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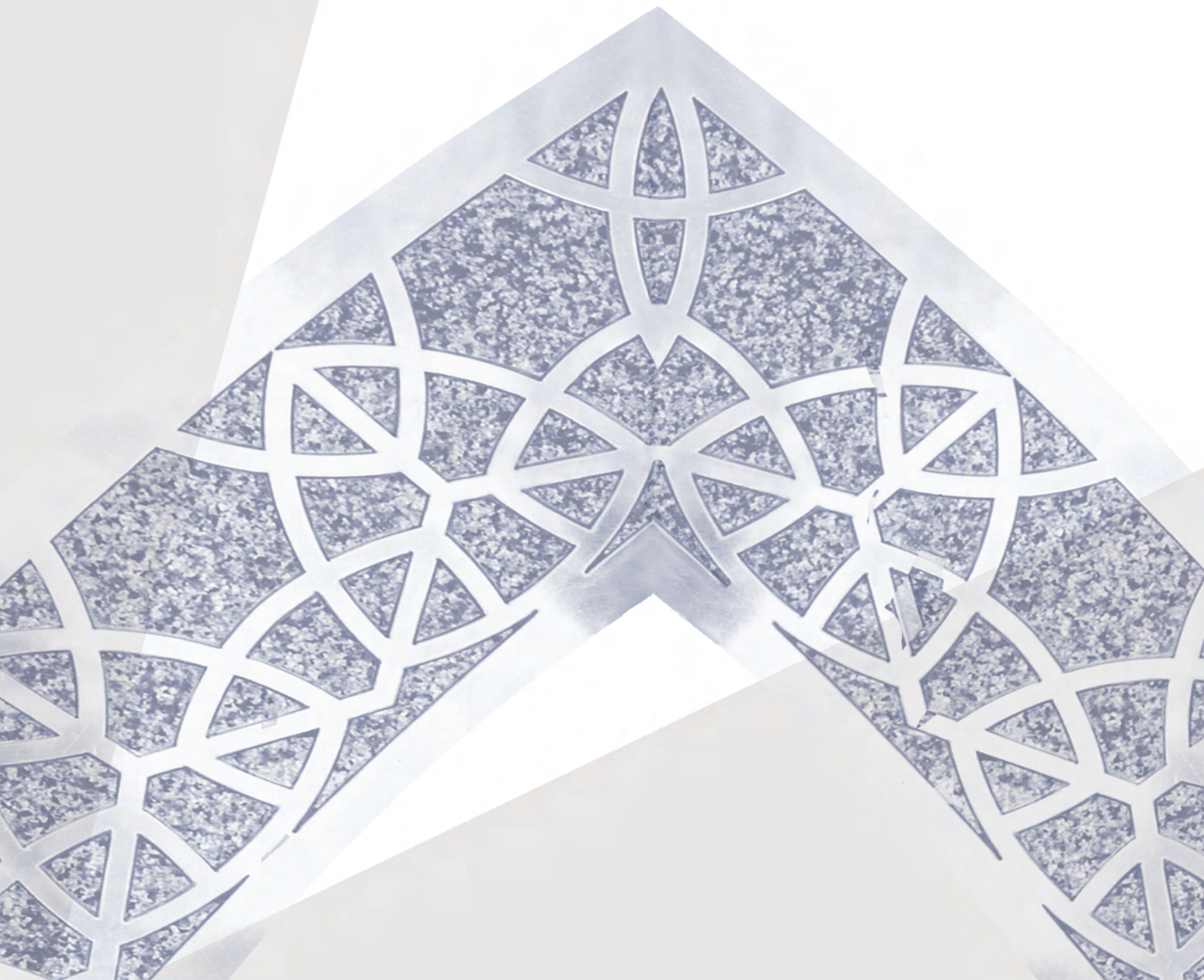
Audit Oversight Board annual report 2012



Suruhanjaya Sekuriti
Securities Commission
Malaysia

Mission Statement

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



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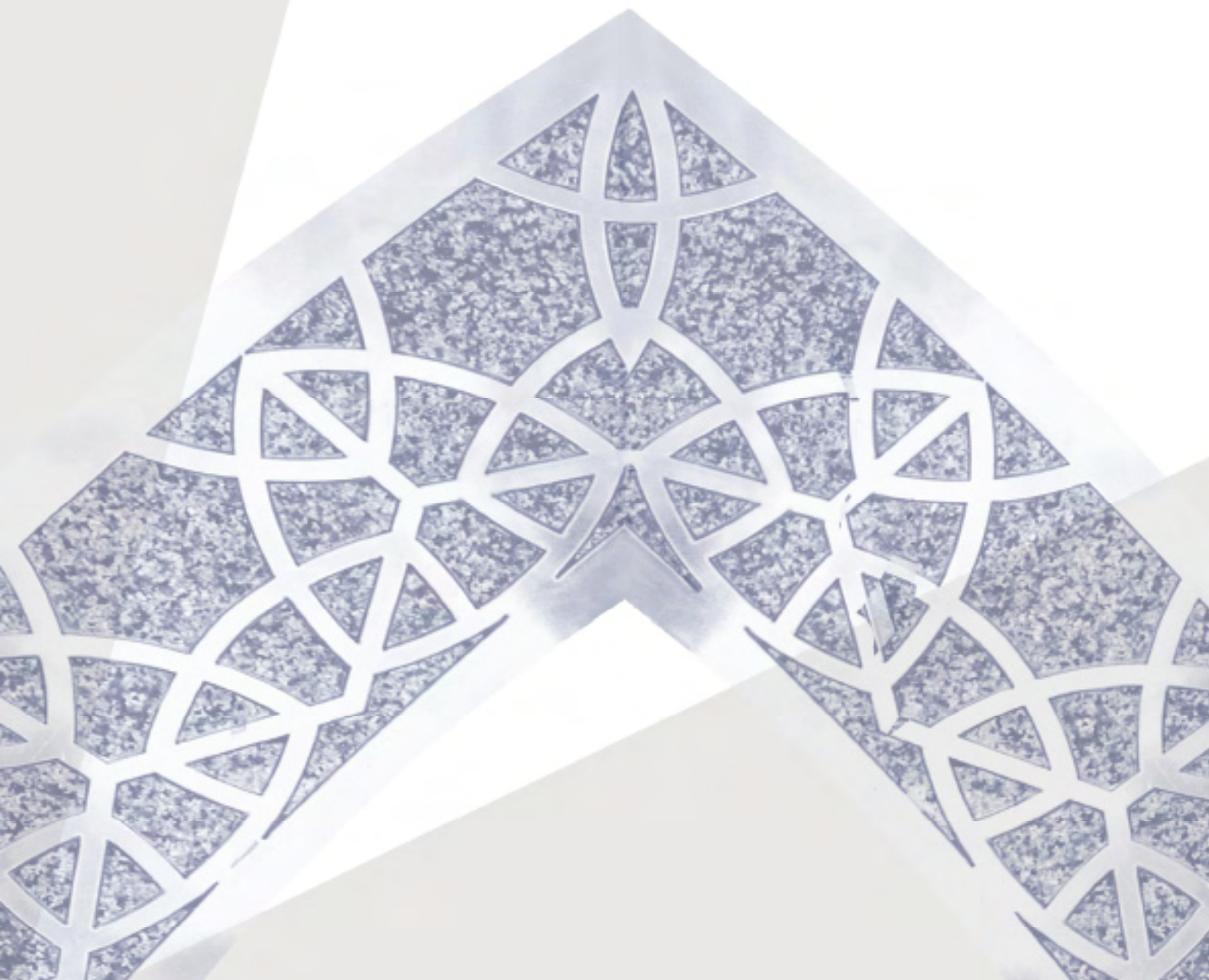
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Executive Chairman's Message



Executive Chairman's Message



I am pleased to report on the Audit Oversight Board (AOB)'s activities for the year 2012. As the attainment of our mission required us to address several key issues in the financial reporting ecosystem, we were involved in numerous activities which included many stakeholders, domestically and from abroad.

As we entered our third year of operation, we observed an increasing trend in the demand for audit quality and efforts to enhance audit quality in our market.

Recognition of our regulatory framework

Accountants and auditors play important roles in influencing the quality of financial reporting and auditing. Apart from a strong accounting profession, a solid and robust regulatory framework with respect to accounting and auditing is an important feature of a developed capital market. The level of compliance with internationally-recognised standards and codes in accounting and auditing reflects the strength and robustness of the regulatory framework.

An assessment on Malaysia's compliance with standards and codes in accounting and auditing was conducted by the World Bank. Through its Report

on the Observance of Standards and Codes on Accounting and Auditing (ROSC AA) the World Bank notes that the Malaysian accounting and auditing profession is well developed and the accounting and auditing standards are in line with international standards.

Further, ROSC AA recognises that the institutional framework of corporate financial reporting by public interest entities (PIEs) in Malaysia is well developed with multiple layers of systematic control, review and enforcement including the role of the AOB in ensuring and enforcing compliance with auditing and ethical standards by PIE auditors.

While such recognition is a testimony of the level of the maturity of our accounting profession and the robustness of our regulatory framework, more needs to be done to ensure we move in tandem with other markets. This is to ensure confidence and investor protection through high quality financial reporting and audit.

The report also recognises the importance of the roles played by all components of the financial reporting ecosystem such as directors, regulators and auditors in ensuring the quality of our corporate reporting, remained respectable.

Global efforts in improving auditor reporting

In 2012, the International Auditing and Assurance Standard Boards (IAASB) issued an Invitation to Comment: Improving the Auditor's Report (ITC). The ITC sets out the IAASB's indicative direction proposed for the future auditor's report. Among the key proposals in the ITC were 'Auditor Commentary' where an auditor provides additional information highlighting matters that, in the auditor's judgement, are likely to be most important to users' understanding of the audited financial statements or the audit; auditor conclusion on the appropriateness of management's use of the going concern assumption in preparing the financial statements and an explicit statement as to whether material uncertainties in relation to going concern have been identified. The AOB was invited to present its views at the roundtable held in Kuala Lumpur on 8 October 2012.

The AOB supports the initiative to enhance auditor reporting and addresses the information gap between the auditor and the reader of the auditor report. The AOB believes that audit quality and auditor reporting are equally important where the former is about the reliability of the audit opinion while the latter is about how such opinion is communicated.

Further progress in this area would certainly influence financial reporting and the practice of audit, moving forward.

The need to address root causes of audit deficiencies

The AOB continued to inspect both Major Audit Firms and Other Audit Firms to assess their audit practices and their level of compliance with relevant standards.

While the AOB observed remediation efforts by audit firms to address our concerns on the quality of their practices and audit work, such efforts would be more effective if the root causes of the deficiencies were correctly identified and addressed.

This stand is consistent with the first global survey of audit inspection findings summarising issues identified by International Forum of Independent Audit Regulators (IFIAR) members located around the world which suggests that more need to be done to improve the consistency of performance by auditors.

Many national audit inspection bodies which responded to the survey also noted that a lack of auditors' professional scepticism on audit engagements was a significant performance issue as well as a possible cause underlying many inspection findings.

The AOB expects audit firms to accept the need to remediate by identifying the actual root causes of the deficiencies, develop and implement appropriate remedial actions, ensure effectiveness of the outcome of the remedial actions and its sustainability.

In this respect, audit firms must ensure their self-governance mechanisms to be forcefully applied to improve quality across the audit firms. The AOB will intensify its oversight over audit firms' remediation efforts and will not hesitate to take appropriate enforcement actions if significant improvements are not observed.

Enforcing standards

The focus of the AOB's oversight efforts has always been on audit firms performance and their efforts to strengthen their internal quality control process

to enable them to maintain consistent high quality audit. Deficiencies noted during audit inspection and other oversight activities were normally addressed through remediation by audit firms. However, when the deficiencies were serious, enforcement actions were taken.

In 2012, the AOB took two enforcement actions against two auditors for their failures to comply with the relevant standards and rules in the performance of their audits. While we believe most firms are already serious in ensuring their audit opinion is based on sufficient and appropriate audit evidence, the enforcement actions provided a clear message that the AOB would not hesitate to act when public confidence on the reliability of their audit reports could be compromised.

Global co-operation in audit oversight

Given that trade continued to be more globalised and regionalised, the quality of financial reporting has increasingly been influenced by the financial reporting practices across the countries and jurisdictions in which the businesses were operating. In this respect, audit quality has also been influenced by the collective performance of auditors who operated across these borders.

The AOB continued to be involved with the activities of IFIAR and the Association of Southeast Asian Nations (ASEAN) Audit Regulators Group (AARG). This has

allowed AOB to build strong relationship with other regulators and share experience and information with them in enhancing our audit oversight activities. We entered into a memorandum of understanding with the Japan Financial Services Authority (JFSA) and the Certified Public Accountants and Auditing Oversight Board of Japan (CPAAOB) to enhance co-operation and exchange of information.

Closing

The AOB welcomed Datuk Gumuri Hussain and Mohd Naim Daruwish to our board early this year. They joined the other board members who had provided their counsel, guidance and support in ensuring the AOB continued to progress towards fulfilling its mission. We continued to work closely with other regulators and stakeholders who shared the same aim of enhancing the quality and reliability of financial statements and auditors reporting. I wish to thank all of them and trust more contribution and support will be offered in the future.

The dedicated staff of the AOB have demonstrated their commitment in ensuring we progressed based on the strategy adopted. I would like to acknowledge their efforts and contributions. The AOB will continue to aim for better achievements, moving forward.



Nik Mohd Hasyudeen Yusoff

OVERVIEW OF AOB'S STRATEGIES

The AOB aims to achieve the following desired outcomes:

- High quality financial reporting practices by PIEs
- Resourceful and high quality audit practices
- Independent and high quality audits
- High quality and reliable audited financial statements
- Enhanced confidence in audited financial statements

The AOB has adopted a strategic framework which links the service areas and activities of AOB to the desired outcomes which manifest the attainment of its mission. The strategic framework has four strategic themes, which are:

- Support adoption and implementation of standards
- Promote high quality audit practices
- Influence financial reporting ecosystem
- Leverage on stakeholders' support

Support adoption and implementation of standards

Auditing and ethical standards provide the baselines for high quality independent auditing to be achieved. In this respect, the AOB pursues the following goals:

- Ensure no significant gaps
- Promote substance over form implementation
- Facilitate the implementation of standards among audit firms

Promote high quality audit practices

Our key oversight activities such as registration, inspection and inquiry are aimed at ensuring audit firms and individual auditors are committed to delivering high quality independent audits while achieving their business objectives. Towards this, the goals pursued under this theme are:

- Enforce registration policy that promotes quality and capacity
- Drive quality audit practices through inspection and remediation of auditors
- Set the tone for quality through enforcement actions

Influence financial reporting ecosystem

High quality financial reporting would only be achieved if all the key components in the financial reporting ecosystem are effective in playing their respective roles. Understanding this, the AOB would also focus on influencing other important stakeholders to ensure audit quality remains high on their business agenda. The goals pursued are:

- Increase collaboration among stakeholders in the financial reporting ecosystem
- Promote research and discourse on audit quality

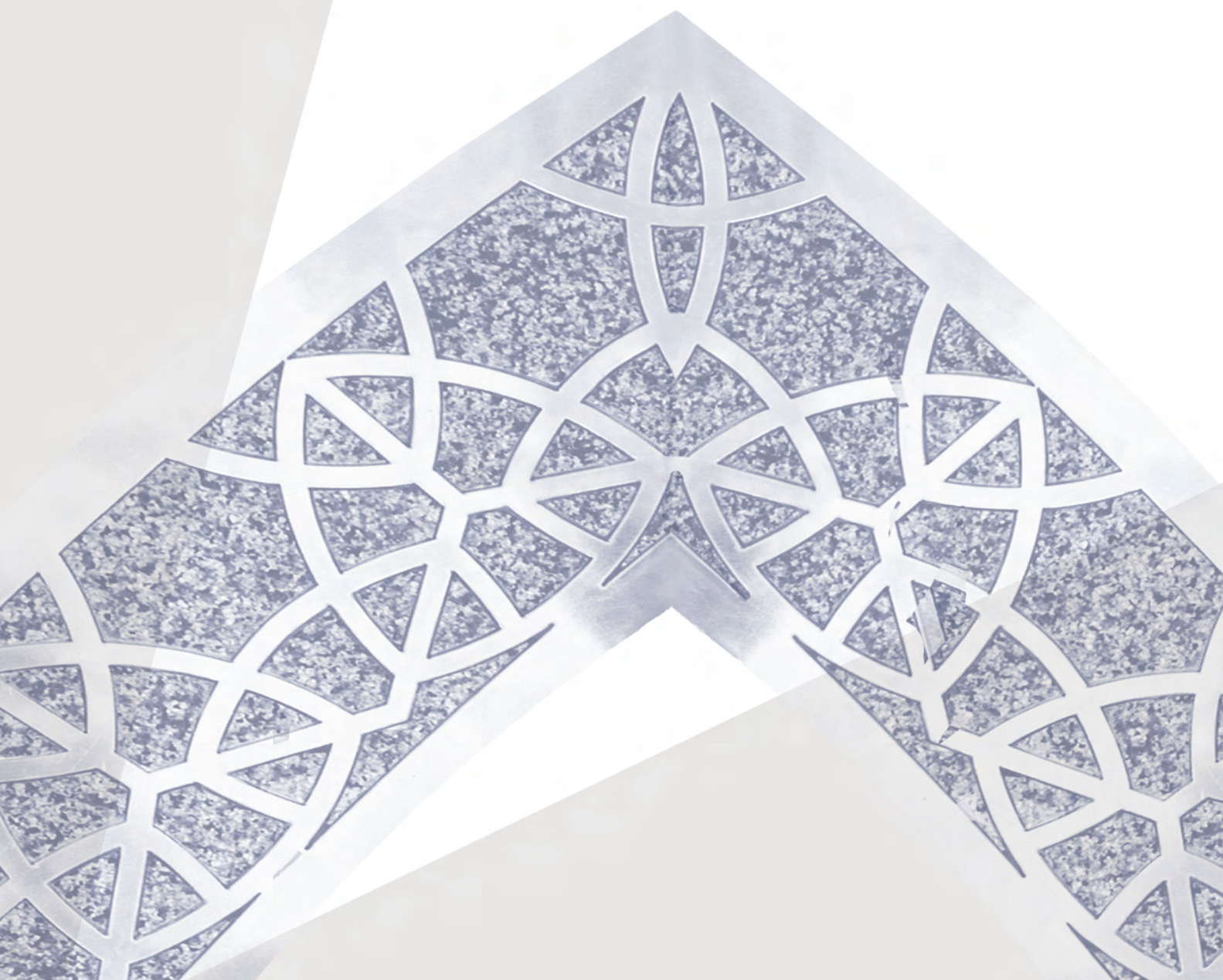
Influence Leverage on stakeholders' support

The effectiveness of the AOB would be enhanced if it could leverage on efforts of other stakeholders who share the same interest in enhancing the quality of financial reporting of PIEs. This includes co-operating with international counterparts as auditing itself has become a global affair. The AOB aims to achieve the following goals:

- Enhance the co-ordination of activities with other authorities in Malaysia and abroad
- Participate in international activities to gain knowledge and experience and promote confidence in Malaysian audit quality
- Obtain higher financial support from stakeholders

Part One

Support Adoption and Implementation of Standards



SUPPORT ADOPTION AND IMPLEMENTATION OF STANDARDS

RECOGNITION OF THE MALAYSIAN FINANCIAL REPORTING AND AUDITING FRAMEWORK

In February 2012, the World Bank released its ROSC AA which recognises that the institutional framework of corporate financial reporting by PIEs in Malaysia is well developed with multiple layers of systematic control, review and enforcement. These include the role of the AOB in ensuring and enforcing compliance with auditing and ethical standards by PIEs auditors.

