Registration with the AOB</b>, following its in-depth review of existing registration criteria and its engagement with the audit profession.</li> </ul> |  <div style="background-color: #8BC34A; color: white; padding: 5px; text-align: center; font-weight: bold;">Monitoring</div> <ul style="list-style-type: none"> <li>• <b>Strengthened ongoing monitoring efforts</b>, where non-compliances with auditing standards and regulations identified were routed for enforcement or other appropriate action.</li> <li>• <b>Mitigated the risk of future failure arising from serious audit quality concerns identified during inspections and through ongoing monitoring efforts</b>, where auditors' current and past performance in and outside of Malaysia were considered. Actions taken included additional conditions imposed on registered auditors and revocations of auditors' registrations.</li> </ul> |  <div style="background-color: #673178; color: white; padding: 5px; text-align: center; font-weight: bold;">Collaboration</div> <ul style="list-style-type: none"> <li>• <b>Joint research by the AOB, Malaysian Institute of Accountants (MIA) and Association of Chartered Certified Accountants (ACCA)</b> on the <i>Enhanced Auditors' Report (EAR): A Review of First-Year Implementation Experience in Malaysia</i>, contained insights into auditors' communication with audit committees and investors' perceptions and behaviour.</li> <li>• <b>AOB Dialogue with Professional Bodies</b>, concerns were shared following inspections. The AOB also facilitated discussions and brainstorming with the audit profession on the best way forward to improve audit quality in Malaysia.</li> <li>• <b>Annual AOB Conversation with Auditors of PIEs and Schedule Funds</b>, where greater insights were shared from the inaugural <i>2017 AOB Annual Inspection Report</i> and the announcement of the New Criteria for Registration with the AOB.</li> </ul> |
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In 2018, the AOB's monitoring function identified instances where AOB-registered auditors exceeded the maximum period allowed to act as a key audit partner of a PLC audit client.

These breaches of the *By-Laws (On Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants (MIA By-laws)* compromised the auditor's independence when conducting the audits.

**The AOB views such ethical breaches seriously, and enforcement proceedings were initiated against the individual auditor as well as the audit firm.**

## New Criteria for Registration with the AOB

The AOB conducts regular inspections on audit firms and individual auditors to assess their compliance with auditing standards and regulations. Over the years, results of the AOB inspections raised concerns that:

- There were audit firms which lacked sufficient internal capacity at the partner level to effectively carry out audits of PIEs and schedule funds, and comply with partner rotation requirements under the MIA By-Laws;
- There were audit firms legally formed solely for the purpose of accepting PIE audit engagements. However, in substance, these audit firms outsourced the roles and responsibilities of the engagement partner (EP) and/or engagement quality control review (EQCR) partner. Consequently, when audit quality concerns arose, these audit firms were unable to exercise effective oversight and governance over the audit partners carrying out the audits of financial statements of PIEs or schedule funds; and
- There were audit firms registered with the AOB for a number of years which have yet to perform audits of financial statements for any PIEs or schedule funds since their registration. This raised questions whether these audit firms have serious intentions to conduct audits of financial statements of PIEs or schedule funds.

In view of the above, the AOB embarked on an in-depth review of its existing registration criteria in 2018 to ensure that its gatekeeping focus remains current and relevant, in line with the focus areas identified in the AOB's Strategic Plan 2017-2020. Further details on the review will be provided in the *2018 AOB Annual Inspection Report*.

Diagram 2

### New Criteria for Registration with the AOB – Project Timeline

#### Jan–Jun 2018

In-depth review conducted on the AOB's existing registration criteria which considers:

- The AOB's experience and inspection findings to date; and
- Jurisdictional study and experience of other established audit regulators.

#### Jul 2018

Engaged with the audit profession e.g. Dialogue with Professional Bodies.

#### Aug 2018

Announced the New Criteria for Registration during the annual AOB Conversation with Auditors of PIEs and Schedule Funds.

