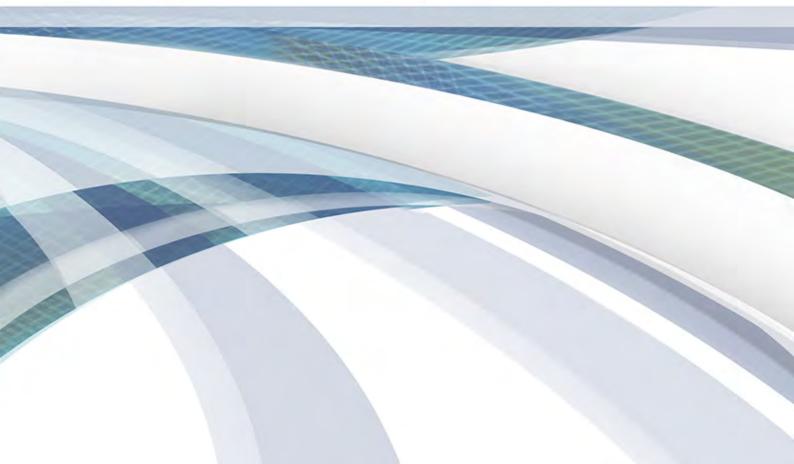


audit oversight board annual report

Suruhanjaya Sekuriti
Securities Commission





# AUDIT OVERSIGHT BOARD ANNUAL REPORT 2015

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The cut-off date for the data included in this report was 31 December 2015.

## **MISSION STATEMENT**

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

## **CONTENTS**

Executive Chairman's Message	vii
Overview of the AOB's Strategies	xii
PART ONE Promote High Quality Audit Practices	1
AUDITING LANDSCAPE	3
<ul> <li>Registered Audit Firms and Individual Auditors</li> <li>Recognised Foreign Audit Firms and Individual Auditors</li> <li>Insights on the Top 10 Audit Firms in Malaysia</li> </ul>	3 5 5
AUDIT QUALITY	10
<ul> <li>Box 1: Impact from AOB's Regulatory Activities</li> <li>Inspections</li> <li>Small Firms Initiative – Encouraging Capacity Building Among Smaller Firms</li> <li>Focus Group Discussions – Strengtening Firms' Functions to Support Audit Qualiry</li> <li>Box 2: Key Insights of Small Firms</li> <li>Feedback from Focus Group Discussions – Strengthening Firm's Function to Support Audit Quality</li> </ul>	11 12 13 13 14 15
<ul> <li>Key Observations from Firm Level Review of Major Audit Firms</li> <li>Key Observations from Firm Level Review of Other Audit Firms</li> <li>Key Observations from Engagement Level Review of Major Audit Firms and Other Audit Firms</li> <li>Box 3: Reliance of Valuation Report</li> <li>Box 4: Evaluating Appropriate Accounting Treatment</li> <li>Box 5: Audit Innovation – Leveraging Data Analytics in the Execution of Audits</li> <li>Remediation</li> <li>Conclusion</li> </ul>	17 21 26 32 33 34 35 38
ENFORCEMENT	40
<ul> <li>Significant Enforcement Milestones</li> <li>Suitability of Auditor</li> <li>AOB Actions in 2015</li> </ul>	40 41 42

PART TWO Influence Financial Reporting Ecosystem and Leverage Stakeholders' Support	45
<ul> <li>The Financial Reporting Ecosystem and Quality of Financial Reporting</li> <li>Reaching Out to the Financial Reporting Ecosystem</li> <li>Capacity Building and Bridging Expectation Gaps</li> <li>Sharing Global Perspectives</li> <li>New Auditor's Report</li> </ul>	47 47 48 48 49
PART THREE  Assessment of Performance and Effectiveness	53
• 2015 Key Performance Review Box 1: Amendments to Part IIIA of the Securities Commission Malaysia Act 1993	55 58
PART FOUR  Support Adoption and Implementation of Standards	59
<ul> <li>Development and Implementation of Standards and Regulations</li> <li>Global Initiatives in Reforming the Audit Market and Practices</li> </ul>	61 64
PART FIVE  Statement on Governance	67
<ul> <li>Members of the Audit Oversight Board</li> <li>Statement on Governance</li> </ul>	69 73
PART SIX Financial Statements and Others	77
<ul> <li>Financial Statements of the Audit Oversight Board</li> <li>Acronyms and Abbreviations</li> <li>Definitions</li> </ul>	79 96 97

## **Executive** Chairman's Message



## **EXECUTIVE CHAIRMAN'S MESSAGE**



The efforts in fostering high quality audit in confidence in audited maintaining financial statements of public-interest entities (PIEs) require all stakeholders to play their roles effectively.