Overall, the report acknowledges that Malaysia had adopted and implemented the clarified International Standards on Auditing (ISA) and the International Standards in Quality Control (ISQC1).

While the overall regulatory and enforcement regime for PIEs is well developed, the ROSC AA raises concerns over the ability of small audit firms to fully comply with the clarified ISA and ISQC1.

The ROSC AA further recommends certain areas to be reviewed or improved towards further strengthening of the regulatory framework in what is already a strong and cohesive financial reporting and auditing system in Malaysia. Among those areas are:

- Whether the requirements for all companies to be audited needs to be replaced with a statutory audit exemption regime;
- The need to enhance the financial reporting standards for private entities;
- An independent review of the governance structure of the Malaysian Institute of Accountants (MIA) should be conducted; and
- MIA admission criteria and quality assurance process on the university degree programmes recognised by MIA need to be reviewed and enhanced.

TRACKING THE DEVELOPMENT AND IMPLEMENTATION OF STANDARDS

The continued participation as an observer in the MIA Auditing and Assurance Standards Board (AASB) meetings has provided the AOB with insights into how the profession views specific and emerging issues faced by auditors. It also provided the AOB with the opportunity to provide its views on those matters. The following were the key activities of AASB in 2012:

- Adoption, withdrawal and implementation of IAASB pronouncements in Malaysia which included the adoption of ISA 610 (Revised) *Using the Work of Internal Auditors*, ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, the new International Standards on Assurance Engagements (ISAE) 3410 *Assurance Engagements on Greenhouse Gas Statements* and ISAE 3420 *Assurance Engagements to Report on Compilation of Pro Forma Financial Information Included in a Prospectus* and publication of International Auditing Practise Note (IAPN) 1000 *Special Considerations in Auditing Financial Instruments*.
- The Recommended Practice Guide No. 11 – *Auditor's Report on Financial Statements Prepared In Accordance With the Malaysian Financial Reporting Standards (MFRS) Framework* was issued in 2012.
- The AASB participated in a number of IAASB activities including the IAASB Roundtable on Improving the Auditor's Report held in Kuala Lumpur and provided comments on the consultation on the same issue.

revised auditor's report that illustrates the application of the IAASB's suggested improvements. The ITC also provides the IAASB's rationale for the suggested improvements, together with a discussion of their potential value and impediments, and in what areas feedback is sought.

Among the key proposals in the ITC were:

- Additional information in the auditor's report to highlight matters that, in the auditor's judgement, are likely to be most important to users' understanding of the audited financial statements or the audit, referred to as "Auditor Commentary";
- Auditor conclusion on the appropriateness of management's use of the going concern assumption in preparing the financial statements and an explicit statement as to whether material uncertainties in relation to going concern have been identified; and
- Auditor statement as to whether any material inconsistencies between the audited financial statements and other information have been identified based on the auditor's reading of other information, and specific identification of the information considered by the auditor.

CONTRIBUTING TO THE FUTURE OF AUDITOR REPORTING

As a follow up to its consultation paper issued in May 2011 in exploring the options for improvements in auditor reporting, the IAASB issued an Invitation to Comment: Improving the Auditor's Report (ITC). The ITC sets out the IAASB's indicative direction proposed for the future auditor's report. The ITC features a

To further inform this important initiative to the stakeholders, the IAASB held three global roundtables in New York, Belgium and Kuala Lumpur. The AOB was invited to present its views at the roundtable held in Kuala Lumpur on 8 October 2012.

The AOB supports the initiative to enhance auditor reporting and address the information gap between the auditor and the reader of the auditor report.

The AOB believes that audit quality and auditor reporting are equally important where the former is about the reliability of the audit opinion while the latter is about how such opinion is communicated.

While the AOB agrees that auditors should say more regarding the work performed, sufficiency and appropriateness of audit evidence obtained, key judgements made and the overall conclusion of the audit, auditors should not be required to report on matters which are within the purview of those charged with governance.

The introduction of auditor commentary provides the opportunity for auditors to communicate more about their audit, especially regarding areas which require more attention from the readers. While the IAASB should not be too prescriptive on how auditors should go about doing this, some sort of broad guidance may be necessary to avoid the usage of boilerplates, which will reduce the value of the enhanced reporting model.

The AOB sees the merit of having legal and governance frameworks supporting the performance of high quality audit which is the basis of reliable and relevant auditor reports. Other stakeholders, including the investor community should also be more involved to create an environment that demands, supports and rewards high quality audit.

GLOBAL INITIATIVES IN REFORMING THE AUDIT MARKET AND PRACTICES

There were a number of ongoing global efforts in reforming the audit market towards achieving better audit quality. These following developments would

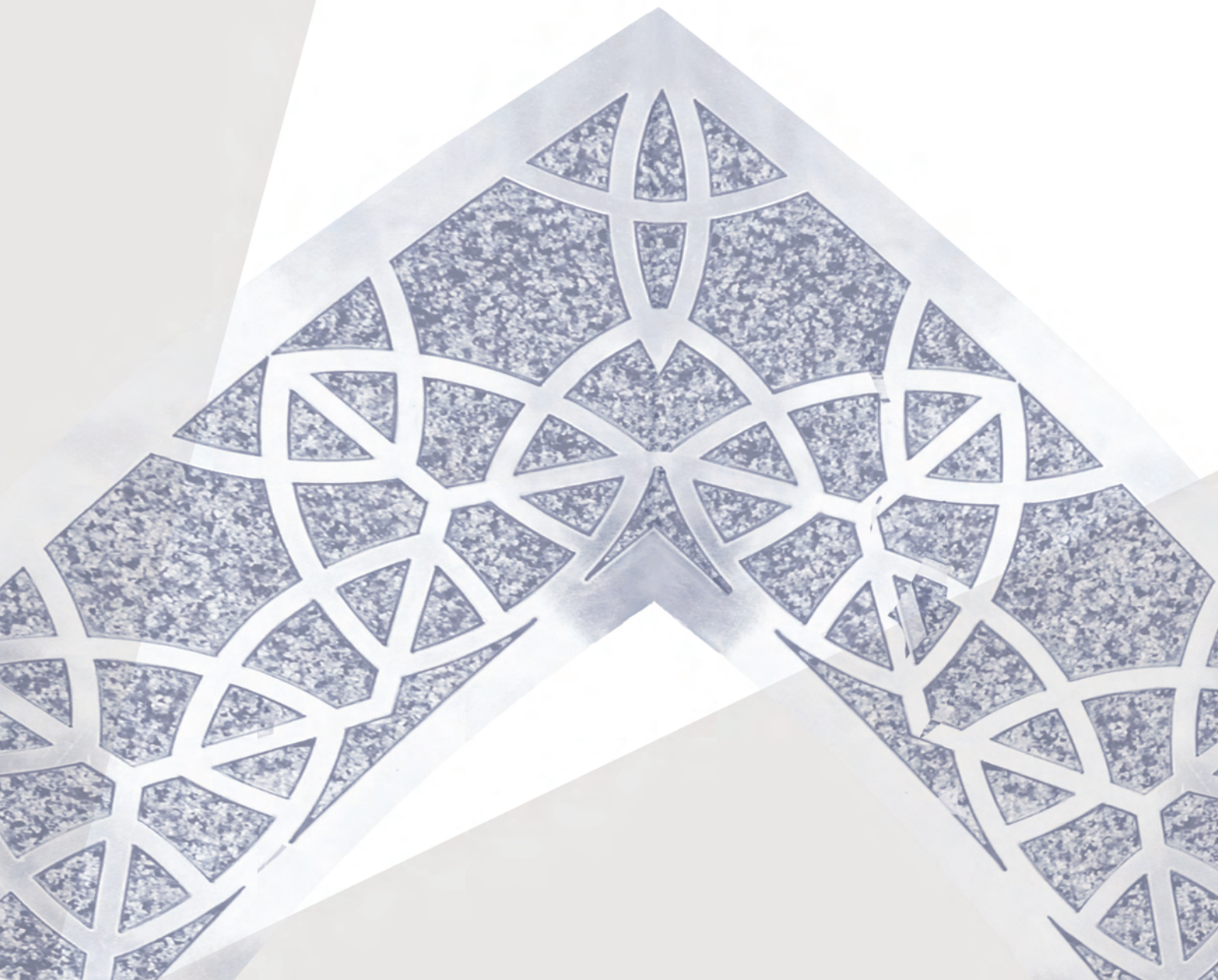
influence standards and practices governing audit and the audit market, moving forward:

- Although the European Commission issued proposals to enhance regulation of the audit of PIEs in November 2011, a final decision has yet to be decided. As the proposals included some radical changes such as mandatory rotation of audit firms, mandatory tendering and prohibition of audit firms from providing non-audit services to their audit clients, the final outcome would certainly alter the audit landscape in Europe;
- The Public Company Accounting Oversight Board of the United States (PCAOB) continued to pursue the issue of auditor independence and rotation of audit firms. It held a number of public meetings to solicit views from stakeholders on the further strengthening of auditor independence, hence improved audit quality; and
- The Competition Commission of United Kingdom has been considering whether the domination of the Big Four accounting firms is restricting the competition in the UK audit market for listed companies. The Commission held hearings with the main parties involved. This was the follow up to the Office of Fair Trading investigation amid the growing concern about the dominance of the four main audit firms, which audit all but one of the constituents of the FTSE100.

The AOB will continue to monitor the above developments and decide the necessary course of action to be taken.

Part Two

Promote High Quality Audit Practices



PROMOTE HIGH QUALITY AUDIT PRACTICES

REGISTRATION OF AUDIT FIRMS AND INDIVIDUAL AUDITORS

The AOB continued to influence audit practices through its audit oversight activities primarily through its registration, inspection and enforcement functions. The main outcome envisaged was for audit firms to build capacity and quality framework which would enable worthwhile audits to be performed consistently.

In pursuing the outcome, the AOB remained consistent in expecting audit firms to comply with applicable international auditing and quality control standards

adopted by the accountancy profession in Malaysia.

The number of registered audit firms and individual auditors fell slightly in 2012. Some smaller firms decided to exit the market while other firms decided to consolidate their practices. However, the concentration of clients remained with the top 15 audit firms which collectively audit 1,004 PIEs covering 96% of the market capitalisation of public-listed companies (PLC) in Malaysia.

The AOB did not reject any application for registration in 2012.

Table 1

Registration of audit firms and individual auditors as at 31 December 2012

Profile of audit firms	No. of audit firms	No. of individual auditors	No. of PIEs audited	% of market capitalisation
Partnerships with more than 10 partners	6	144	840	94.5
Partnerships with 5 – 10 partners	9	44	164	1.5
Partnerships with 2 – 4 partners	43	96	139	3.9
Sole proprietors	9	9	9	0.1
TOTAL	67	293	1,152	100.0

Table 2

Registration statistics: Comparison between 2012 and 2011

Profile of audit firms	No. of audit firms (2012)	No. of audit firms (2011)	No. of individual auditors (2012)	No. of individual auditors (2011)
Partnerships with more than 10 partners	6	6	144	138
Partnerships with 5 – 10 partners	9	8	44	38
Partnerships with 2 – 4 partners	43	48	96	108
Sole proprietors	9	13	9	13
TOTAL	67	75	293	297

RECOGNITION OF FOREIGN AUDIT FIRMS AND INDIVIDUAL AUDITORS

As at 31 December 2012, the AOB recognised 14 foreign individual auditors from six foreign audit firms who audited seven foreign incorporated companies which were listed on Bursa Malaysia.

The AOB relied on the oversight frameworks of the foreign auditors' home countries when considering

their recognition. The foreign auditors should be approved or registered with the relevant foreign authorities which exercise similar functions to the AOB. Among the considerations taken into account by the AOB were whether these firms were required to comply with international auditing and quality control standards and whether they were subjected to regular inspection by their home audit regulators.

Table 3

Profile of the foreign audit firms recognised by the AOB

Jurisdiction	No. of audit firms	No. of individual auditors	No. of PLCs audited
Singapore	4	10	5
Hong Kong	1	2	1
United Kingdom	1	2	1
TOTAL	6	14	7

REVIEW OF COMPLIANCE WITH PARTNER ROTATION AND EQCR REQUIREMENTS

The AOB considers compliance with the partner rotation and the Engagement Quality Control Reviewer (EQCR) requirements as among the critical building blocks to ensure the independence of auditors and audit quality. In this respect, the AOB closely monitored the audit firms' compliance with partner rotation rules to ensure that any possible breach of the rule was rectified at the early stage.

In 2012, all audit firms were reminded to ensure compliance with partner rotation rules for all audits of PIE and all EQCR for PIE audit engagements must be registered with AOB.

Seven audit firms did not comply with the partner rotation requirement and were warned for the non-compliance.

These firms had subsequently rectified the non-compliance either by registering a new partner under the firm or not seeking reappointment as the auditor of the PIE concerned. There were cases where other registered partners from other registered audit firms were engaged to act as EQCR.

The AOB also noted that seven audit firms were not able to fully comply with the EQCR requirement and had given their commitment to rectify the situation within the most practicable period of time.

ENFORCEMENT

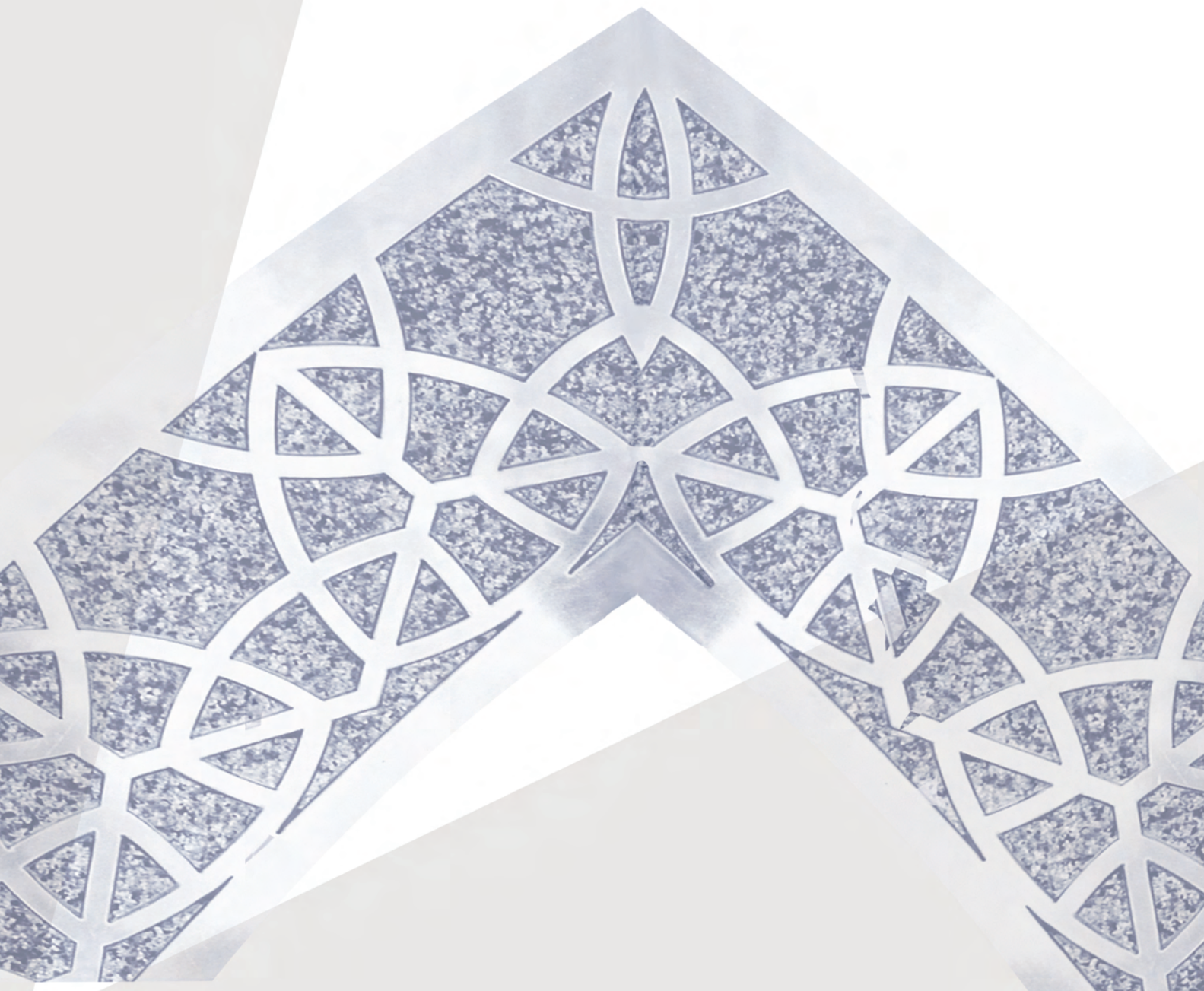
The AOB adopts a strategic enforcement approach whereby the principles of proportionality, efficiency and achieving the desired outcome are considered before any sanction is imposed on any person. In determining the type of sanction that will be imposed on any contravention or breach, the AOB takes into account the nature and seriousness of the offence, previous regulatory record and any other mitigating factors.