#### Jan 2020

- New Criteria for Registration with the AOB is fully effective; and
- All audit firms and individual auditors seeking registration or are registered with the AOB are expected to fully comply with the New Criteria for Registration.

The New Criteria for Registration took effect on **16 August 2018**. However, audit firms and individual auditors who were already registered with the AOB as at 16 August 2018 are given an extension until **1 January 2020** to ensure compliance with these new requirements.

Following the review, which incorporated input from the audit profession, the AOB announced the New Criteria for Registration at the annual AOB Conversation with Auditors of PIEs and Schedule Funds on 16 August 2018. To address the above concerns, the criteria below are designed to enable audit firms in Malaysia to further grow and increase their capacity for the purpose of strengthening audit quality and achieving the desired outcomes:

#### Improvement of the audit firms' internal capacity

A **minimum of three audit partners in the audit firm must be registered** with the AOB for audits of PIEs and schedule funds

#### Strengthening audit firms' governance over their audit partners

An audit firm registered with the AOB shall ensure that all its **audit partners registered with the AOB are attached to only one audit firm at all times**. A person who applies for registration with the AOB must be an audit partner attached only to one audit firm unless otherwise exempted by the AOB

#### Greater accountability among audit firms over the EQCR process

The **EQCRs** 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

#### Continued involvement in PIE or schedule fund audit clients

The **continued registration** of an audit firm with the AOB is **subject to the audit firm having at least one PIE or schedule fund audit client in the last 24 months**

## STRENGTHENING THE FOCUS ON RISK-BASED INSPECTIONS

In accordance with Section 31V(1) of Part IIIA of the *Securities Commission Malaysia Act 1993* (SCMA), the AOB conducts regular inspections on auditors of PIEs and schedule funds with the objective of promoting high quality audits and reliable audited financial statements.

In developing and carrying out its inspection programme, the AOB adopts a risk-based approach that takes into consideration the impact of an audit failure to the capital market and public confidence.

Further details on the inspection programme including common inspection findings, trend analysis and remediation efforts taken by the inspected audit firms will be presented separately in the *2018 AOB Annual Inspection Report*.

Diagram 3

### 2018 Inspection Coverage

#### 6 Major Audit Firms



#### 7 Other Audit Firms



## 2018 Inspection Highlights

- Conducted regular inspections with a focus on the following economic trends, market concerns and developments in audit, accounting and regulatory areas:
  - The second year implementation of the *New and Revised Auditor Reporting Standards* which became effective for audits of financial statements with financial periods ending on or after 15 December 2016;
  - PIEs with going concern issues; and
  - Utilisation of Data Analytics (DA) tools by the Big-Four Audit Firms.
- Increased the number of special inspections to respond to risks that were newly identified during 2018.
- Actions taken in 2018 included:
  - Imposed additional registration conditions on an inspected audit firm and 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 failure and potential impact to the capital market;
  - Specific remedial measures imposed on certain inspected audit firms and individual auditors; and
  - Referrals of certain inspected audit firms and individual auditors including EQCR partners to the Enforcement Department due to the severity of inspection findings.
- Issuance of the inaugural *2017 AOB Annual Inspection Report* and subsequently the distribution to all PLCs in an effort to facilitate and enhance the communication and engagement between Boards of Directors and/or Audit Committees and their auditors. The AOB strongly encourages Boards of Directors and their Audit Committees to gain an understanding and discuss the findings as well as trends shared in the report with their respective auditors to ensure that risk areas specific to its entities are adequately addressed.



## FOCUSED AND IMPACTFUL ENFORCEMENT OUTCOMES

For the very first time in 2018, the AOB imposed prohibitions against auditors for failing to carry out their role as EQCR partners effectively and withdrew the recognition of a recognised foreign audit firm and individual auditor.

The EQCR partner plays an important role in the quality control process of an audit and is key to safeguarding audit quality. The action on the EQCR partners reinforces the gatekeeping responsibility in an audit engagement.