Building on the outcomes achieved in previous years, the Audit Oversight Board (AOB) continued to set the tone by bringing new dimensions in its oversight activities and sending strong signals through enforcement actions taken when regulatory expectations and professional standards were compromised. Challenging economic environment and the sense of frustration at the global level on the pace of improvements in audit quality certainly indicated that more is required to be done to ensure capital market participants are able to make economic decisions based on reliable information, particularly audited financial statements of PIEs.

While we acknowledge the ongoing efforts of audit firms to ensure the reliability of their work, we noted the increase in engagements requiring significant improvement by Major Audit Firms as a signal for immediate attention. In this respect, audit firms need to improve their root cause analyses to ensure their remediation measures address the real drivers of risks and weaknesses.

On the other hand, we noted that firms which were determined to maintain audit quality and professional standards were not worse off economically compared to their peers, and in certain market segments were more competitive. This is a good signal to audit firms that maintaining quality and upholding professional standards are sensible to do in business.

#### **Auditing landscape**

We continue to see that audit clients are concentrated with audit firms which have more than 10 partners and collectively audit 922 PIEs covering 95.64% of the market capitalisation of public-listed companies (PLCs), and 872 schedule funds covering 99.3% of the fund size in Malaysia.

We also observed active movements of PIE clients from Major Audit Firms to Other Audit Firms. While it is encouraging to note that there is increased competitiveness among audit firms, it is important to bear in mind that it should not be at the expense of audit quality.

We also noted that audit fees continued to grow in the same trajectory in the last few years while the pressure on salary had moderated, although

the overall salary cost was still on the uptrend. We believe with the appropriate pricing model, audit firms would have enough margins to ensure their audit work would be more effective.

#### Continuing with the momentum for audit quality

Leadership by example is a key success factor for the promotion of audit quality. It is obvious that the tone at the top that promotes a quality-oriented internal culture will positively influence partners and audit engagement teams' behaviour and commitment to audit quality.

Inspections findings revealed that firms need to strengthen efforts to promote effectiveness of their system of quality controls. These efforts need to be holistic and cover partner accountability framework, human resources, training and monitoring functions. The emphasis should be on the outcomes of remediation rather than the input, which many firms are using as indicators of their efforts.

In addition to inspections, AOB attempted to influence audit quality by engaging smaller firms and embarking on data collection and analysis covering the top 10 audit firms.

In the engagements with selected small audit firms, issues and challenges observed through our past work were discussed. Firms were required to update AOB on the progress of their plans in improving audit quality and any potential risk would be raised to their attention. We hope to observe meaningful progress when the firms are inspected in the future.

Sharing of key statistics with leadership of the top 10 audit firms also facilitates identification of the audit firms' areas for improvement and allows them to benchmark themselves against their peers. This would also encourage audit firms to set targets for better positions and performance levels to be achieved through their future work.

#### Maintaining strong tone through regulation

Actions by AOB are intended to send a strong signal to the profession and market that non-compliance to standards and regulation will not be viewed liahtly.

This year for the very first time, AOB revoked the registration of an audit firm and two of its partners for failure to remain fit and proper to audit PIEs. We trust other firms will view this seriously and would respond appropriately in improving their work.

Moving forward, we will continue to deal with failure of maintaining audit quality and professional standards decisively while working closely with audit firms to address any concern or difficulty in dealing with issues which they need to confront in the market.

#### Building the foundation for the new audit reporting model

The new audit reporting model will be applied beginning 2017. In preparing for this, AOB has been involved in efforts to ensure the revised reports would be able to be implemented without any major hiccup. We have worked with fellow regulators and the accountancy profession in ensuring issues such as supportive legal framework, guidance and awareness were dealt with earlier.

AOB had also monitored the early adoption of the standards in certain markets and had shared views on their implementation with relevant parties. While it could be too early to judge the effectiveness of the new reporting model, we trust auditors would attempt to communicate as effectively as possible and refrain from using boilerplates, the issue that many stakeholders have with the existing approach.

PIEs should also assess the impact of the new auditor reporting model and ensure that they have effective finance functions to deal with some of the issues which may arise.