In 2012, the AOB sanctioned the following two registered auditors:

- On 12 July 2012, the AOB reprimanded Alvin Tee Guan Pian, a partner of UHY, for his failure to comply with the relevant requirements of the ISA in the performance of an audit of a PIE for the financial year ended 31 July 2010. Alvin Tee Guan Pian appealed to the SC against the decision. On 28 August 2012, the SC decided that the appeal be rejected.
- On 7 November 2012, the AOB reprimanded and imposed a monetary penalty of RM5,000 against Liew Tip Chan of T.C. Liew & Co. for his failure to comply with the MIA By-Laws which are related to independence of auditors and the relevant requirements of ISA in the performance of an audit of a PIE for the financial year ended 31 January 2011.

Part Three

Influence Financial Reporting Ecosystem and Leverage on Stakeholder's Support



INFLUENCE FINANCIAL REPORTING ECOSYSTEM AND LEVERAGE ON STAKEHOLDERS' SUPPORT

THE FINANCIAL REPORTING ECOSYSTEM AND QUALITY OF FINANCIAL REPORTING

High quality financial reporting can only be achieved if all the key components in the financial reporting ecosystem effectively play their respective roles. Recognising this, the AOB undertook activities to influence the relevant stakeholders which were critical in shaping the quality of financial reporting practices and the reliability of audited financial statements of PIEs. The relevant stakeholders included the accounting profession, audit firms, regulators, directors and academicians.

ENGAGING THE ACCOUNTING PROFESSION AND LEADERSHIP OF AUDIT FIRMS

The AOB continued to engage with the leadership of the registered audit firms to discuss among others, the challenges faced by auditors in the industry and issues identified during the AOB's oversight activities.

In this respect, the AOB hosted an industry consultation on the role of the accounting profession in the development of the Malaysian capital market. This industry consultation discussed the steps which need

to be taken in enabling the accounting profession to be more effective in growing and strengthening capital market under the ambit of *Capital Market Masterplan 2* (CMP2).

This industry consultation focused on the roles of accountants in the following three broad areas:

- Capital formation;
- As gatekeepers of financial information; and
- Restructuring of companies.

The dialogues also provided opportunity for accounting professionals and audit firms to share ideas in enhancing quality of the audit practices and playing a greater role to ensure that financial reporting is in compliance with the requirements of the financial reporting standards applicable in Malaysia.

The AOB also participated in the external events to share its views which included conferences and symposiums organised by the MIA, a forum jointly-organised by the Malaysian Institute of Certified Public Accountants (MICPA) and the Institute of Chartered Accountants Australia (ICAA), and conferences organised by the Institute of Bankers Malaysia, the National Audit Department and the Malaysia Anti-Corruption Commission Academy.

In November 2012, the AOB held three dialogue sessions with the registered auditors to obtain feedback on the trend in the industry. The dialogues also served as a platform to share observations and set expectations on remediation activities as well as to continue promoting high quality audit practices. This is in line with the AOB's mission to foster high quality independent auditing to promote confidence in the quality and reliability of audited financial statements of PIEs in Malaysia.

STRENGTHENING RELATIONSHIP WITH OTHER REGULATORS

The AOB continued to enhance collaboration with other regulators, particularly Bank Negara Malaysia (BNM) and the Companies Commission of Malaysia (CCM). The AOB also assisted the SC in areas involving standards, conduct and performance of auditors and shared experience in audit oversight with other regulators.

We also engaged Bursa Malaysia on the issue of recognition of foreign auditors who audit financial statement of foreign corporations listed on Bursa Malaysia, performance of auditors and the role of the directors of the PLCs in ensuring quality financial reporting.

Given the breadth of the financial reporting ecosystem, leveraging on the supervisory and enforcement roles of other regulators minimises duplication of efforts and increases effectiveness of supervision of financial reporting and auditing.

PROMOTING HIGH QUALITY FINANCIAL REPORTING PRACTICES BY LISTED COMPANIES

The AOB continued to engage with directors and members of audit committees of PIEs to promote high quality financial reporting practices. To this end, the AOB participated in several forums discussing topics related to the involvement of directors in financial reporting, which include:

- 'Board Effectiveness: Keeping Pace with Changing Environment' at the Internal Audit Conference 2012 organised by the Institute of Internal Auditors Malaysia (IAAM);
- 'Reflections on Oversight of Auditors of Financial Services Companies' at the ICAA-MICPA Audit Forum with the theme 'Corporate Governance in Financial Services Companies – The Role of the Audit Committee'; Forum on 'Global Business Outlook' organised by MICPA; and
- 'Enhancing the Value of Auditor Reporting-Boosting Confidence in the Capital Market' at the MIA International Accountants Conference; 2012.

We noted that the issue of audit quality had gained traction among the members of audit committees. However, we believe more could be done in ensuring that PIEs would deploy adequate resources to ensure that their financial reporting functions are effective, and able to meet the demand of the standards and market expectations.

SUPPORTING ACCOUNTING EDUCATION

Accounting education is one of the building blocks in enabling high quality financial reporting. Given the fast changing business environment, the need for accounting programmes offered at our higher learning institutions to remain relevant is obvious. The value of these programmes impact the quality of accounting graduates entering the market.

In 2012, the AOB participated in the following events in bridging the gap between practice and academics:

- The National Accounting Educators Symposium organised by the MIA where AOB shared its view of the issue of enhancing and raising the audit quality; and
- Events organised by local higher learning institutions where the AOB shared updates on global audit oversight activities, development in audit practices and matters noted in AOB audit inspections which influence audit quality.

CONTINUED PARTICIPATION IN IFIAR

The participation in IFIAR's activities enables the AOB to understand the developments in the audit oversight globally and develop working relationships with the multi-country audit oversight regulators.

In 2012, the AOB participated in two IFIAR Plenary Meeting held in Busan, Korea and London, United Kingdom.

Among the issues discussed at the Plenary Meetings were–

- current market conditions and findings of recent audit inspections;
- audit policy developments;
- audit quality issues with the Global Public Policy Committee (GPPC); and
- engagements with stakeholders such as investors and other regulatory groupings such as International Organization of Securities Commissions (IOSCO), Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS).

Apart from that, the representative from each country discussed the reports of IFIAR working groups which focused on specific issues relating to auditor oversight.

They consist of–

- Investor Working Group;
- Global Public Policy Committee Working Group;
- Standard Co-ordination Working Group;
- Inspection Workshop Working Group; and
- International Co-operation Working Group.

At the side of the plenary meeting in London, the AOB also attended the International Co-operation Working Group Workshop. The purpose of the workshop was to assist IFIAR members in developing best practices with respect to international co-operation and the sharing of information among regulators.

The AOB also participated in IFIAR's inspection workshop in Abu Dhabi, United Arab Emirates.

IFIAR 2012 Summary Report of Inspection Findings

This is the first global survey of audit inspection findings summarising issues identified by IFIAR. Members who are located around the world. The survey was to identify the level of inspection activity and common inspection findings related to the audits of public companies. The survey also responds to a request from the FSB to provide information regarding findings from the inspections of audits of major financial institutions.

There are common audit findings among members in a number of inspection themes including four that have been discussed by IFIAR with representatives from the six largest international audit firm networks since 2010: professional scepticism, group audits, revenue recognition, and the role of the engagement quality control reviewer.

This survey, however, shows that more needs to be done to improve the consistency of performance by auditors. For example, the survey results confirm that members are noting audit findings in numerous common areas (inspection themes) across the different jurisdictions.

The survey results indicate that the largest number of inspection findings in audits of public companies occurred in the following areas:

- Fair value measurement;
- Internal control testing; and
- Engagement quality control reviews.

Inspections of the audits of major financial institutions revealed that the largest number of common inspection findings occurred in the following areas:

- Internal control testing;
- Valuation of investments and securities; and
- Audit of allowance for loan losses and loan impairments.

Many members who responded to the survey also noted that a lack of auditors' professional scepticism on audit engagements was a significant performance issue as well as a possible cause underlying many inspection findings.

With regard to members' inspections of the audit firms' own firm wide quality control systems, the survey results highlighted concerns with policies and procedures in place to provide the firms with reasonable assurance that—

- audit engagements are performed in accordance with professional standards and

legal requirements;

- the firms have sufficient personnel with the technical competence, capabilities, and commitment to ethical principles necessary to perform audits; and
- the firms and their personnel are in compliance with independence and ethical requirements.

Although members who responded to the survey noted that audit firms have taken remedial actions in response to the members' inspection findings, the frequency of findings across jurisdictions in the various audit areas demonstrates that auditors still need to improve the consistency of their performance. That many findings recurring year after year suggest that audit firms should continue to improve their auditing techniques and their oversight policies and procedures. Audit firms should also take steps to develop a robust root cause analysis to gain a clearer understanding of the factors that underlie the inspection findings and take appropriate actions to remediate those findings.

STRENGTHENING THE ASEAN AUDIT REGULATORS GROUP

As a support to the activities conducted by the AARG, the AOB attended the Inaugural ASEAN Audit Regulators Inspection Workshop held in Singapore in January 2012. Twelve sessions were conducted during the three-day workshop. Among other issues presented were, ISQC1 Reviews, Offsite Monitoring, Peer Rating Process and Technical Updates on the IFRS and International Accounting Standards Board (IASB).

In 2012, the AOB also met with the audit regulators in the ASEAN region, in Singapore. At the meeting, audit regulators from Malaysia, Singapore, Thailand, Indonesia, Laos, Vietnam shared their experiences in their audit oversight activities and discussed issues relating to audit quality and areas for co-operation.

The second meeting of the AARG was held in May 2012 in Kuala Lumpur. At this meeting, the audit regulators from Malaysia, Singapore and Thailand shared information relating to audit oversight activities, the industry's issues and ways to co-operate in enhancing audit quality in ASEAN.

In conjunction with the meeting, the ASEAN Audit Regulators held a dialogue with the leadership of the Big Four Audit Firms from Malaysia, Singapore and Thailand to discuss the challenges faced by the audit firms in the region and their remediation efforts.

Apart from this dialogue session, the AOB hosted the AARG Roundtable Discussion with other related agencies and representative from the Big Four Audit Firms to discuss issues relating to the implementation of the *ISA 600: Special Considerations – Audits of*

Group Financial Statements (Including the Work of Component Auditors).

During the roundtable session, the audit firms shared their challenges in implementing the standards, including the difficulties faced in obtaining information from significant components accounted for under the equity method, especially if their shares are listed. The audit regulators on the other hand shared their findings, obtained through audit inspection in three countries on the application of ISA 600 by the auditors.

The AOB also attended the 2012 Singapore Public Accountants Conference which was organised by Accounting and Corporate Regulatory Authority of Singapore (ACRA).

SHARING EXPERIENCE IN AUDIT REGULATION INTERNATIONALLY

The AOB was involved in sharing its views and experiences at the following international events:

- 6th IFRS Regional Policy Forum with the theme of Convergence and Beyond, Navigating Change in March 2012 – The Executive Chairman moderated in a forum entitled 'Auditing Legislative and Professional Framework'.
- ROSC AA Dissemination Workshop – Organised by the AOB. The Executive Chairman moderated in a discussion session on 'Enhancing the Quality of Private Company Financial Reporting and Auditing', whilst the General Manager and Head of AOB moderated in the discussion

session on 'Towards a Stronger Accounting Profession'. The representatives from the World Bank shared their findings of the ROSC AA with the relevant stakeholders.

The AOB also shared its experiences in audit oversight activities with the Financial Reporting Council of Hong Kong and Accounting Supervision Department of Financial Supervisory Service of Korea.

ENHANCING COLLABORATION WITH OTHER STAKEHOLDERS

The AOB formed an official collaboration in audit oversight with the JFSA and the CPAAOB through an exchange of letter during the International Forum of Independent Audit Regulators plenary meeting in London on 3 October 2012.

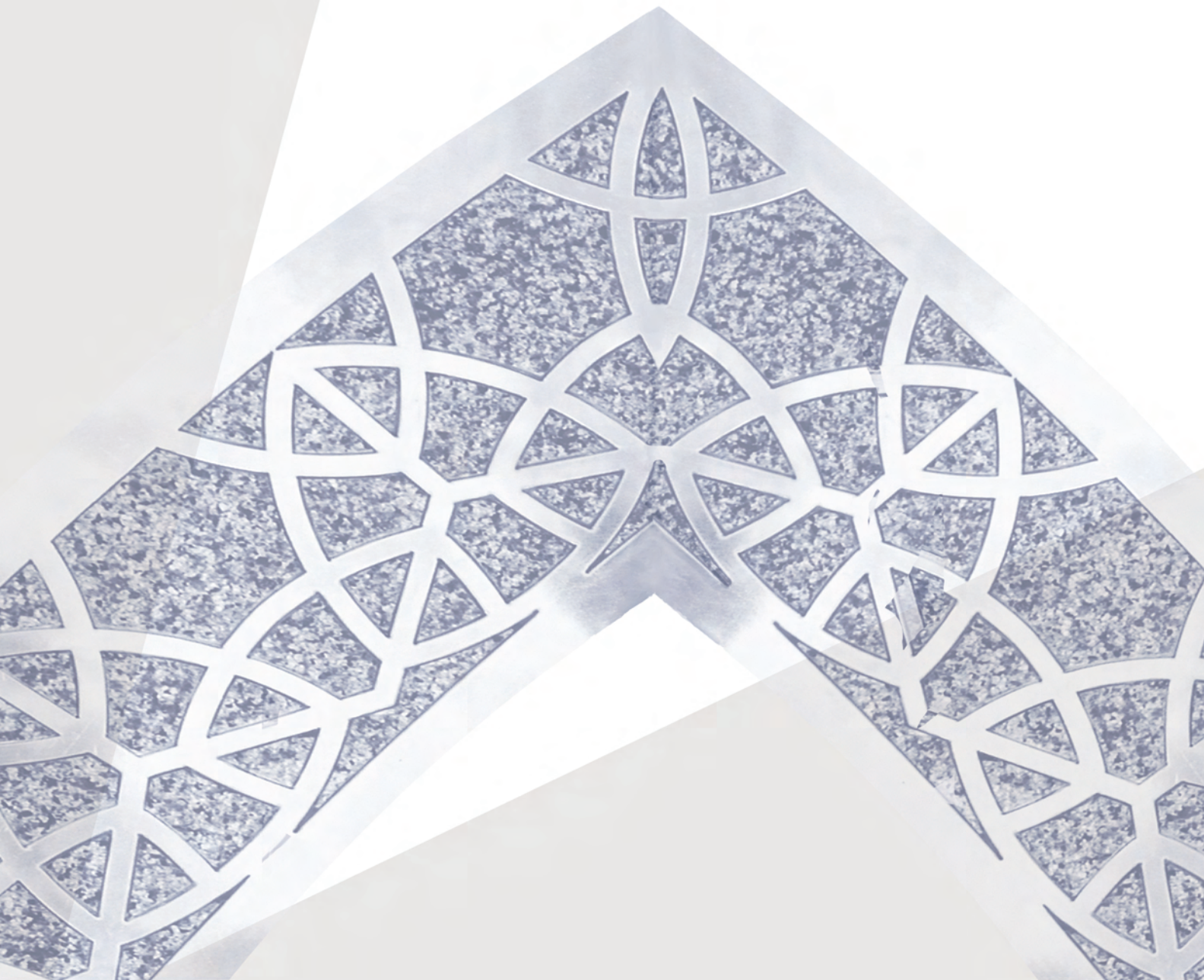
This collaboration facilitates the audit regulators to oversee cross-border audits towards enhancing the soundness of the securities markets and investor protection in the respective countries.

On 30 October 2012, the SC signed a Memorandum of Understanding (MoU) with the BNM. This MoU builds on and further strengthens the MoUs signed by both parties in 2002 and 2007 respectively taking into account the changing financial landscape in the new international regulatory regime.

Among others areas for co-operation and collaboration, the SC and BNM agreed on the framework for co-operation between the AOB and BNM in accessing the working papers of external auditors who audit entities under the BNM's oversight and supervision.

Part Four

Inspection Activities



INSPECTION ACTIVITIES

INTRODUCTION

The mission of the AOB is to foster high quality independent auditing to promote confidence in the quality and reliability of the financial statements of PIEs in Malaysia. In discharging its duties, the registered audit firms and auditors will be subjected to inspections by the AOB, in accordance with section 31V(1) of Part IIIA of the *Securities Commission Act 1993* (SCA), to assess the degree of compliance with the auditing and ethical standards by the auditors and the quality of the audit reports prepared by the auditors relating to the audited financial statements of the PIEs.

The function of the inspection is to provide an independent oversight to monitor the auditors of PIEs in carrying out their duties in accordance with auditing and ethical standards and legal requirements. The inspection process is designed to assess the quality of the audit performed by the audit firms. In responding to the observations identified, the audit firms are required to identify the root causes of the observations and the appropriate remedial actions to be taken towards enhancing audit quality.

SUMMARY OF ACTIVITIES

The AOB inspects the Big Four Audit Firms and

two Major Audit Firms (collectively referred to as “the Major Audit Firms”) which have more than 10 partners and audit more than 40 PIEs annually. The AOB intends to cover the mid-tier audit firms and sole proprietors (“the Other Audit Firms”) within a pre-determined inspection cycle.

In 2012, the AOB conducted regular inspections on 19 audit firms which audit over 95% of the market capitalisation of PLCs or 78% of the total number of PIEs.

The inspections focused on both the audit firms’ overall quality control and compliance with ISQC 1 and the MIA By-Laws and involved a review of 37 audit engagements of PIEs for compliance with the International Standards on Auditing.

The AOB also followed up with the review of remediation plans proposed by the audit firms that were inspected. By the end of the year the AOB issued 20 final regular inspection reports and approved 19 remediation plans.

In terms of the selection of engagements for inspection under the risk-based approach, the AOB took into consideration specific industries and their respective areas of concern in addition to selecting engagements based on size. In 2012, the AOB conducted inspection on bank audits focusing on impairment of loans

and advances and revenue recognition involving information technology (IT) audit and performed a thematic review on stockbroking industry.