The enforcement actions imposed commensurated with the nature and severity of the matter. The AOB imposed stricter actions in cases of multiple instances of failures to perform audit procedures, failure in key audit areas, failure to co-operate and provide accurate and timely information to the SC, failure to remain fit and proper, and failure to comply with ethical standards.

In determining the appropriate enforcement action, the AOB considers the desired outcome it seeks to achieve. To mitigate any risk of future failures in the capital market, the AOB imposed prohibition on its registered auditors and audit firms from auditing any PIEs or schedule funds and/or accepting as clients any PIEs and schedule funds. This includes situations where the AOB has observed the lack of capacity and capabilities with the audit firm and/or auditor which may have an impact on the quality of audits of PIEs and schedule funds. The duration of the prohibition is determined by the AOB after considering the facts of the case.

Monetary penalties were imposed as a deterrent to send a strong signal to the auditors and stakeholders that non-compliance with auditing standards, laws and regulations are viewed seriously by the AOB.

Diagram 4

### Enforcement actions for 2018



Note: \*Out of 6 Prohibitions, 4 included monetary penalty totalling to RM475,000.  
 #Out of 5 Reprimands, 1 included a monetary penalty of RM225,000.

Diagram 5

## The AOB's enforcement observations

### Firm Review Findings

- Significant compliance gaps in the International Standards on Quality Control (ISQC) 1 elements that compromised the engagement performance quality
- Lack of commitment by the audit firm's leadership to ensure audit quality

### Engagement Review Findings

- Failure to design and perform audit procedures in key audit areas, which included planning and risk assessments, consolidation and multi-location audits
- Lack of professional scepticism during the course of the audit engagement
- Breaches of ethical standards
- EQCR Partner was not effective in the review of the audit engagement

The AOB requires its registrants to remain fit and proper at all times. In 2018, the AOB revoked the registration of an auditor for failing to remain fit and proper. The United States' (US) Public Company Accounting Oversight Board (PCAOB) shared information with the AOB on its enforcement action against the auditor, which among others, included breaches of independence requirement. Independence is fundamental to an audit engagement and the AOB has been very clear with its expectations that breaches relating to ethical standards will not be tolerated.

The recognition of a Singapore-based audit firm and its partner was withdrawn by the AOB for their failure to co-operate with the SC. The audit firm and the partner failed to co-operate with a request for audit evidence in respect of an audit client, a PLC and its subsidiaries, within a prescribed time.

The AOB took to task the audit firm, EP and EQCR partner for findings noted in its engagement

review of three PLCs. The audit firm, EP and EQCR partner were prohibited from auditing the financial statements of a PIE or schedule fund for nine months. In addition, the EP and the audit firm were fined RM81,000 and RM227,000 respectively.

Similarly, enforcement actions were taken by the AOB against another audit firm, EP and EQCR partner for failures noted in its inspection in respect of a PLC. The audit firm, EP and EQCR partner were prohibited from accepting as audit clients any PIEs or schedule funds, and prohibited to audit any PIEs or schedule funds for 12 months. The audit firm and EP were also imposed with a monetary penalty of RM123,000 and RM44,000 respectively.

The AOB imposed five reprimands for failure to comply with certain requirements of the *International Standards on Auditing* (ISAs). One of the reprimands included a monetary penalty of RM225,000.

## Strategic Enforcement

The AOB's enforcement function is a vital component of its mission to promote confidence in the quality and reliability of audited financial statements of PIEs and schedule funds in Malaysia. Its enforcement actions are not just about taking registrants to task for non-compliances but also used to deter others from engaging in similar behaviour.

Diagram 6

### The AOB's Regulatory Principles

#### Proportionality

The AOB does not take any action that exceeds what is required to achieve the objective of strategic enforcement

#### Efficiency

The AOB is mindful that to have the necessary impact, the matter has to be dealt with in a timely manner

#### Achieving the desired outcome

The AOB focuses on identifying and prioritising efforts in taking enforcement actions that will effectively steer the AOB registered and recognised auditors' behaviour towards its expectations of behaviour and conduct

### Enforcement Goals

- Mitigate the risk of future failures
- Send a strong signal that non-compliance with auditing standards, ethical standards, laws and regulation will be taken seriously
- Positively influence behaviour of the firm and individual auditor in breach
- Ensure consistency in the regulatory actions taken by the AOB

## EFFECTIVE COMMUNICATION AND COLLABORATION WITH STAKEHOLDERS

The quality of financial reporting is a shared responsibility among directors, management, auditors, and regulators. In 2018, the AOB continued to reach out to a wide cross section of stakeholders.

The AOB's ongoing involvement and contribution at global and regional levels through the International Forum of Independent Audit Regulators (IFIAR) and the ASEAN Audit Regulators Group (AARG) facilitated mutual sharing of valuable insights into audit regulatory best practices. The AOB shared the Malaysian trends and good practices observed from the AOB, MIA and ACCA joint study on the *Enhanced Auditors' Report: A Review of First-Year Implementation Experience in Malaysia* launched in January 2018. The AOB also subsequently shared its experience with fellow regulators interested to conduct similar studies in their respective jurisdictions.

### Diagram 7

#### The AOB's capacity building and collaborative efforts in 2018

##### Directors and management

- Worked closely with the SC's Corporate Surveillance Department and Bursa Malaysia to engage directors and management of PLCs as well as share key concerns and findings noted during the AOB's inspections

##### Auditors

- Continued to share the AOB's regulatory expectations and common inspection findings through speaking engagements and at the annual AOB Conversation with Auditors of PIEs and Schedule Funds
- Engaged with the audit profession to identify solutions to address common inspection findings, e.g. through Dialogue with Professional Bodies

##### Regulators

- Increased co-operation with the Accountant General's Office to strengthen Malaysia's audit licensing process
- Participated in a regional roundtable discussion to contribute views and regulatory concerns from the AOB's experiences in relation to the consultation paper, *Strengthening the Governance and Oversight on the International Audit-Related Standard Setting Boards in the Public Interest*, issued by the Monitoring Group<sup>1</sup>
- Shared key audit oversight and regulatory experiences with other foreign authorities such as the Ministry of Finance of the People's Republic of China, the Audit Oversight Board of Pakistan and the Capital Markets Authority of Saudi Arabia

<sup>1</sup> The Monitoring Group consists of the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Supervision (BCBS), the European Commission (EC), the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS), the World Bank Group (WBG) and IFIAR.

## 2018 KEY STAKEHOLDERS ENGAGEMENT AT-A-GLANCE

25 JANUARY 2018

### The AOB-MIA-ACCA Joint Study on Enhanced Auditors' Report: A Review of First-Year Implementation Experience in Malaysia

The AOB, MIA and the ACCA jointly issued the *Enhanced Auditor's Report (EAR) – A Review of First-Year Implementation Experience in Malaysia*. The study explored the impact of the first generation of EAR issued in Malaysia, focusing on auditors' communication with audit committees and the perceptions as well as behaviour of investors.

Results of the study were based on the review of the EARs and annual reports of 190 companies listed on Bursa Malaysia with financial periods ended 31 December 2016. It also included survey and focus group feedback from over 170 audit committee members and investors.

Key findings:

- Audit committee discussions on financial reporting risks with auditors and management are more focused and robust, putting audit committees in a stronger position to ensure accountability on behalf of the investors;
- The audit process has been strengthened through more visible audit partner involvement in discussions with audit committees due to the need for in-depth deliberation and discussion of Key Audit Matters (KAMs) in particular;
- Management teams are taking greater efforts to improve disclosures in annual reports, following discussions on KAMs; and
- The EARs have improved the relevance and value of the auditors' report. Investors have gained insights into the financial reporting risks of the companies invested in and the audit process.



The full report is available on the SC website.