The AOB also conducted two special inspections due to specific concerns, either arising from 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 addition to the regular and special inspections, the AOB also conducted off-site supervision where we actively engaged with audit firms, either directly or through the accounting profession to communicate our expectations, particularly those which have yet to

be inspected. The following were dialogues conducted during the year:

- 21 March 2012 – Dialogues with the Public Practice Committee of MIA (PPC) to communicate the AOB's inspection observations on small and mid-tier firms; and
- 21–23 November 2012 – Three dialogue sessions with the Major Audit Firms and the Other Audit Firms to communicate AOB's inspection observations and to invite feedback on challenges faces by the audit firms in the industry.

Table 1
Inspection progress in 2012, 2011 and 2010

Year	No. of audit firms inspected	No. of individual auditors inspected	No. of audit engagements inspected	Inspection reports issued	Remediation plan received and approved
				Final	
2010 [^]	6	24	22	2	–
2011	17*	48	52	16	13
2012	19*	40	37	20	19
TOTAL	42	112	111	38	32

[^] : The first inspection activity commenced in August 2010.

^{*} : Includes the six audit firms which are subject to annual regular inspection.

Chart 1

Analysis of the audit engagements inspected in 2012 and 2011 (by sector)

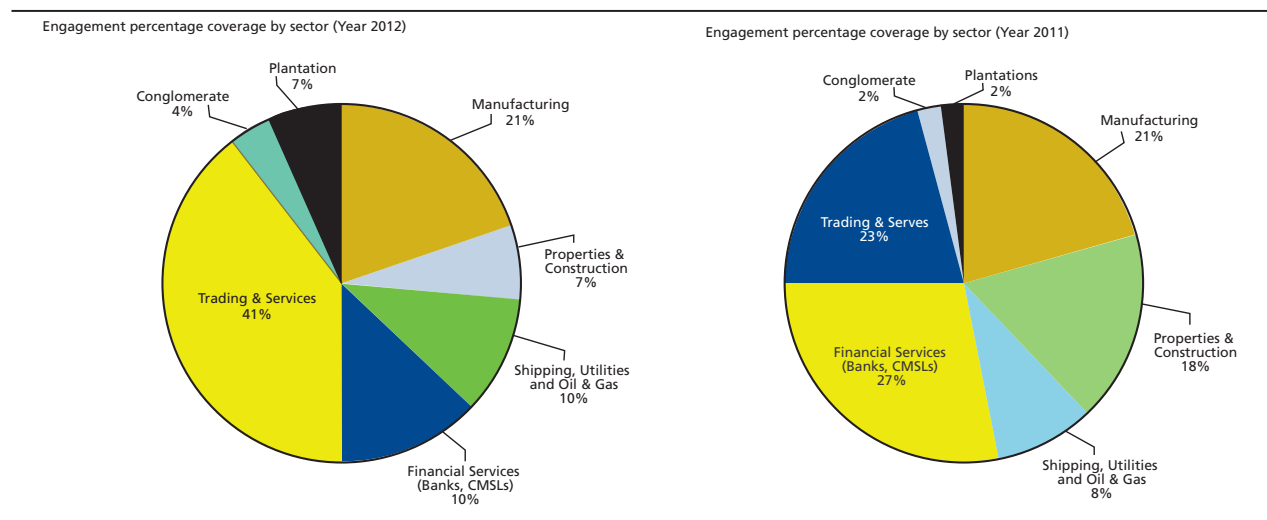


Table 2

Time spent by the engagement team at various stage

	Planning		Execution		Conclusion	
	Low	High	Low	High	Low	High
Major Audit Firms	6%	22%	33%	86%	6%	46%
Other Audit Firms	3%	30%	38%	92%	5%	32%

Table 2 comprises the statistics gathered during inspections for percentage of time spent by the engagement team at various stages of audit execution from planning to conclusion.

The AOB is concerned with the low percentage of time spent for planning and execution of audit work. Audit firms have to ensure an appropriate amount of

time is spent at the evidence gathering stage to ensure appropriate and sufficient evidence are obtained to support the basis of audit opinion.

Table 3 tabulates the range of percentage of time spent by engagement partner and engagement quality control review partner in proportion to the total engagement hours.

Table 3

Percentage of time spent by the engagement team partner and engagement quality control reviewer

	Engagement Partner		Engagement Quality Control Reviewer	
	Low	High	Low	High
Major Audit Firms	0.21%	8.40%	0.21%	0.79%
Other Audit Firms	1.21%	8.60%	0.00%	2.90%

All AOB's inspection officers have completed by the ICAEW ISAs Programme.

The AOB acknowledges the importance of sharing of experiences with international regulators including benchmarking the consistency of approach and understanding current emerging issues across various jurisdictions as these enable us to apply them in our inspections.

In this respect, in 2012, the AOB participated in the annual international inspection workshop organised by the IFIAR and 1st ASEAN Audit Regulators Inspection Workshop hosted by ACRA and conducted internal training to ensure AOB inspection officers were kept abreast of the recent developments of accounting and auditing standards.

The engagement partner is responsible for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements. The engagement quality control reviewer is expected to perform an objective

evaluation of the significant judgments made by the engagement team, and conclusions reach in formulating the auditor's report.

The AOB is concerned with the incidences where engagement partners and EQCRs spent minimal time in audit engagements as indicated above.

It is expected that engagement partners and EQCRs spent sufficient time to commensurate with the required level of efforts to support the engagement team in the performance of audits.

OVERVIEW OF FINDINGS

In general, the Major Audit Firms continued to place their efforts to focus on remediation plans to support audit quality. Although the AOB observed areas of high quality work demonstrated by the Major Audit Firms, there were still serious lapses on some engagements selected for inspections.

At the firm level review, the AOB focused on business practices and self-governance, the monitoring control framework and engagement quality control review roles and responsibilities.

The results of AOB's current year inspections on engagement reviews revealed recurring findings in the following areas:

- Fraud risk inquiry;
- Revenue cut off procedures;
- Extent of test of controls;
- Related parties and related party transactions;
- Multi-location audit procedures;
- Substantive analytical procedures;
- Understanding and documentation of management estimation process;
- Follow-up on confirmations; and
- Documentation discipline.

The recurring observations in these areas indicate that the Major Audit Firms' remediation plans may not be sufficiently effective. The AOB expects the Major Audit Firms to perform a more robust root cause analysis to identify the more relevant remediation plans and to measure the effectiveness of remediation plans.

The AOB expects audit firms to—

- accept the deficiencies identified by the AOB as indicators for them to remediate;
- identify actual root causes of the deficiencies;
- develop and implement appropriate remedial actions;
- ensure the effectiveness of the outcome of the remedial actions and its sustainability; and
- ensure their self-governance mechanisms to be forcefully applied to improve quality across the audit firms.

In addition to the above, the following were the key areas of observations identified by the AOB in 2012 inspections of Major and Other Audit Firms:

- Planning and risk assessment;
- Assets and goodwill impairment;
- Estimates;
- Test on reliability of reports or data;
- Use of experts; and
- Supervision and review by engagement partner.

In 2012, the inspections of Other Audit Firms which were not inspected previously continued to report gaps in the system of quality control policies and procedures and the application of such policies and procedures and these gaps continued to be more prevalent in these firms similar to those inspected in 2011. The engagement files review also revealed common observations which relate to the non-performance of basic auditing procedures to the basis of sampling not clearly evident in the documentation.

The AOB expects that all auditors approach the audit of financial statements with sufficient professional scepticism. Even though the audit firms often cited lack of audit documentation was the cause of audit deficiencies, the AOB observed on various occasions that the underlying cause of audit deficiencies could be attributed to shortcomings in the audit evidence obtained by the auditors. The auditors are expected to evaluate the audit evidence before placing reliance on them, failing which the auditors may not have a basis to support their opinions.

Although the areas for improvement observed by the AOB may not necessarily imply that inappropriate

audit opinions were issued, the AOB has observed instances of changes to the audit opinions in the years after AOB's inspection. The AOB will continue to challenge the sufficiency and appropriateness of audit evidence used to support audit opinions formed by auditors in enhancing the reliability of audited financial statements of PIEs.

KEY FINDINGS OF FIRM LEVEL REVIEW AND ENGAGEMENT REVIEW OF MAJOR AUDIT FIRMS

Setting the right tone from the top drives quality messages

Although strong leadership sets the tone for professional conduct among partners, maintaining consistent quality in the performance of audit engagements within the audit firms continues to be the main challenge. This is especially so as an audit firm is heavily dependent on the composition of the audit engagement team.

To address challenges faced by many audit firms relating to the shortage of talents and the increase in the partners' workload, the AOB observed efforts by the Major Audit Firms to rebalance their portfolio and recalibrate their risks appetite. This resulted in the Major Audit Firms culling some audit clients with certain risk profiles to enable better use of resources to deliver quality audit work. However, balancing risks and capacity will continue to be a challenge faced by the Major Audit Firms.

In 2012, the benefits from the rebalancing of partners' workload have not fully materialised as the AOB continued to observe deficiencies at the engagement

level. While some audit firms had tried to spread the workload of partners, the statistics gathered during the inspections revealed instances of insufficient time charged by partners. The concentration of audits with similar financial year end and demands from audits of non-PIEs further contributed to the challenge on the workload of the engagement partner.

The AOB reiterates the need for audit firms to reconsider their competency and capability in respect of time and resources before accepting new audit engagements. As there were movements of audit clients from one audit firm to another, audit firms considering the acceptance of prospective audit clients are reminded to observe and apply appropriate client acceptance due process. Similarly, predecessor auditors are required to extend professional co-operation when professional clearance is sought and both parties are reminded of the need to comply with due process of standards/requirements and in substance.

Monitoring system of quality control

The AOB continued to emphasise the importance of having an effective monitoring system of quality control policies and procedures to safeguard audit quality. Notwithstanding that the Major Audit Firms had demonstrated that adequate designs were in place, the following shortcomings were identified:

- Qualitative aspects were not evaluated in determining the severity of observations to identify the corresponding remediation plans;
- Incomplete communication of findings and subsequent follow up action plans;

- Focus was on completion of checklist and compliance with methodology rather than substance; and
- Action taken on the relevant engagement partner did not commensurate with the severity of the findings.

There were also instances where the AOB's inspections revealed different observations from those identified by the firm's monitoring control review team. This raised the concern on the effectiveness of the monitoring control review performed by the internal or network firms.

Engagement performance

Engagement quality control review

The EQCR plays an important role in audit quality by providing an independent and objective evaluation of the key judgement areas, particularly in high-risk areas and assessment of whether the related audit procedures and documentation support the conclusions reached. As in the previous year, the AOB remains concerned over the quality of work performed by the EQCR, in view of the deficiencies identified by the AOB in 2012 inspections. Although there is no accountability framework for EQCR currently, some firms have considered increasing the EQCR accountability by various ways:

- EQCR involvement is made a KPI for partners;
- Impact on EQCR's performance appraisal; and
- Emphasis of EQCR's involvement during the internal quality review.

In 2012, the AOB conducted interview sessions with the EQCRs of inspected engagements to discuss the

understanding of their roles and responsibilities as well as challenges thereon. It was often cited that the EQCRs' involvement was mainly in key judgements made in significant areas brought to their attention by the engagement team. As such, it was inherent that the EQCRs may not necessarily identify all issues. The AOB does not view this as a justification for an EQCR's failure to play the role of an objective and effective quality control reviewer.

In fact, there have been instances where the EQCRs took initiatives to be more involved in engagement reviews which resulted in better quality audit. Such instances are highly encouraged by the AOB.

It is a professional duty of an EQCR to understand the responsibilities in assuming the role of EQCR which would include the application of professional scepticism to provide the relevant challenge on key areas of judgement. Accordingly, there is a need to reinforce the message on the EQCR's role in providing an 'objective evaluation' of an audit engagement.

In the remediation plans of the Major Audit Firms, there was some progress in refining the role of the EQCR, as this was driven by their network firms. However, the AOB continued to identify lapses in engagement reviews which revealed that the EQCRs may not be effective.

Professional scepticism

The AOB observed that the Major Audit Firms took various initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. They included guided trainings and structured communications on professional scepticism. The latter encompasses two parts,

auditing with the questioning of mind and critically analysing audit evidence. Often the observations by the AOB's inspection revealed that the auditor failed to critically analyse the audit evidence.

Although the AOB believes that more effort should be in place across the audit industry, the application of professional scepticism varies, depending on the level of scepticism required when auditing a particular audit engagement.

The AOB will continue to give particular attention to the application of professional scepticism in 2013 inspections.

The following areas where the audit work exhibited lack of professional scepticism by the engagement team observed by AOB inspections were:

- Cash flow forecast to support impairment assets assessment was not supported by historical results of the company or a decreasing revenue trend;
- There was no challenge on the management estimation or budget on cost to completion for projects;
- There was no further evaluation on management's representation;
- No follow-up on discrepancies or conflicting evidences within the audit working papers; and
- Despite the existence of specific factors giving rise to risks related to management control override, the potential risks were not identified or evaluated.

Reliance on audit methodologies

The AOB is particularly concerned when auditors place full reliance in the audit methodology of the firms without contextualising such methodology to the circumstances of their audit. Whilst the audit methodology prescribes for the audit procedure to be performed, it does not demonstrate how to evaluate audit evidence or what to look out for. Where the methodology is mainly supported by checklists, this may further stifle the thinking process of auditors especially when the auditors are in haste to meet deadlines. In such a case, there may be a tendency for auditors to complete the checklists without considering issues at hand from a wider perspective.

Evaluation of audit evidence

There is a continuous need for auditors to critically analyse audit evidence. There were a number of occasions where the AOB observed discrepancies or conflicting evidences within the audit working papers. However there were no further assessments performed to dispose of such discrepancies by the auditors.

There were also instances where the audit evidences relied on were the PIE's internally-generated documents and there were no further audit procedures performed to determine the reliability of these documents.

There is also a need for increased vigilance to ensure reliable evidence is obtained and audit quality is not affected, given the emerging concerns on fraud risks and business practices.

Deficiencies in basic auditing procedures

The AOB observed deficiencies on various occasions where the audit firms obtained audit evidence from a combination of control and substantive analytical procedures. The deficiencies ranged, from the extent of control tested to wrong control being tested. There were also occasions where the control tested resulted in exceptions. However, there was no audit disposition on this and how the control can be relied on. In other instances, the AOB observed that the substantive analytical procedures were not performed in accordance with ISA 520 which requires the following–

- determine the suitability of substantive analytical procedures;
- evaluate the reliability of data used to set expectation;
- develop an expectation and evaluate whether the expectation is sufficiently precise; and
- set of threshold for investigating differences.

There were a few occasions where the underlying data that was the subject of the analytics was not verified for accuracy.

Consistency of audit quality in branch offices

In 2012, the AOB selected engagement reviews from branch offices and there were a number of cases where the deficiencies observed by the AOB were more prevalent in branch offices. There is a need for a consistent tone and tighter control from the top to manage the branch offices and to ensure consistency of performance throughout branch offices.

Management override

It is important to continually assess and conclude appropriately on management control consciousness and operating style. The AOB observed on many occasions where there was no further assessment of potential management override situations even though there were prevalent indicators. This is important as it sets the expectation of whether there is a need to extend audit procedures to mitigate the risk of management override.

Thematic review on stockbroking firm

As part of the regular inspections in 2012, the AOB also carried out thematic reviews on audits of stockbroking firms. The thematic inspection revealed common findings in certain areas such as risk assessment procedures, revenue and clients monies held in trust.

Examples of deficiencies were as follows:

- Audit procedures on fraud inquiry with internal auditors were not performed;
- Insufficient audit procedures performed to test brokerage volume and rates;
- Not all sources of revenue were scoped in for audit due to lack of understanding of trade placement and client's business model;
- Client's Monies Held in Trust was not verified for consideration by auditors on whether there was a need for disclosure; and

- Insufficient review on allowance for doubtful debts, including lack of understanding of management's estimation process and controls.

Significant areas such as revenue, where it is susceptible to fraud risk, will be the continued area of focus for stockbroking audits. There is a need to further understand the key controls surrounding the complex stockbroking processes and systems. This is especially so when the audit process involved the audit of foreign brokers where reliance was often placed on the regional support in verifying the system's application and general controls.

In addition to the observations as reported, there were different practices in the presentation and disclosure in the financial statements relating to the amount due to or amount due from the stock exchange. There were many instances where the amounts presented were on a net basis as compared to one instance where the balances were disclosed at their gross amounts.

KEY FINDINGS OF FIRM LEVEL REVIEW AND ENGAGEMENT REVIEW OF OTHER AUDIT FIRMS

Tone from the top

In the second year of the AOB's inspections of the Other Audit Firms, we continued to observe deficiencies where there were no holistic frameworks which defines, measures, monitors and rewards audit quality. This rooted from not having formal partnership agreements in place to govern their practices and the absence of quality performance evaluation.

The AOB expects the leaders of Other Audit Firms to continue to drive messages and build capacity to support audit quality.

Independence and ethics

Independence is fundamental to audit work. Hence it is important to have in place policies, procedures and the relevant documents to support facts of circumstances that may create threats to independence. The AOB inspections revealed a number of the Other Audit Firms which did not have in place, the independence compliance systems and processes to support their compliance with the ethical requirements.

Due to the lesser number of partners in the Other Audit Firms, the AOB observed many instances of breaches of the 5-year partner rotation rule. The AOB had warned these firms and some had immediately rectified the situation or proposed remedial actions. It is important that the Other Audit Firms are cognisant of such rule and take pro-active actions to rectify the situations to ensure their independence and reinforce their commitment towards audit quality.

The areas of independence and compliance with other ethical requirements will continue to be the AOB's focus areas for future inspections as the AOB expects audit firms comply with the requirements in substance rather than in form to mitigate the relevant threats.

Resources on training needs

Training is the basic element to ensure that partners and staffs are kept abreast of the latest development

of the financial reporting standards. However the AOB inspections of some Other Audit Firms revealed that there were various engagement partners and staff who were not kept up to date with the Clarified ISAs and the new/revised Financial Reporting Standards for the purposes of application in the audit engagements.

Client acceptance process

The acceptance and continuance of client process is pertinent as it provides an assessment on the prospective audit client and provides a means to decide whether to accept the engagement based on risks, capacity, competence and audit fee. As there was a trend of culling of audit clients from the Major Audit Firms, the Other Audit Firms are reminded to perform an 'objective evaluation' on the acceptance of prospective audit clients as there may be underlying risks which may not necessarily be documented in the professional clearance letter of the predecessor auditors.

The AOB continued to observe instances where certain Other Audit Firms did not have complete client acceptance policies and procedures in place.

Monitoring quality control policies and procedures

The AOB inspections revealed prevalent deficiencies in the monitoring of quality control policies and procedures of the Other Audit Firms. This ranges from not having an established monitoring framework to instances where the monitoring review was limited to quality check on audit engagements only and not on the firm's system of quality control.

Although it was often cited that this remained a challenge for the Other Audit Firms due to resource constraints, the AOB reminds that the considerations of cost should not be a pretext for not having the system in place.

The monitoring process encompasses the testing of the firms' quality control policies and procedures to demonstrate their effectiveness. Such process will facilitate and enable appropriate follow-up remediation measures being undertaken to safeguard audit quality. An established process should also address cases where the results of the monitoring procedures indicate that an audit report may be inappropriate or that procedures were omitted during the performance of an audit engagement.

Engagement performance

Engagement quality control review

The AOB observed many instances where the EQCR was not a registered partner with the AOB despite such requirement is clearly stated in the *AOB Registration Handbook*. Although AOB had given indulgence for specific cases, the Other Audit Firms are reminded to ensure full compliance in 2013.

The observations from AOB inspections of Other Audit Firms continued to raise concern over the effectiveness of the role of EQCRs in audit engagements.

Professional scepticism

The Other Audit Firms are reminded of the need to raise their professional scepticism in performing their

audit work both in questioning the reliability of audit evidence and critically analyse the audit evidence. Raising the awareness of such need among the members of the audit team is important to safeguard audit quality.

The following were the areas where the audit work exhibited lack of professional scepticism by the engagement team observed by AOB inspections:

- Cash flow forecast to support impairment assets assessment was not supported by historical results of the company or a decreasing revenue trend;
- The absence of further work performed to ensure reliability of faxed copies of confirmation;
- Tendency to rely on management's representation without further verification; and
- The absence of audit procedures performed to understand management estimates.

Audit consultation

The AOB noted that some Other Audit Firms had not put in place the relevant consultation policies and procedures. In various situations noted by the AOB, consultations on relevant critical accounting and auditing matters were important to support the basis of audit opinion. Hence, the AOB is concerned if there is no policy to require documentation and/or consultation on complex transactions or areas which involve critical judgement.

Insufficient or inappropriate audit evidence

As in previous years, the AOB identified a number of instances where there were insufficient or inappropriate audit evidence in high-risk audit areas. There were instances where the audit risk assessments were not clearly evidenced in the audit working papers. There were also many occasions of reliance on alternative procedures. However, the alternative procedures performed were not appropriate to support the planned/intended objectives of the audit.

The AOB would like to emphasise the need to immediately improve the quality of audit evidence to support the basis of audit opinions.

The deficiencies in basic auditing procedures of engagement performance are further explained below.

Planning and risk assessment

The importance of audit planning cannot be overemphasised, because it establishes the overall audit strategy for the engagement and development of an audit plan. It is beneficial to ensure that proper planning is strategised to identify risk areas and significant areas of concern in an audit engagement. It provides direction for the engagement team members to carry out the audit work as planned and to make the changes, if they are necessary and relevant. Setting expectations is one of the key functions especially where different skills and expertise are required to assist in the audit engagement.

While the risk appetites of audit firms may influence their audit strategy, the AOB observed that their risk appetites may not necessarily align with the risk of the capital market. The potential elements of business risks factored in when forming an audit opinion may affect the audit risks of an audit engagement. Auditors need to be cautious in their own risk appetites when forming an audit conclusion.

The AOB inspections revealed a tendency by some Other Audit Firms to immediately perform the substantive procedures without a comprehensive audit planning. There were many instances where the planning performed was insufficient to address the risks at the financial statements and assertions levels.

Sampling

The AOB continued to observe the following deficiencies in sampling:

- No documentation to support the basis for sample selection for control and substantive testing;
- No structured approach in the identification of sampling methods;
- The completeness of the population where the samples were selected were not verified; and
- No evidence to support the reasons for untested population where the amounts were above materiality threshold.

Group audit arrangement

Consistent with previous year, in considering the extent of the principal auditor's involvement and the use of the work of other component auditors, the AOB identified limitations in the scoping process, and consistency in the application of work done based on the threshold set.

There were also needs to critically evaluate the work of component auditors. In many instances, the primary auditors were not diligent in following up with the component auditors on their reporting deliverables.

The AOB also observed that there was a tendency for Other Audit Firms to fully rely on the work performed by the component auditors particularly when those component auditors were from the Major Audit Firm. This should not be the case, as the role of primary auditors is clearly defined in Clarified ISA 600. If the major subsidiaries were audited by other audit firms, there is a need to re-look into the client acceptance process whether the risks arising from component auditors can be managed.

Related-parties transactions and disclosures

In 2012 inspections, there were still gaps in the audit of related-parties' transactions. In particular, there were insufficient audit procedures performed to review the management's process to identify related parties and related-parties transactions. The tendency of reliance on management's representation on related-parties transactions should be viewed with profession scepticism.

The AOB continuously reminds audit firms that disclosures made on arm's-length transactions must be supported by audit procedures to verify the transactions in accordance with Financial Reporting Standards 124 – "Related-Party Disclosures".

Third-party confirmations

The AOB inspections continued to reveal observations on the timeliness of follow-up action with third parties on audit confirmations. Although this continued to be a challenge for the audit profession, it cannot be used as a pretext for the absence of any alternative work performed to ensure that the intended planned audit objectives were achieved.

In the current environment where recent fraud cases involved the use of fake documents, the audit firms need to continue to be vigilant in this area. In order to rely on photocopy, scanned copy and faxed copy of confirmations, there is a need under the auditing standards to perform further validation work.

Substantive analytical review

This was a recurring issue whereby many audit firms relied on substantive analytical review as one of their audit procedures, particularly on the income statement items. The AOB observed that the majority of the Other Audit Firms may not have performed the procedures sufficiently. The following procedures are required by the Clarified ISAs in performing substantive analytical review:

- Determining the suitability of substantive analytical procedures;

- Evaluating the reliability of data used to set expectation;
- Developing an expectation and evaluate whether the expectation is sufficiently precise; and
- Setting of threshold for investigating differences.

The AOB continued to observe that substantive analytical review performed by a majority of the Other Audit Firms was limited to the comparison of current year figures with those of the previous year. This is insufficient to fulfill the requirement of Clarified ISAs and had compromised the quality of audit evidence to support the audit conclusions.

The AOB requires compliance with Clarified ISAs with immediate effect because this is the second year after the effective date of Clarified ISAs.

Presentation and disclosures

There were instances where the AOB observed shortcomings in the audit procedures performed to verify the classification in the statement of financial position in accordance with the following relevant accounting standards:

- Financial Reporting Standards (FRS) 117 – Leases;
- FRS 5 - Assets and Liabilities Held For Sale; and
- FRS 101 – Presentation of Financial Statements.

The AOB would like to remind that any material departure of classification and disclosure requirements may affect the basis of the audit opinion.

REMEDIATION AND ROOT CAUSES

Remediation

In 2012, consistent with the previous year, the following are among the areas of remediation of both the Major and Other Audit Firms:

- Strengthening the governance structure, tightening audit quality improvement plan;
- Enhancement of consultation process;
- Enhancement of performance evaluation of partners and staff;
- Structured annual training plan and relevant changes to audit manual, policies and procedures;
- Tightening the approach to professional scepticism;
- Enhancement of the role of engagement quality control reviewer; and
- Commitment to enforce compliance on proper and relevant documentation.

During the current year inspections, the AOB performed a follow up review on the remediation efforts taken by inspecting the audit procedures performed in the subsequent audit of the affected engagements in the Major Audit Firms.

Some positive measures observed by the AOB include the following:

- Improved communication and collaboration between the financial auditors and IT auditors to address shortcomings in the audit procedures;
- Enhanced audit procedures and documentation to support the understanding of relevant system processing and application controls to address

relevant audit assertions; and

- Leveraging on Computer Assisted Audit Techniques (CAATS) to facilitate efficient and effective testing of reports to support the basis for reliance by the financial auditors.

Notwithstanding the above, the AOB's inspections continued to identify recurring issues which may raise questions on the effectiveness of remediation plans. The AOB believes that the audit firms need to measure the effectiveness of the remediation plans. The identification of actual root causes is important as this leads to the relevant and appropriate remediation plans.

The inspection findings are consistent with those noted by other audit regulators around the world and are consistent with the latest survey released by the IFIAR. Hence, the importance of detailed root cause analysis is required for remediation.

Root causes

The AOB further analysed the following potential root causes of the audit deficiencies:

- Lack of drive of audit quality messages by the leaders;
- Lack of understanding of the business of audit client;
- Mechanical approach in fulfilling training needs and not understanding the impact of the application of standards;
- Lack of technical support to safeguard audit quality;
- Lack of understanding of Clarified ISAs and outdated audit manual;

- Lack of understanding of the impact of extent of control testing on substantive audit procedures;
- Too much reliance on audit methodology;
- Lack of application of professional scepticism in evaluating audit evidence and questioning of mind;
- Lack of timely involvement and insufficient supervision by the engagement partner; and
- Ineffective EQCR.

Resource constraint

The AOB acknowledges the challenge in respect of the supply of talent in the auditing profession. This is among the issues discussed during the dialogue sessions held with the registered auditors to obtain feedback on the trend in the industry. As this has been a known issue for years, and will not be resolved immediately, it is important for the audit firms to continue to look into various ways and processes to manage the risks resulting from talent constraint and high attrition rate.

Such limitation cannot be used as a reason for compromising the quality of audit work.

Financial reporting function of audit client

The AOB recognises the challenges faced by the audit firms where the audit client's financial reporting functions themselves were not geared towards quality financial reporting. There could also be a lack of internal governance of the audit client. However, the audit firms are reminded that during the acceptance

engagement process, they should assess or understand the state of the financial reporting function of the prospective client and the underlying risks so that this is managed accordingly when performing the audit work.

If the risk is too high for acceptance, then there is a need for the audit firm to consciously decide whether it is appropriate to accept the audit client. However once accepted, the audit firms have assumed the associated risks and would need to manage the risks accordingly.

Understanding risks of audit

The AOB also reminds the audit firms that the notion of focusing only on the risks of overstatement of revenue and assets or risks of understatement of expenses and liabilities may not sufficiently cover the audit risk of an audit engagement.

This should not be a pretext to perform substandard audit work in other areas and assertions.

In addition the exercise of professional scepticism will enable auditors to identify other high risk areas.

Limitation of access to information

The AOB recognises the current prevalent issues arising from limited access of information to associates in particular when the associate is a public-listed company. The AOB reminds the audit firms that such access should have been discussed upfront with the audit client before acceptance of the audit work.

Fee pressure and pressure to improve efficiency

A reduction in audit fee for a complex business in a demanding financial reporting environment should be viewed as a red flag. Audit firms are continuously reminded that in a free market, they are the primary driver in determining the audit fees. An unreasonably low audit fee should not be a pretext for not performing audit work up to the required technical and professional standards.

If the audit fee is too low to cover the costs, then audit firms should cautiously decide whether they can accept the audit engagement accordingly.

The AOB continues to track the development of the trend of audit fees and takes this into account when selecting audit engagements for review.

CONCLUSION

In 2012, the Major Audit Firms made good progress in driving quality messages and focused on remediation plans to target consistency of performance among engagement partners. These are positive efforts which demonstrated their commitment to audit quality, although the AOB acknowledged that some results may not be immediately realised.

As for the Other Audit Firms, the AOB continues to observe some that require greater effort to consider ways to safeguard audit quality. The fact that the AOB inspections have observed some Other Audit Firms have demonstrated good quality audit, proved that the size of the firm is not a constraint to perform quality audit.

Setting a right tone from the top that drives audit quality is important as the firms need to balance business considerations with commitment to audit quality.

The effectiveness of monitoring quality control is therefore important to ensure that there is a continuous check and balance on the firm's quality policies and procedures to safeguard risks of exposure. The results from the monitoring quality control review should flow into the governance process of the audit firms so that appropriate action can be taken.

The AOB also expects that the role of EQCRs be enhanced and that there should be a form of accountability framework to ensure that EQCRs play their role objectively to provide a robust challenge process to the engagement teams.

In the execution of audit work, the engagement partner needs to ensure a well balanced team to manage the resource constraint or retention issue.

It should not be ignored that the presumption of fraud risks in revenue exists and that all audit firms must be reminded that the emerging issues in the recent years have also revealed heightened risks in this area. A good understanding of business and the critical evaluation of audit evidence needs to be emphasised in mitigating fraud risks faced by the auditors.

In view of the increasing robustness and complexity of systems and automated transactions, the audit firms are reminded of the technology risks which may affect the audit risks. An appropriate understanding of the flow of transactions within the systems and the control environment is essential to manage the risks.

The auditors are continuously reminded to strengthen

the client acceptance procedures to mitigate risks of any limitation in audit scope or which posed greater risks to auditors if the audit client reporting function is weak. However, if the audit firms have assumed such risks, then they are reminded of their own exposure and need to manage the risks during audit execution work.

As professional scepticism is an essential part of an audit process, it cannot be taken as a mechanical process in arriving at a conclusion nor should it be subject to engagement deadlines.

Lapses in documentation continued to be AOB inspection observations. Although it is often claimed that lack of discipline on documentation is the cause for the lapses in audit deficiencies, the audit firms need to be reminded that the absence of documentation casts concern as to whether the audit work has been performed. This also casts doubt on the rigour of the supervision and review performed by the engagement partner and engagement quality control reviewer.

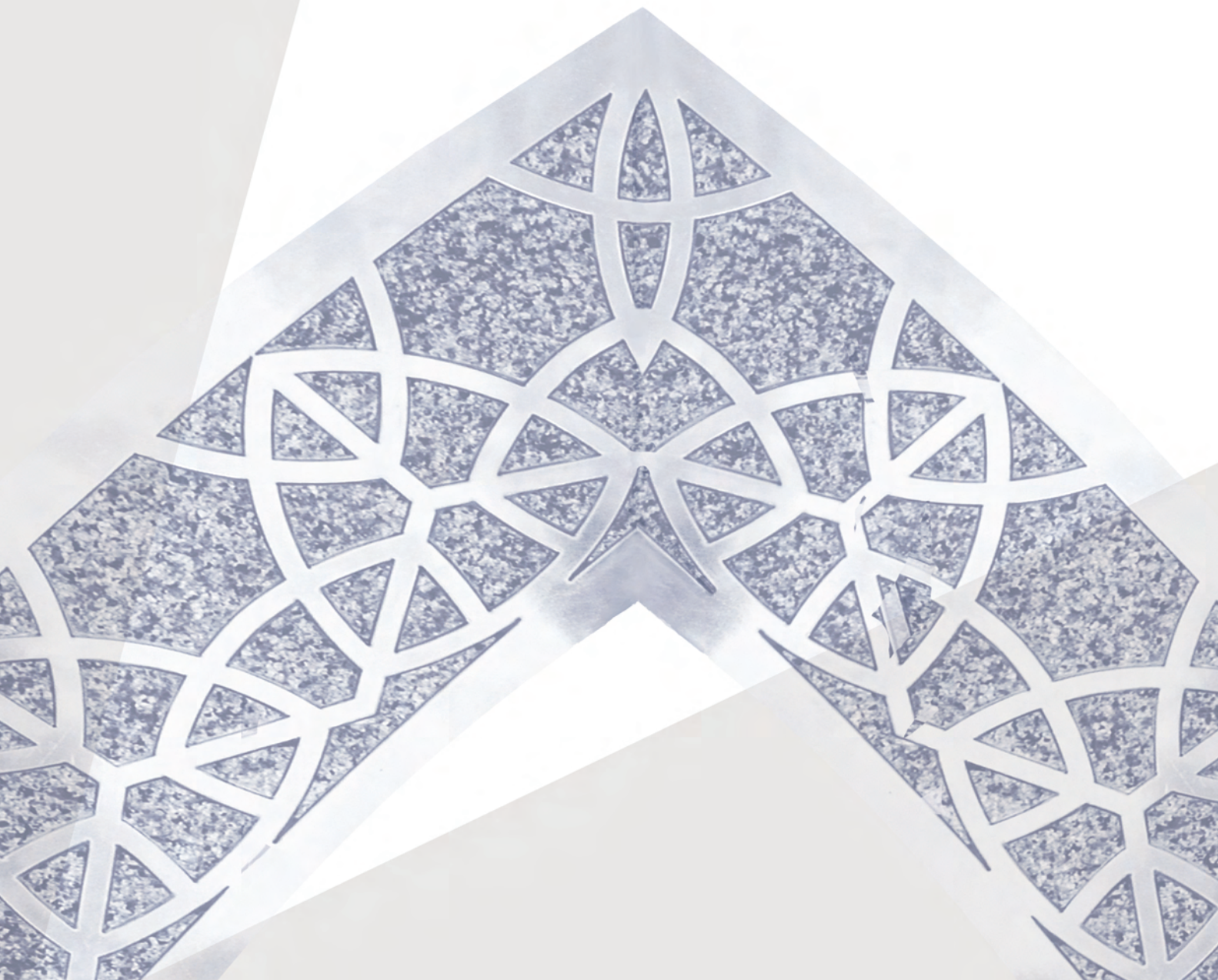
The AOB re-emphasises the need to reinforce the focus of audit strategy in mitigating the risk of material misstatement as opposed to focusing on audit efficiency which may compromise audit quality. An alignment of the capital market risks and the business risks of the audit firms is important to mitigate the audit risk which may affect audit quality.

As there were still recurring observations identified by the AOB in 2012, there is a need for the audit firms to critically analyse the root causes and measure the effectiveness of remediation plans. The results also suggested that maintaining consistency of performance is crucial to maintain commitment to audit quality.

The AOB will continue to maintain lines of communication and consistent interactions with the stakeholders to contribute to improving audit quality.