30 JANUARY 2018

### Monitoring Group Roundtable on the Governance of Audit-Related Standard Setting Boards

The AOB shared its regulatory experiences and views on the Monitoring Group's consultation paper, *Strengthening the Governance and Oversight on the International Audit-Related Standard Setting Boards in the Public Interest*, at a global roundtable discussion hosted by the Singapore's Accounting and Corporate Regulatory Authority (ACRA).

20–22 FEBRUARY 2018

### 12<sup>th</sup> IFIAR Inspection Workshop

The AOB facilitated a session and jointly shared insights into the experiences, trends and best practices observed from the first-year implementation experience of EARs in Malaysia and Singapore at the 12<sup>th</sup> IFIAR Inspection Workshop hosted by the Sri Lanka Accounting and Auditing Standards Monitoring Board. The session also included experience sharing from the UK and Switzerland audit regulators. The annual workshop was attended by over 110 participants representing 40 audit regulators worldwide.

11 APRIL 2018

### The AOB's Engagement with MIA

The AOB highlighted common findings and trends during its inspection of audit firms and individual auditors with MIA.

16–19 APRIL 2018

### IFIAR Annual Plenary Meeting

During the IFIAR 2018 Plenary Meeting hosted by the Canadian Public Accountability Board in Ottawa, Canada, the AOB co-hosted a session and shared insights into the experiences, trends and best practices observed from the first-year implementation experience of EARs in Malaysia.

19 JULY 2018

### AOB Dialogue with the Professional Accountancy Bodies

The AOB organised a dialogue with professional accountancy bodies in Malaysia such as MIA, the Malaysian Institute of Certified Public Accountants (MICPA), Certified Practising Accountant (CPA) Australia, ACCA and the Institute of Chartered Accountants in England and Wales (ICAEW).

The dialogue provided an avenue for discourse on the key observations and concerns from the AOB's inspections among the professional accountancy bodies who were then able to discuss and agree on the best way forward towards improving audit quality in Malaysia. Their views were incorporated into the New Criteria for Registration with the AOB.

The professional accountancy bodies were also urged to consider and convey the AOB's concerns when organising capacity building activities and opportunities for their respective members. The AOB continues to welcome invitations to speak and share its regulatory experiences and expectations at events organised for relevant stakeholders.

31 JULY–1 AUGUST 2018

### 2018 AARG Inspection Workshop

The AOB shared Malaysia's regulatory updates and EAR implementation experiences and observations, as well as presented and facilitated discussions on challenges in the audits of judgmental and complex areas at the 2018 AARG Inspection Workshop in Jakarta hosted by the Finance Professions Supervisory Centre, Indonesia.

Regulators from 11 countries and representatives from IFIAR, the International Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants attended the annual regional workshop.

31 JULY–1 AUGUST 2018

### 2018 AARG Meeting with the Audit Firms

Following the AARG Inspection Workshop, the AOB was also involved in the annual 2018 AARG Meeting with the Big-Four Audit Firms. The one-on-one meetings were held between AARG and the leaderships of the Big-Four Audit Firms from Malaysia, Indonesia, Thailand and Singapore. Topics of discussion included key developments of the audit firms and the initiatives to improve audit quality, impact of audit innovations and technology to the firms, and audits of cryptocurrency.

16 AUGUST 2018

### AOB Conversation with the Auditors of PIEs and Schedule Funds

The AOB organised the annual AOB Conversation with the Auditors of PIEs and Schedule Funds which was attended by the leadership and representatives from all AOB-registered audit firms.

Insights into the inaugural *2017 AOB Annual Inspection Report* as well as common inspection findings from audit firms and engagement level reviews were shared. Other highlights included sharing of developments in auditing standards and regulations, and an overview of recent enforcement actions taken by the AOB.

The AOB also announced the enhanced AOB registration framework and New Criteria for Registration with the AOB.



19 OCTOBER 2018

### Modernising ISA 315 – Key Revisions

As a panellist during the discussion organised by MIA, the AOB shared its views on the proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*. The session aimed to create awareness and seek feedback from MIA members regarding the proposed key revisions to ISA 315 (Revised).