Part Five

Assessment of Performance and Effectiveness



ASSESSMENT OF PERFORMANCE AND EFFECTIVENESS

The AOB had established a strategic framework linking its service areas to the outcomes envisaged by the mission. While the core services such as registration and inspection are ongoing oversight activities, focus areas have been identified after considering the operating environment, developments in financial reporting and auditing, regulatory changes as well as global development in audit regulation to achieve the outcomes which are in line with the mission. The five strategic outcomes were:

- High quality financial reporting practices by PIEs;
- Resourceful and high quality audit practices;
- Independent and high quality audit;
- High quality and reliable audited financial statements; and
- Confidence in the audited financial statements of PIEs.

At the beginning of each year, the AOB Board considers and approves proposal from management on the annual operational plan including areas that the AOB would focus on in performing its audit oversight function. The plan also incorporates a three-year outlook of the market and regulatory landscape envisaged by management. The progress of the AOB's oversight activities would be reported to the AOB Board on a quarterly basis. A review of performance is performed in the middle of the year.

The outcomes and progress achieved in relation to the focus areas of the AOB in 2012 indicate that the AOB is progressing well in line with the overall aim of its strategic framework.

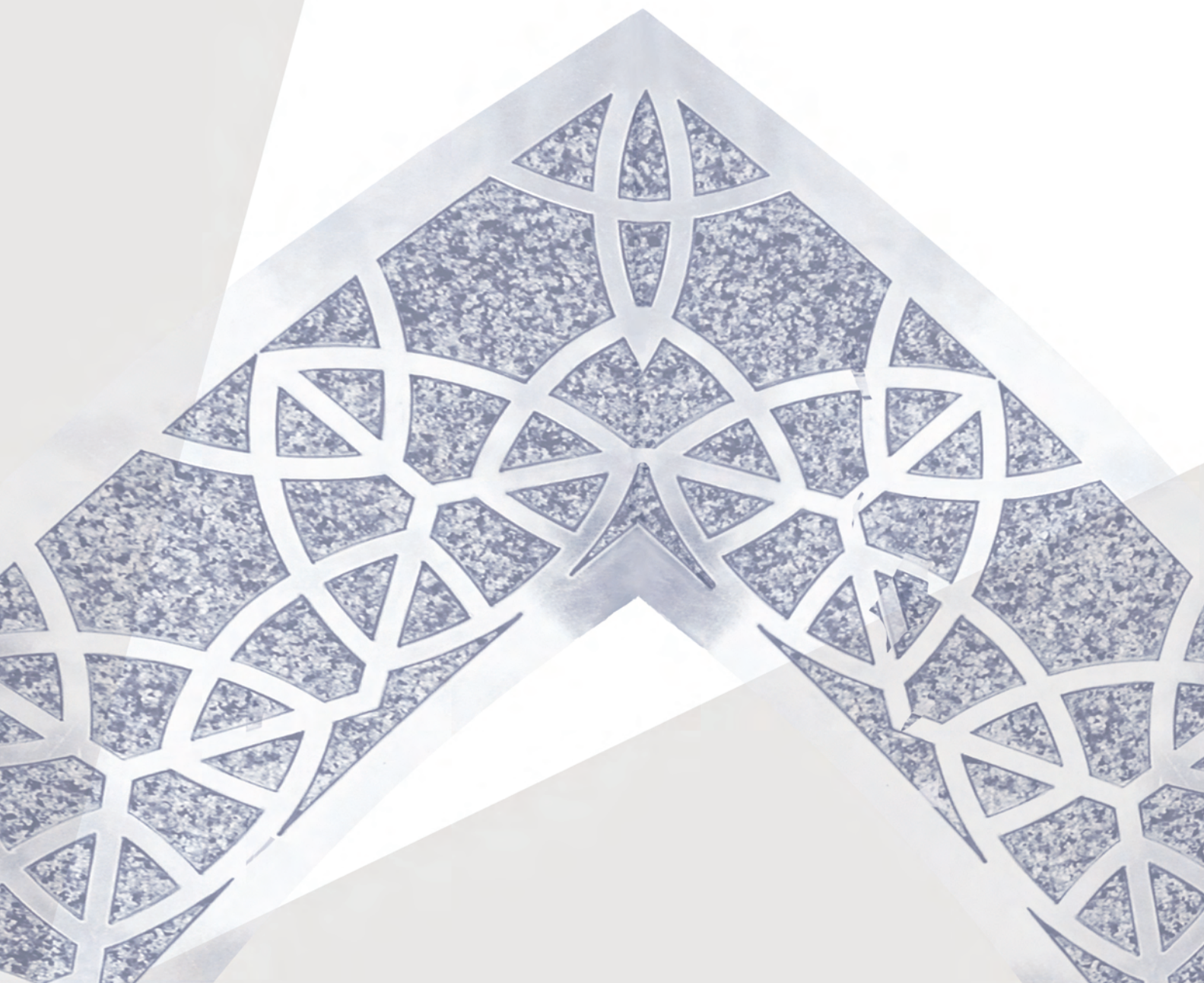
Table 1

Outcomes and progress in 2012

AOB Strategic Outcomes	Progress and performance assessment
High quality financial reporting practices by PIEs	<ul style="list-style-type: none"> The AOB participated in events to engage directors and member of audit committees to remind them of their roles in enhancing the quality of financial reporting of PIEs. Given the complexity of financial reporting, PIEs need to invest more in talents and systems to ensure the effectiveness of their financial reporting functions.
Resourceful and high quality audit practices	<ul style="list-style-type: none"> The AOB continued to identify deficiencies across all audit firms. Firms inspected by the AOB had embarked on remediation plans which were at various stages of implementation. Some firms deployed holistic approach in remediation while some addressed the deficiencies on a piece meal basis. Talent remained to be a critical challenge for audit firms in ensuring the quality of their work. This is attributed to the workload demand and competitive offers from other industries and overseas.
Independent and high quality audit	<ul style="list-style-type: none"> The AOB noted that some firms did not give appropriate attention on auditor rotation, a key requirement to ensure auditor independence. Upon the intervention of the AOB, this matter was addressed by the relevant audit firms. Audit firms need to comply with the substance of professional ethics and not be comfortable with compliance in form.
High quality and reliable audited financial statements	<ul style="list-style-type: none"> The AOB did not note any major audit failure reported among the companies with large market capitalisation in the year under review. Two special audit inspections were performed in response to market events which could influence the confidence in financial reporting and audit.
Confidence in the audited financial statements of the PIEs	<ul style="list-style-type: none"> The AOB participated in events in sending messages about audit quality to key stakeholders. While confidence in the audited financial statements is difficult to be measured, the AOB had commissioned an academic research to assess the market impact of the establishment of the AOB. The outcome will be reported in 2013.

Part Six

2013 Outlook



2013 OUTLOOK

GETTING FIRMS TO FOCUS ON ROOT CAUSES

The recurring observations in the work of auditors raise question over the effectiveness of remediation plan deployed by audit firms. Although it is acknowledged that such efforts take time to show tangible outcomes, it should be a continuous process and there should be some audit quality measures determined by the audit firms to ensure they are progressing in the right direction.

This will continue to be a focus area and the AOB reminds the audit firms that the remediation plans should be tied to the root causes of their audit deficiencies. As such, it cannot be over-emphasised here of the need of the audit firms to own up to the actual root causes of audit deficiencies to ensure the effectiveness of their remediation efforts.

DEALING WITH AUDIT FIRMS SPECIFIC CHARACTERISTICS

The AOB acknowledges that firms with different sizes and capacity would respond differently to the issues raised by us. Hence, we will deal with them based on their characteristics and situations.

While the Major Audit Firms may have structures, systems and processes supporting high quality audit, the AOB believes that they have ample room to progress in ensuring the consistency of performance across engagements and audit partners. Given their nature, their efforts in ensuring major audit failure would not occur would be one of the focuses of our oversight activities.

We will also be focusing on the mid-tier firms which are gaining market share in terms of the number of PIEs as their clients and would engage them appropriately to ensure they are able to meet the addition demand of their services which continue to enhance the quality of their work. As the AOB would not be able to inspect all firms within a year, it will engage them through our registration activities to ensure the baseline structure which is required to support quality audit are in place.

MORE HOLISTIC REFORM OF THE ACCOUNTANCY PROFESSION

The ROSC AA revealed a number of issues which need to be addressed by the accountancy profession. They include the number of audits performed in this country considering the challenges faced by

audit firms in acquiring and retaining talent and the immediate need to review the governance structure of the MIA.

Most of these issues influence audit quality and the AOB would certainly endeavor to support any effort in ensuring they are addressed in a more holistic manner through a country action plan, as envisaged in the ROSC AA.

While the above could be a long haul journey, it should not stop the accountancy profession to embark on reform which could be done without any major overhaul of the profession. This includes enhancing effectiveness of the practice review conducted by the MIA and sending strong messages to accountants and auditors who are member of MIA to ensure they continue to be committed in ensuring high quality financial reporting and auditing.

2013 INSPECTION FOCUS

The following focus areas continue to remain valid in 2013:

- Business Practices and Self Governance;
- Compliance with ethical requirements;
- Assessment of EQCR;
- Assessment of Monitoring Quality Policies and Procedures;
- Auditor responsibility with respect to fraud (ISA 240), including management override considerations;
- Audit of accounting estimates, including estimated fair values and related disclosure (ISA 540);

- Related parties (ISA 550);
- Group Audit Arrangements, including work performed by component auditors (ISA600); and
- Audit of IT.

Other high risk areas arising from analysis of specific circumstances including going concern, goodwill and intangible assets will continue to be a focus area.

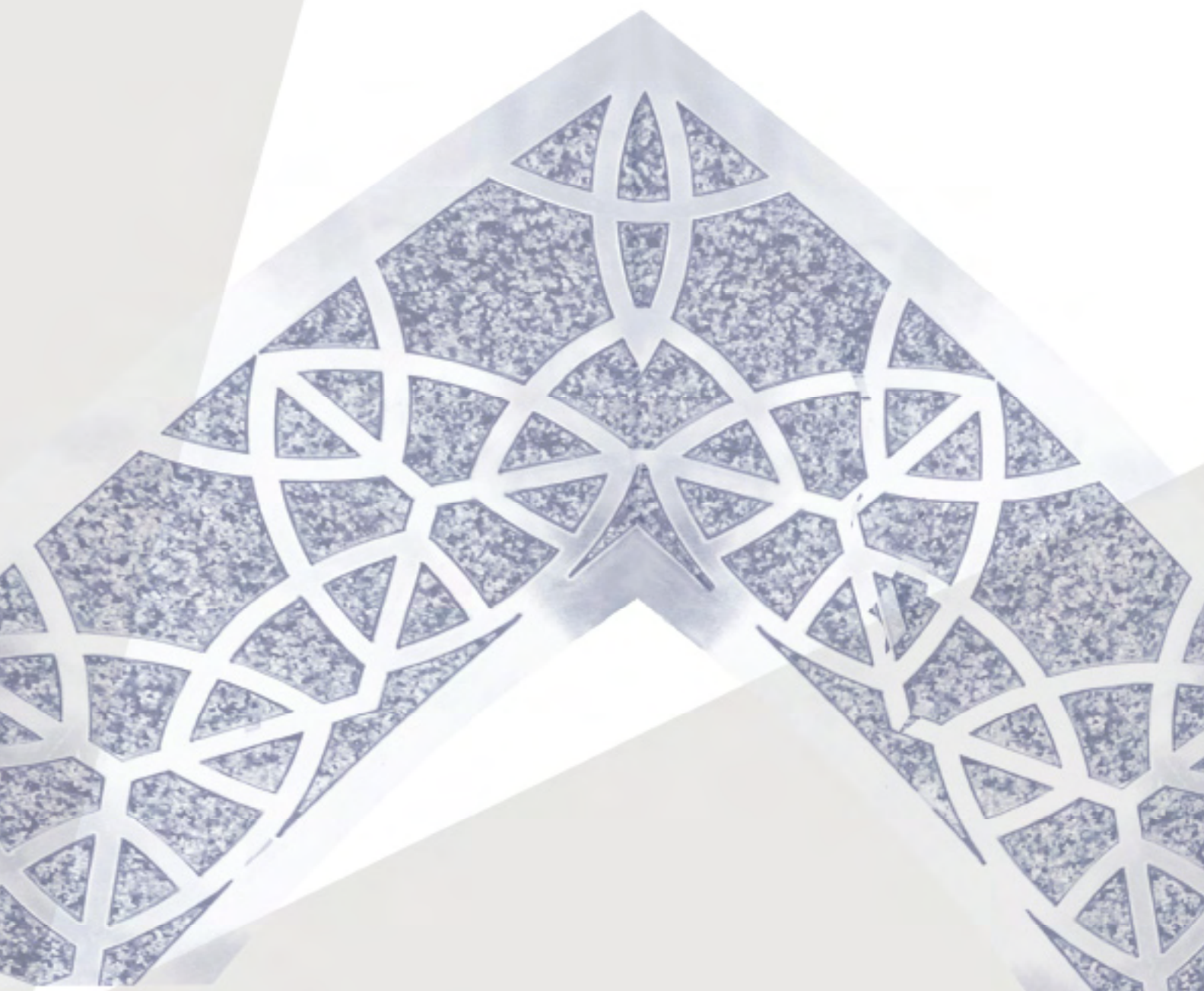
As part of its efforts in understanding the impact of the current economy, emerging issues and changes to the accounting standards on audit quality, the AOB will continue to interact with domestic and international regulators and other stakeholders in the financial reporting ecosystem. Dialogue with audit firms will also continue to take place.

There will be continuous efforts in the following areas:

- Drive messages on remediation and focus on what matters most to achieve high quality audit;
- Drive changes to behavior to enhance the professional conduct;
- Continuous monitoring on professional conduct to mitigate risk of audit failure;
- Drive message to enhance capacity building;
- Continuous engagement with other stakeholders in the financial reporting ecosystem;
- Higher level of cooperation among independent audit regulators and enhancing effectiveness and efficiency; and
- Continuous involvement in IFIAR and ASEAN Regulators meeting and inspection workshops.

Part Seven

Statement on Governance



STATEMENT ON GOVERNANCE

MEMBERS OF THE AUDIT OVERSIGHT BOARD





**Nik Mohd Hasyudeen
Yusoff**

Goh Ching Yin

Dato' Gumuri Hussain

**Datuk Nor Shamsiah
Mohd Yunus**



Cheong Kee Fong



Chok Kwee Bee



Mohd Naim Daruwish

NIK MOHD HASYUDEEN YUSOFF

Nik Hasyudeen is the Executive Chairman of the AOB and an Executive Director of the Securities Commission Malaysia.

He is presently a member of the Operational Review Panel of the Malaysian Anti-Corruption Commission (MACC), a member of the Financial Reporting Foundation (FRF) and also serves on the Corporate Debt Restructuring Committee which was set up by BNM. Nik is an Adjunct Professor at the Faculty of Business and Accountancy, University of Malaya.

Nik was the former President of the MIA and also the former Vice-President of the ASEAN Federation of Accountants (AFA). He had also served on the Malaysian Accounting Standards Board (MASB) and the Listing Committee of Bursa Malaysia.

He holds a Bachelor of Business degree from Curtin University of Technology and is a Fellow of CPA Australia.

GOH CHING YIN

Goh Ching Yin is the Executive Director for Strategy and Development of the Securities Commission Malaysia. He is responsible for strategy and research, market development, economics and risk management and corporate governance.

He takes lead with his team in conceptualizing and formulating capital market strategy, developmental initiatives and the Securities Commission Malaysia's business plan to ensure the direction and plans are responsive and relevant, taking into account domestic and international developments; to provide policy analysis of key issues and input to the government

on wider issues affecting the capital market and the boarder economy.

Prior to joining the Securities Commission Malaysia in March 2007, Goh had led a career that spans 12 years in the investment banking arena. The earlier part of his career had seen him holding various leadership and management positions in regional business development, strategic consultancy, corporate insolvencies and auditing. He holds a Master of Business Administration from the Cranfield School of Management, Cranfield University.

DATO' GUMURI HUSSAIN

Dato' Gumuri is currently the Chairman of SME Bank and a member of the Securities Commission Malaysia.

He is a Fellow of the ICAEW, member of the MIA and the MICPA. He sits on the Board of KUB Malaysia Bhd, Media Prima Bhd and Metrod Holdings Bhd.

Dato' Gumuri was the Managing Director and Chief Executive Officer of Penerbangan Malaysia Bhd from August 2002 to August 2004. Prior to this, he was a Senior Partner and Deputy Chairman of Governance Board of PricewaterhouseCoopers Malaysia. He had served as the Non-Executive Director of Bank Industri & Teknologi Malaysia Bhd, Malaysian Airline System Bhd, Kurnia Setia Bhd and Sabah Bank Bhd.

DATUK NOR SHAMSIAH MOHD YUNUS

Datuk Nor Shamsiah is currently the Deputy Governor of BNM.

She is responsible for the division that supervises commercial banks (conventional and Islamic banks), investment banks, insurance companies (conventional and takaful) and development financial institutions. She also oversees the Risk Management Department that formulates the internal enterprise risk management framework for BNM. She is also responsible for the unit that is responsible for combating abuses in the financial system. She sits as one of the members at

the BNM Board of Director. She is also a member of the BNM Monetary Policy Committee and Financial Stability Policy Committee.

Datuk Nor Shamsiah represents BNM in a number of regional and international fora in the areas of banking supervision. She joined BNM in April 1987 and has extensive experience in the development of prudential regulation, legislation, policies and guidelines for the financial sector. She holds a Bachelor's Degree in Accountancy from the University of South Australia and is a Certified Practising Accountant.

CHEONG KEE FONG

Cheong Kee Fong has been a Partner of Cheong Kee Fong & Co. since January 1990. He was the sole proprietor of Cheong Kee Fong & Co. from November 1988 to December 1989.

He was previously a member of the Company Law Reform Committee established by the Companies Commission of Malaysia and a member of the Finance Committee on Corporate Governance Working Group II on Corporate Governance in Malaysia.

Cheong Kee Fong was also a member of Financial Reporting Foundation from 1997–2001, Companies Commission of Malaysia and its Audit Committee from 2002–2005.

Cheong Kee Fong obtained his LLB (honours) from the University of Singapore and his Master of Laws from Harvard Law School. He is an advocate and solicitor of the High Court of Malaya and of the Supreme Court, Singapore.

CHOK KWEE BEE

Chok Kwee Bee is the Managing Director of Teak Capital Sdn Bhd, a venture capital management company managing a technology fund under the Malaysia Venture Capital Management Bhd (MAVCAP) Outsource Partner Program.

Prior to that Kwee Bee was with Walden International, a Silicon Valley based venture capital firm, overseeing the operations and investments of Walden International and BI Walden in Malaysia. Before becoming a venture capitalist, Kwee Bee was the

Head of Corporate Finance at AmInvestment Bank.

Kwee Bee is currently a member of the Malaysian Venture Capital Development Council (MVCDC) and a member of the Exchange Committee of Labuan International Financial Exchange. She also sits on the board of several portfolio companies. She was previously a member of the SC Capital Market Advisory Council and also a past Chairman of the Malaysian Venture Capital and Private Equity Association (MVCA).

MOHD NAIM DARUWISH

Mohd Naim Daruwish is the Chief Executive Officer of the Companies Commission Malaysia.

He graduated with a LLB (Hons) degree from the University of Malaya. He started off his career as a Legal Officer with the Legal Department of Bank Pertanian Malaysia on April 1984 before being appointed as Magistrate in 1985 and later as a Senior Magistrate.

He was then appointed as the Manager and later as the Senior Manager of the Prosecution/Litigation Division, Legal Department of the Employees Provident Fund (EPF), Kuala Lumpur. Among the positions held by him in EPF were the General Manager of the Enforcement Department, the Senior General Manager of Legal Department and the Senior General Manager of the Contribution Department.

MEETING ATTENDANCE

In 2012, the AOB held eight Board meetings. The attendance by the Board members is stated in the table below:

Board member	Number of meetings attended
Nik Mohd Hasyudeen Yusoff	8/8
Dato' Gumuri Hussain	6/8
Datuk Nor Shamsiah Mohd Yunos	6/8
Goh Ching Yin	8/8
Chok Kwee Bee	8/8
Cheong Kee Fong	7/8
Mohd Naim Daruwish	4/8

RESPONSIBILITIES OF THE BOARD

The Board is responsible in assisting the AOB in discharging its functions under the SCA. The responsibilities include:

- Implement policies and programmes in ensuring an effective audit oversight system in Malaysia;
- Register or recognise auditors of PIEs for the purposes of the SCA;
- Direct the MIA to establish or adopt, or by way of both, the auditing and ethical standards to be applied by auditors;
- Conduct inspections and monitoring programmes on auditors to assess the degree of compliance of auditing and ethical standards;

- Conduct inquiries and impose appropriate sanctions against auditors who fail to comply with auditing and ethical standards;
- Co-operate with relevant authorities in formulating and implementing strategies for enhancing standards of financial disclosures of PIEs;
- Liaise and co-operate with oversight bodies outside Malaysia to enhance the standing of the auditing profession in Malaysia and internationally; and
- Perform such other duties or functions as the AOB determines necessary or appropriate to promote high professional standards of auditors and to improve the quality of audit services provided by auditors.

MEETING PROCEDURES

Due notice is given on issues to be discussed with the distribution of agenda and papers for consideration at Board meetings. These meetings provide a forum for a balanced deliberation of issues

and transparent decision making.

A full set of minutes of all Board meetings is kept properly by the Secretary of the Board.

REGISTRATION COMMITTEE

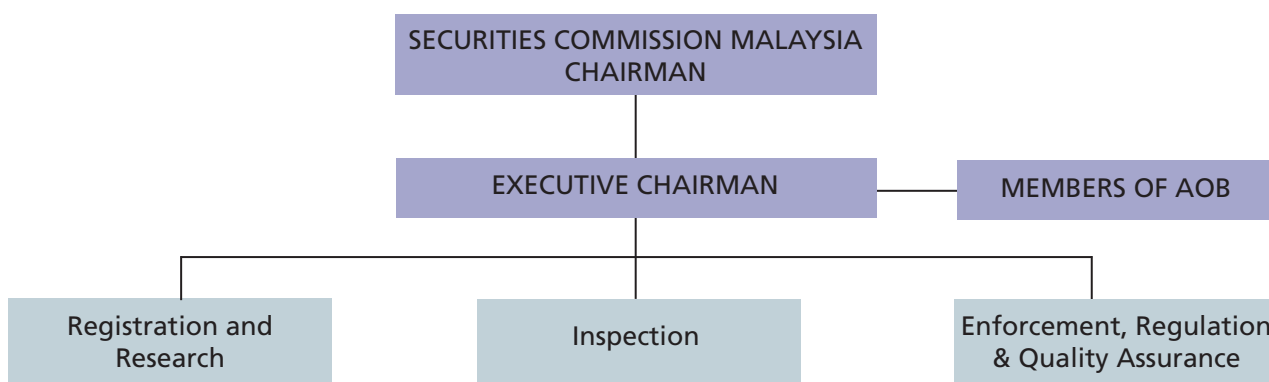
Section 31EA of the SCA provides that the AOB may establish such committees as it considers necessary or expedient to assist in the performance of its responsibilities as specified under section 31E(1) of the SCA.

In this regard, a Registration Committee was established in 2011 to determine matters regarding the approval of application for registration or recognition of auditors with the AOB. The Registration Committee shall recommend to the Board, wherein the Board will deliberate and decide, for matters pertaining to revocation, suspension and non-approval.

The members of the Registration Committee are:

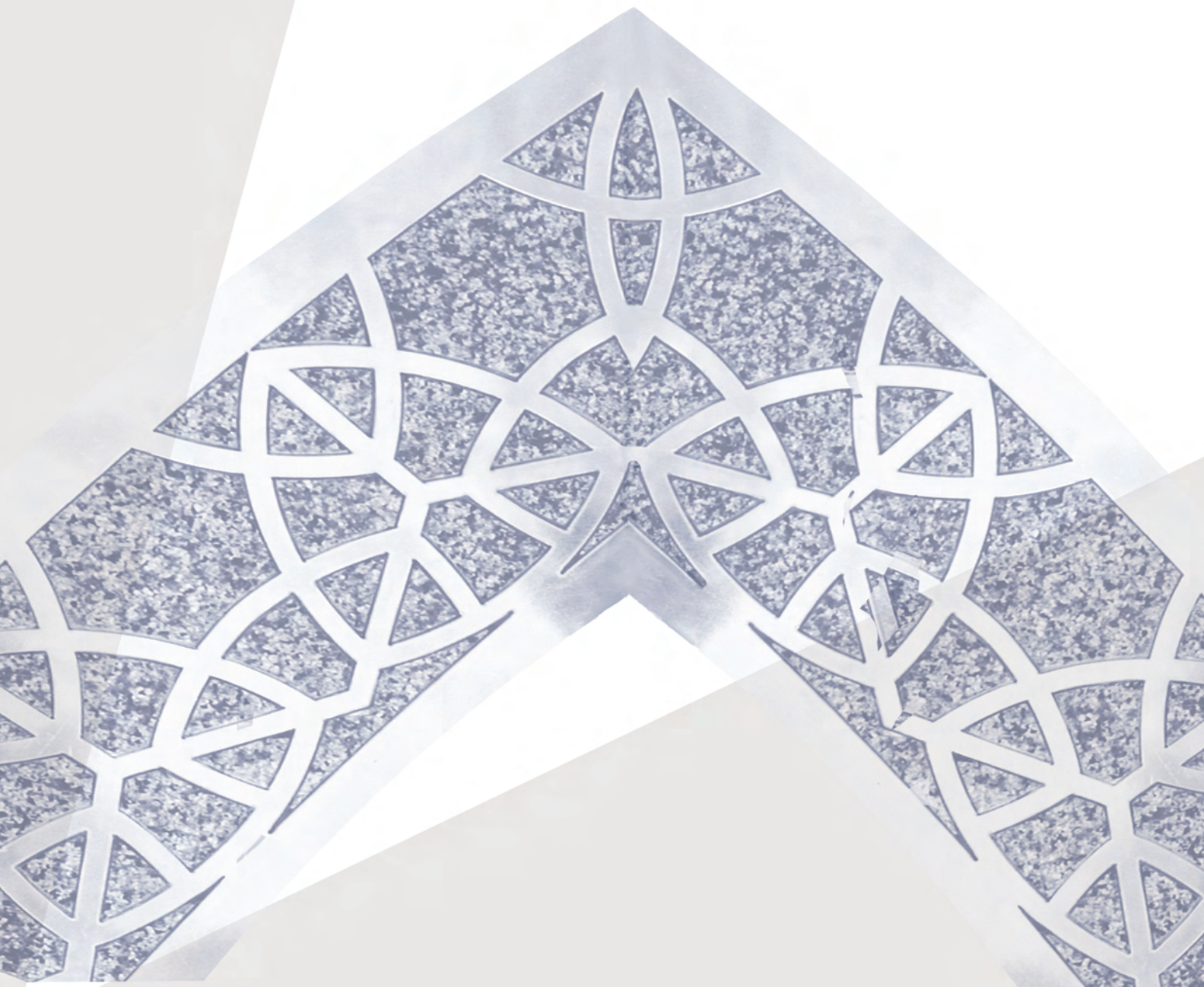
- Nik Mohd Hasyudeen Yusoff
- Goh Ching Yin

ORGANISATION STRUCTURE AUDIT OVERSIGHT BOARD



Part Eight

Financial Statements and Others



FINANCIAL STATEMENTS OF THE AUDIT OVERSIGHT BOARD FUND

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

Statement of financial position as at 31 December 2012

	Note	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Assets				
Current assets				
Other receivables	4	80,850	130,285	124,293
Cash and cash equivalents	5	910,532	3,117,332	4,424,959
Total assets		<u>991,382</u>	<u>3,247,617</u>	<u>4,549,252</u>
Reserves				
Fund from the Securities Commission Malaysia (SC)	6	6,000,000	5,000,000	5,000,000
Accumulated deficit	7	(5,071,724)	(2,375,609)	(549,555)
Total reserves		<u>928,276</u>	<u>2,624,391</u>	<u>4,450,445</u>
Current liability				
Other payables and accruals	8	63,106	623,226	98,807
Total liabilities		<u>63,106</u>	<u>623,226</u>	<u>98,807</u>
Total reserves and liabilities		<u>991,382</u>	<u>3,247,617</u>	<u>4,549,252</u>

The notes set out on pages 48 to 58 are an integral part of these financial statements.



.....
Datuk Ranjit Ajit Singh
Chairman
Securities Commission Malaysia

31 January 2013



.....
Nik Mohd Hasyudeen Yusoff
Executive Chairman
Audit Oversight Board

Statement of profit or loss for the year ended 31 December 2012

	Note	2012 RM	2011 RM
Income			
Registration fee		1,615,029	1,690,000
Financing income from fixed deposits		56,364	113,130
Others		5,000	–
		<u>1,676,393</u>	<u>1,803,130</u>
Operating expenditure			
Administrative expenses	9	(4,372,508)	(3,629,184)
Loss before tax		<u>(2,696,115)</u>	<u>(1,826,054)</u>
Income tax expense	12	–	–
Total loss for the year	7	<u><u>(2,696,115)</u></u>	<u><u>(1,826,054)</u></u>

The notes set out on pages 48 to 58 are an integral part of these financial statements.

Statement of cash flows for the year ended 31 December 2012

	Note	2012 RM	2011 RM
Cash flows from operating activities			
Loss before tax		(2,696,115)	(1,826,054)
Adjustment for:			
Financing income		(56,364)	(113,130)
Operating deficit before working capital changes		(2,752,479)	(1,939,184)
Changes in working capital:			
Other receivables		–	(200)
Other payables and accruals		(560,120)	524,419
Net cash used in operating activities		(3,312,599)	(1,414,965)
Cash flows from investing activities			
Financing income		105,799	107,338
Restricted deposit		(5,000)	–
Net cash from investing activities		100,799	107,338
Cash flows from financing activity			
Funding received from the SC		1,000,000	–
Net cash from financing activity		1,000,000	–
Net decrease in cash and cash equivalents		(2,211,800)	(1,307,627)
Cash and cash equivalents at 1 January		3,117,332	4,424,959
Cash and cash equivalents at 31 December		905,532	3,117,332
Cash and cash equivalents comprise:			
Cash and bank balances	5	400,684	22,869
Deposits placed with licensed bank	5	509,848	3,094,463
		910,532	3,117,332
Less: Restricted deposit		(5,000)	–
		905,532	3,117,332

The notes set out on pages 48 to 58 are an integral part of these financial statements.

Notes to the financial statements

1. General

On 1 April 2010, the Securities Commission Malaysia (SC) established the Audit Oversight Board (AOB) under section 31C of the *Securities Commission Act 1993* (SCA). The AOB was established for the purposes set out in section 31B of the SCA, namely:

- a. to promote and develop an effective and robust audit oversight framework in Malaysia,
- b. to promote confidence in the quality and reliability of audited financial statements in Malaysia, and
- c. to regulate auditors of public-interest entities.

To facilitate the abovementioned purposes, a fund known as the AOB Fund was established under section 31H of the SCA. The AOB Fund is administered by the SC. The SC provides administrative and accounting support to the AOB Fund and the accounts are kept separately from the accounts of the SC in accordance with section 31L(5) of the SCA.

2. Basis of preparation

(a) Statement of compliance

The financial statements of the AOB have been prepared in accordance with Malaysian Financial Reporting Standards (MFRSs) and with International Financial Reporting Standards. This is the AOB's first financial statements prepared in accordance with MFRSs and MFRS 1, *First-time Adoption of Malaysian Financial Reporting Standards* has been applied.

In the previous financial years, the financial statements of the AOB were prepared in accordance with Financial Reporting Standards (FRSs) in Malaysia. The explanation of transition to MFRSs are disclosed in Note 14 to the financial statements.

The AOB has early adopted the amendments to MFRS 101, *Presentation of Financial Statements* which are effective for annual periods beginning on or after 1 July 2012. The early adoption of the amendments to MFRS 101 has no impact on the financial statements.

The following are accounting standards, amendments and interpretations of the MFRS framework that have been issued by the Malaysian Accounting Standards Board (MASB):

MFRSs, Interpretations and amendments effective for annual periods beginning on or after 1 January 2013

- MFRS 10, *Consolidated Financial Statements*
- MFRS 11, *Joint Arrangements*
- MFRS 12, *Disclosure of Interests in Other Entities*
- MFRS 13, *Fair Value Measurement*
- MFRS 119, *Employee Benefits* (2011)
- MFRS 127, *Separate Financial Statements* (2011)
- MFRS 128, *Investments in Associates and Joint Ventures* (2011)
- IC Interpretation 20, *Stripping Costs in the production Phase of a Surface Mine*
- Amendments to MFRS 7, *Financial Instruments: Disclosures – Offsetting Financial Assets and Financial Liabilities*
- Amendments to MFRS 1, *First-time Adoption of Malaysian Financial Reporting Standards – Government Loans*
- Amendments to MFRS 1, *First-time Adoption of Malaysian Financial Reporting Standards (Annual Improvements 2009–2011 Cycle)*
- Amendments to MFRS 101, *Presentation of Financial Statements (Annual Improvements 2009–2011 Cycle)*
- Amendments to MFRS 116, *Property, Plant and Equipment (Annual Improvements 2009–2011 Cycle)*
- Amendments to MFRS 132, *Financial Instruments: Presentation (Annual Improvements 2009–2011 Cycle)*
- Amendment to MFRS 134, *Interim Financial Reporting (Annual Improvements 2009–2011 Cycle)*
- Amendments to MFRS 10, *Consolidated Financial Statements: Transition Guidance*
- Amendments to MFRS 11, *Joint Arrangements: Transition Guidance*
- Amendments to MFRS 12, *Disclosure of Interests in Other Entities: Transition Guidance*

MFRSs, Interpretations and amendments effective for annual periods beginning on or after 1 January 2014

- Amendments to MFRS 132, *Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities*

MFRSs, Interpretations and amendments effective for annual periods beginning on or after 1 January 2015

- MFRS 9, *Financial Instruments* (2009)
- MFRS 9, *Financial Instruments* (2010)

The AOB plans to apply the abovementioned standards, amendments and interpretations:

- from the annual period beginning on 1 January 2013 for those standards, amendments or interpretations that are applicable and effective for annual periods beginning on or after 1 January 2013.
- from the annual period beginning on 1 January 2014 for those standards, amendments or interpretations that are applicable and effective for annual periods beginning on or after 1 January 2014.
- from the annual period beginning on 1 January 2015 for those standards, amendments or interpretations that are applicable and effective for annual periods beginning on or after 1 January 2015.

Material impacts of initial application of a standard, an amendment or an interpretation are discussed below:

MFRS 9, *Financial Instruments*

MFRS 9 replaces the guidance in MFRS 139, *Financial Instruments: Recognition and Measurement* on the classification and measurement of financial assets. Upon adoption of MFRS 9, financial assets will be measured at either fair value or amortised cost.

MFRS 13, *Fair Value Measurement*

MFRS 13, *Fair Value Measurement* establishes the principles for fair value measurement and replaces the existing guidance in different MFRSs.

(b) Basis of measurement

The financial statements have been prepared on the historical cost basis.

(c) Functional and presentation currency

These financial statements are presented in ringgit Malaysia (RM), which is the AOB's functional currency. All financial information presented in RM.

(d) Use of estimates and judgements

The preparation of financial statements in conformity with MFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

There are no significant areas of estimation uncertainty and critical judgements in applying accounting policies that have significant effect on the amounts recognised in the financial statements.

3. Significant accounting policies

The accounting policies set out below have been applied consistently to the periods presented in these financial statements, in preparing the opening MFRS statements of financial position of the AOB at 1 January 2011 (the transition date to MFRS framework), and have been applied consistently by the SC, unless otherwise stated.

(a) Financial instruments

Financial instruments are categorised and measured using accounting policies as mentioned below:

(i) Initial recognition and measurement

A financial asset or a financial liability is recognised in the statement of financial position when, and only when, the AOB becomes a party to the contractual provisions of the instrument.

A financial instrument is recognised initially, at its fair value plus, in the case of a financial instrument not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial instrument.

(ii) Financial instrument categories and subsequent measurement

The AOB categorises financial instruments as follows:

Financial assets

Loans and receivables

Loans and receivables category comprises other receivables and cash and cash equivalents.

Financial assets categorised as loans and receivables are subsequently measured at amortised cost, using the effective interest method.

All financial assets are subject to review for impairment (see Note 3(c)).

Financial liabilities

All financial liabilities are subsequently measured at amortised cost, using the effective interest method.

(iii) Derecognition

A financial asset or part of it is derecognised when, and only when the contractual rights to the cash flows from the financial asset expire or the financial asset is transferred to another party without retaining control or substantially all risks and rewards of the asset. On derecognition of a financial asset, the difference between the carrying amount and the sum of the consideration received (including any new asset obtained less any new liability assumed) and any cumulative gain or loss that had been recognised in equity is recognised in profit or loss.

A financial liability or a part of it is derecognised when, and only when, the obligation specified in the contract is discharged or cancelled or expires. On derecognition of a financial liability, the difference between the carrying amount of the financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss.

(b) Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, balances and deposits with banks which have an insignificant risk of changes in value with original maturities of six months or less. For the purpose of the statement of cash flows, cash and cash equivalents are presented net of restricted deposits.

(c) Impairment

Financial assets

All financial assets are assessed at each reporting date whether there is any objective evidence of impairment as a result of one or more events having an impact on the estimated future cash flows of the asset. Losses expected as a result of future events, no matter how likely, are not recognised.

An impairment loss in respect of loans and receivables is recognised in profit or loss and is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account.

(d) Income

Registration fees

Registration fees from auditors of public interest entities are recognised in profit or loss when the payment is received.

Financing income

Financing income is recognised as it accrues using the effective interest method in profit or loss.

4. Other receivables

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Income receivable	—	49,435	43,643
Deposits	80,850	80,850	80,650
	<u>80,850</u>	<u>130,285</u>	<u>124,293</u>

5. Cash and cash equivalents

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Cash and bank balances	400,684	22,869	410,088
Deposits placed with a licensed bank	509,848	3,094,463	4,014,871
	<u>910,532</u>	<u>3,117,332</u>	<u>4,424,959</u>

The deposits placed with a licensed bank earned income at the rate of 3% per annum (2011: 3.55% per annum) and mature in one month (2011: 6) .

Included in deposits placed with a licensed bank is RM5,000 (2011: Nil) restricted to be utilised for planning and implementing capacity building programmes in relation to the accounting and auditing profession.

6. Fund from the SC

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Cash contribution from: SC	6,000,000	5,000,000	5,000,000

7. Accumulated deficit

	RM
As at 1 January 2011	(549,555)
Loss for the year	(1,826,054)
As at 31 December 2011	(2,375,609)
Loss for the year	(2,696,115)
As at 31 December 2012	(5,071,724)

8. Other payables and accruals

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Amount due to the SC	–	586,819	–
Other payables	63,106	36,407	98,807
	63,106	623,226	98,807

In prior year, amount due to the SC arose from expenses paid on behalf. The amount owing is unsecured, interest free and repayable on demand.

9. Administrative expenses

	2012 RM	2011 RM
The administrative expenses consist of:		
Auditor's remuneration:		
– Audit services	20,000	20,000
– Other services	10,000	-
Honorarium payment	13,325	6,380
Non-executive members' allowance	102,500	56,000
Other miscellaneous charges	319,367	300,271
Rental of premises	325,296	326,273
Staff costs	3,582,020	2,920,260
	<u>4,372,508</u>	<u>3,629,184</u>

10. Financial instruments

10.1 Categories of financial instruments

The table below provides an analysis of financial instruments categorised as follows:

- (a) Loans and receivables (L&R); and
- (b) Other financial liabilities measured at amortised cost (OL).

	Carrying amount RM	L&R RM	OL RM
31.12.2012			
Financial assets			
Other receivables	80,850	80,850	-
Cash and cash equivalents	910,532	910,532	-
	<u>991,382</u>	<u>991,382</u>	<u>-</u>
Financial liabilities			
Other payables and accruals	(63,106)	-	(63,106)
	<u>(63,106)</u>	<u>-</u>	<u>(63,106)</u>
31.12.2011			
Financial assets			
Other receivables	130,285	130,285	-
Cash and cash equivalents	3,117,332	3,117,332	-
	<u>3,247,617</u>	<u>3,247,617</u>	<u>-</u>

Financial liabilities

Other payables and accruals	(623,226)	–	(623,226)
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1.1.2011**Financial assets**

Other receivables	124,293	124,293	–
Cash and cash equivalents	4,424,959	4,424,959	–
	4,549,252	4,549,252	–

Financial liabilities

Other payables and accruals	(98,807)	–	(98,807)
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10.2 Financial risk management objectives and policies

The AOB is primarily exposed to liquidity risk in the normal course of the AOB's operations. As the AOB is administered by the SC, the AOB is subject to the SC's financial risk management policies.

10.3 Credit risk

Credit risk is the risk of a financial loss to the AOB if a counterparty to a financial instrument fails to meet its contractual obligations.

The AOB is not exposed to any credit risk as the AOB does not have any trade debts.

10.4 Liquidity risk

Liquidity risk is the risk that the AOB will not be able to meet its financial obligations as they fall due.

The AOB, via the SC, monitors and maintains a level of cash and cash equivalents deemed adequate to finance the AOB's operations and to mitigate the effects of fluctuations in cash flows.

Maturity analysis

The table below summarises the maturity profile of the AOB's financial liabilities as at the end of the reporting period based on undiscounted contractual payments.

	Carrying amount RM	Contractual cash flow RM	Under 1 year RM
31.12.2012			
Financial liabilities			
Other payables and accruals	63,106	63,106	63,106
	<u> </u>	<u> </u>	<u> </u>
31.12.2011			
Financial liabilities			
Other payables and accruals	623,226	623,226	623,226
	<u> </u>	<u> </u>	<u> </u>
1.1.2011			
Financial liabilities			
Other payables and accruals	98,807	98,807	98,807
	<u> </u>	<u> </u>	<u> </u>

10.5 Market risk

Market risk is the risk that changes in market prices, such as interest rates that will affect the AOB's financial position or cash flows.

10.5.1 Interest rate risk

The interest rate profile of the AOB's significant interest-bearing financial instruments, based on carrying amounts as at the end of the reporting period was:

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Fixed rate instruments			
Financial assets	509,848	3,094,463	4,014,871
	<u> </u>	<u> </u>	<u> </u>

Interest rate risk sensitivity analysis

Fair value sensitivity analysis for fixed rate instruments

The AOB does not account for any fixed rate financial assets at fair value through profit or loss, and the AOB does not designate derivatives as hedging instruments under a fair value hedge accounting model. Therefore, a change in interest rates at the end of the reporting period would not affect profit or loss.

10.6 Fair values

In respect of cash and cash equivalents, other receivables, other payables and accruals, the carrying amounts approximate fair value due to the relatively short-term nature of these financial instruments.

11. Fund management

	31.12.2012 RM	31.12.2011 RM	1.1.2011 RM
Fund from the SC	6,000,000	5,000,000	5,000,000
Accumulated deficit	(5,071,724)	(2,375,609)	(549,555)
	<u>928,276</u>	<u>2,624,391</u>	<u>4,450,445</u>

The AOB's objective is to maintain adequate reserves to safeguard the AOB's ability to perform its duties and functions independently. The reserves are managed by the SC.

12. Taxation

The SC was granted approval from the Minister of Finance to be exempted from taxation with effect from Year Assessment (YA) 2007 onwards. Accordingly, the AOB is tax-exempted.

13. Authorisation of financial statements

The financial statements for the year ended 31 December 2012 were authorised by the SC for issuance and signed by the Chairman of the SC and Executive Chairman of AOB on 31 January 2013.

14. Explanation of transition to MFRSs

As stated in note 2(a), these are the first financial statements of the AOB prepared in accordance with MFRSs.

The accounting policies set out in note 3 have been applied in preparing the financial statements of the AOB for the financial year ended 31 December 2012, the comparative information presented in these financial statements for the financial year ended 31 December 2011 and in the preparation of the opening MFRS statement of financial position at 1 January 2011 (the AOB's date of transition to MFRSs).

There are no differences between the financial statements of AOB prepared in accordance with FRSs in Malaysia and MFRSs.

STATUTORY DECLARATION

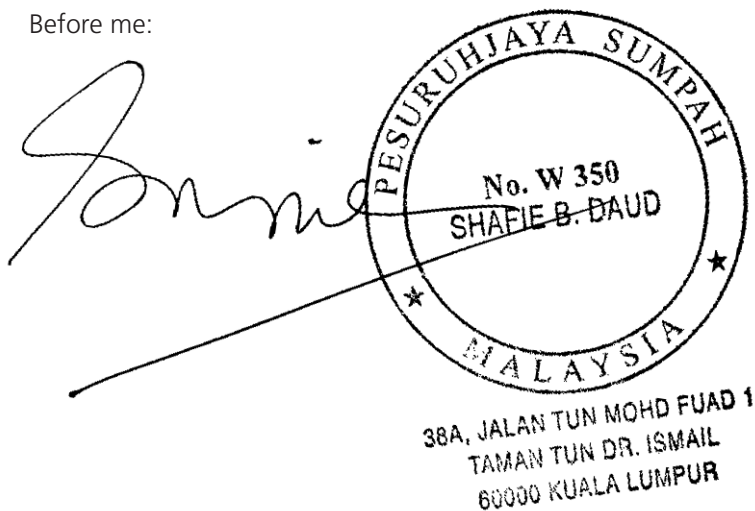
I, Vignaswaran A/L Kandiah, the officer primarily responsible for the financial management of Audit Oversight Board, do solemnly and sincerely declare that the financial statements set out on pages 45 to 58 are, to the best of my knowledge and belief, correct and I make this solemn declaration conscientiously believing the same to be true, and by virtue of the provisions of the *Statutory Declarations Act, 1960*.

Subscribed and solemnly declared by the abovenamed in Kuala Lumpur on 31 January 2013.



Vignaswaran A/L Kandiah

Before me:



Report on the Financial Statements

We have audited the financial statements of the Audit Oversight Board (AOB), which comprise the statement of financial position as at 31 December 2012, and the statements of profit or loss and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information, as set out on pages 45 to 58.

Commission Members' Responsibility for the Financial Statements

The Commission Members of the Securities Commission Malaysia (Commission) are responsible for the preparation of these financial statements that give a true and fair view in accordance with Malaysian Financial Reporting Standards and with International Financial Reporting Standards, and for such internal control as the Commission Members determine are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with approved standards on auditing in Malaysia. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Commission's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the AOB's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Commission Members, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements have been properly drawn up in accordance with Malaysia Financial Reporting Standards and with International Financial Reporting Standards so as to give a true and fair view of the financial position of the AOB as of 31 December 2012 of its financial performance and cash flows for the year then ended.

Other Matters

This report is made solely to the Securities Commission Malaysia, as a body, and for no other purpose. We do not assume responsibility to any other person for the content of this report.



KPMG

Firm Number: AF 0758
Chartered Accountants



Peter Ho Kok Wai
Partner

Approval Number: 1745/12/13(J)

Petaling Jaya, Malaysia

Date: 31 January 2013

INSPECTION PROCESS AND BASIS OF REPORTING

The AOB conducts its inspection based on the auditing and ethical standards promulgated by the MIA which have been adopted by the AOB as provided for under section 31U of Part IIIA of the SCA.

In determining compliance with the relevant auditing and ethical standards, the AOB could emphasis on the audit firms and auditors to comply in substance rather than in form. As such, any compliance of the standards in form but not in substance may be regarded as non-compliance with the standards.

The inspection process commences with communication with the audit firms, following through with planning matters, the entrance meeting, on-site inspection and the exit meeting.

As an essential means to audit quality, it is necessary for all audit procedures and audit evidences to be documented properly and adequately to support the audit opinion. Some deficiencies may be of such importance that it appeared that the auditor may have failed to obtain sufficient and appropriate evidence to support its audit opinion on the financial statement at the time it issued the audit report. Robust written explanations on critical areas such as estimates and professional judgement is pertinent, with an appropriate depth of analysis as evidence to support

the audit conclusion. Therefore, in the absence of documentation or other persuasive evidence, even if the auditor claimed to have performed the procedure, the auditor is regarded to have failed to perform an audit procedure.

At the conclusion, following each inspection, the AOB issues a draft inspection report to each audit firm which includes deficiencies observed during the inspection, notwithstanding such deficiencies may have been addressed by the firm or in other audit engagements after the deficiencies were uncovered by the AOB. The audit firms are expected to provide their responses within specific time periods prescribed by the AOB. The AOB will finalise the inspection report after taking into account representations made by the audit firms. Remediation measures and timelines would also be agreed with the firms with the focus on safeguarding and enhancing audit quality.

Each audit firm is required to report on the outcome of the remedial measures which have been or are being taken to address the deficiencies raised in the inspection report. The AOB may publish the inspection report if the auditor fails to take the relevant remedial measures.

Scope of Inspections, Remediation and Root Causes

The AOB conducts regular inspection on the Major Audit Firms with more than 10 individual auditors and auditing more than 40 PIEs on an annual basis. In addition, the AOB performs risk assessments annually and selects Other Audit Firms for inspection based on a pre-determined cycle. In 2012, there were 19 audit firms scoped in for AOB's inspection, which includes the Major Audit Firms. The AOB envisages that the Major Audit Firms will continue to be inspected annually while other firms registered with the AOB will be subjected to inspection over a pre-determined cycle.

The AOB may inspect a registered audit firm either through a regular inspection or special inspection.

Regular inspection refers to an inspection conducted on a routine basis to ensure that all audit firms of PIEs are at least reviewed within a pre-determined cycle. A regular inspection is conducted with a focus on high risk areas and generally considers the possible impact the audit firm or auditor's quality has on the overall confidence of the market and investors.

Special inspection is usually driven by specific concerns, either by events or industry issues that may pose a risk to investor protection or raise concerns over the quality and reliability of the related audited financial statements. Such an inspection covers specific aspects of an audit with greater depth and detail as compared to a regular inspection.

A risk-based approach is adopted by the AOB which considers the risks of the audit firm and its portfolio of clients to enable the AOB to focus its efforts on

the areas of highest risk. The approach was designed to focus on aspects of these audit firms' operations that have impact on audit quality. The inspection methodology provides a framework for the application of a consistent process to all inspections.

The principle risk that will impact the market and investors' confidence in audited financial statements of the PIEs is where an audit firm forms an inappropriate audit opinion on these financial statements. Consequently, the key challenge of an inspection is to detect the gaps in the audit firms' application of auditing and ethical standards.

Given the AOB's inspections are risk-based, it will not review all aspects of the firm's quality control policies and procedures or audit engagements to identify every aspect in which a reviewed audit is deficient. Hence, an inspection should not be taken to provide an assurance that the quality control of the firm, its audits or the financial statements are free from any deficiencies not specifically uncovered.

For a firm review, the evaluation of the system of quality controls entail how an audit firm has established and maintained the system that includes policies and procedures which address each of the following elements stipulated in ISQC 1:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

The matters arising from the firm level review could be placed into two categories i.e. design and compliance issues. The design issue refers to the absence of control to address the identified risks. The compliance issue is defined as the failure of the firm's control to detect the identified risks. The objectives of the engagement reviews are to assess the degree of compliance with auditing and ethical standards by the auditor and to assess the quality of audit reports prepared by an auditor relating to the audited financial statements of the PIEs. In essence, the inspection places emphasis on the sufficiency and appropriateness of audit evidence obtained, in particular for key audit judgement areas that support the audit opinion.

In 2012, the AOB continued to follow up on remediation plans that were submitted by the audit

firms that were inspected for continuous improvement in audit quality. The AOB acknowledges that there is no generic prescription to fully eliminate risks to audit quality. However, positive relevant measures implemented to address the deficiencies identified during inspection and their corresponding root causes are pertinent to drive audit quality. The remediation plan generally covers certain firm specific improvement areas in the short, medium and long term including specific performance indicators and timelines.

The AOB expects the audit firm to provide a holistic approach to remediation, mainly to identify and address the root causes of the audit deficiencies. The AOB discusses the proposed plans with the audit firms and provides its views to ensure their appropriateness.

ACRONYMS AND ABBREVIATIONS

AARG	ASEAN Audit Regulators Group
AASB	MIA Auditing and Assurance Standards Board
ACRA	Singapore Accounting and Corporate Regulatory Authority
AOB	Audit Oversight Board
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
CCM	Companies Commission of Malaysia
CPAAOB	Japan Certified Public Accountants and Auditing Oversight Board
EQCR	Engagement Quality Control Review
FRS	Financial Reporting Standards
FSB	Financial Stability Board
IAASB	International Auditing and Assurance Standard Boards
ICAA	Institute of Chartered Accountants Australia
ICAEW	Institute of Chartered Accountants in England and Wales
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
ISAE	International Standards on Assurance Engagements
ISQC 1	International Standards on Quality Control 1: Quality Controls for Other Assurance and Related Services Engagements
ITC	Invitation to Comment: Improving the Auditor's Report
JFSA	Japan Financial Services Authority
MIA	Malaysian Institute of Accountants
MIA By-laws	By-Laws (On Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
PIE	Public-interest entity
PLC	Public-listed company
ROSC AA	Report on the Observance of Standards and Codes on Accounting and Auditing
SC	Securities Commission Malaysia
SCA	<i>Securities Commission Act 1993</i>

DEFINITIONS

Auditor	An individual auditor or audit firm who is registered under section 310 of the <i>Securities Commission Act 1993</i> as an auditor of a PIE.
Big Four Audit Firms	Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.
Public-interest entity	<p>An entity meeting the following definition:</p> <ul style="list-style-type: none">(a) A PLC or a corporation listed on the stock exchange(b) A licensed institution licensed under the <i>Banking and Financial Institutions Act 1989</i>.(c) An insurance company licensed under the <i>Insurance Act 1996</i>(d) A takaful operator registered under the <i>Takaful Act 1984</i>(e) An Islamic bank licensed under the <i>Islamic Banking Act 1983</i>(f) A developmental financial institution prescribed under the <i>Development Financial Institutions Act 2002</i>(g) A holder of Capital Markets Services Licence for the carrying on of the regulated activities of dealing in securities, dealing in derivatives and fund management; and(h) Any other person as the Minister may, by order published in the <i>Gazette</i>, prescribe.
Major Audit Firms	Audit firms with more than 10 partners and audit more than 40 PIEs annually.
Other Audit Firms	Mid-tier audit firms and sole proprietors.