#### Setting for the next phase of **AOB**

Four members of the AOB conclude their statutory term in March 2016. They are Datuk Nor Shamsiah Mohd Yunos, Goh Ching Yin, Cheong Kee Fong and Chok Kwee Bee who have been with AOB since establishment. Their pioneering efforts have enabled AOB to be recognised and respected by our stakeholders in Malaysia and internationally for the work that has been done.

AOB also welcomed Dato' Zahrah Abd Wahab Fenner who joined the Board this year.

I wish to record my appreciation to all Board members for their counsel, advice and challenge which has enabled AOB to remain on the right path in pursuing its mission.

The same goes to fellow regulators, professional accountancy bodies and other stakeholders for their ongoing support. Maintaining confidence in audited financial statements of PIEs requires all stakeholders' commitment.

Our operations have been facilitated by the support of the Securities Commission Malaysia (SC) especially in ensuring our legal framework is current and able to deal with specific issues within our market.

Last but not least, to the AOB management team and staff, I would like to express my sincere gratitude for your outstanding performance and efforts.

In conclusion, the collective efforts by all individuals and institutions mentioned above have positioned AOB to meet the challenges in its next phase of growth.

Nik Mohd Hasvudeen Yusoff

# Overview of the AOB's Strategies

AOB aims to achieve the following desired outcomes:

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

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:

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

#### 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, AOB focusses 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

## Leverage stakeholders' support

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

## Support adoption and implementation of standards

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

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





## **AUDITING LANDSCAPE**

#### **REGISTERED AUDIT FIRMS** AND INDIVIDUAL AUDITORS

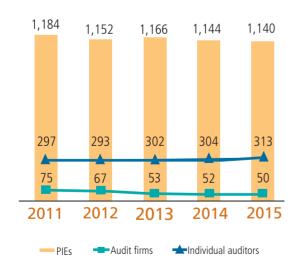
In cognisance that quality audits play a key role in upholding public trust and investor confidence in the capital market, AOB continues to heighten its audit oversight activities through its registration, inspection and enforcement functions. The envisaged outcome is for audit firms to deliver consistent quality audits through continuous capacity building and effective quality framework.

Chart 1 shows the number of audit firms and individual auditors registered with AOB, as well as the number of PIEs audited for the last five years.

While the number of registered audit firms has reduced to 50, the number of registered individual auditors increased to 313 as at 31 December 2015. It should also be noted that the 1.140 PIEs as at 31 December 2015 includes eight new capital market institutions as a result of the amendments to the Securities Commission Malaysia Act 1993 (SCMA).

The upward trend in the number of registered individual auditors and reduction in number of partnerships with less than two partners are indicative of the audit firms' improved commitments to capacity building and succession planning. This also reinforces the audit firms' ability to take on challenges when auditing increasingly complex

Chart 1 5-year registration statistics of registered audit firms and individual auditors from 2011 to 2015



Source: AOB

The upward trend in the number of registered individual auditors and reduction in number of partnerships with less than two partners are indicative of the audit firms' improved commitments to capacity building and succession planning. This also reinforces the audit firms' ability to take on challenges when auditing increasingly complex clients.

Table 1 Registration of audit firms and individual auditors as at 31 December 2015

Profile of audit firms	No. of audit firms	No. of individual auditors	No. of PIEs	% of market capitalisation	No. of schedule funds	% of fund size
Partnerships with more than 10 partners	8	191	922	95.64	872	99.30
Partnerships with 5 – 9 partners	7	32	88	0.68	7	0.20
Partnerships with 2 – 4 partners	35	90	130	3.57	18	0.51
TOTAL	50	313	1,140	99.89	897*	100.00

<sup>\* 84</sup> schedule funds have yet to appoint an auditor as at 31 December 2015.

Source: AOB

clients. AOB consistently reiterates that auditors are required to comply with international quality control, auditing, ethical and other assurance standards adopted by the accountancy profession in Malaysia.

As at 31 December 2015, clients were concentrated with audit firms having more than 10 partners which collectively audited 922 PIEs covering 95.64% of the market capitalisation of PLCs, and 872 schedule funds covering 99.3% of the fund size in Malaysia.

#### PIE clients' movements

In 2015, AOB observed active movement of PIE clients from Major Audit Firms<sup>1</sup> to Other Audit Firms. While the increased competitiveness is encouraging, audit firms should remain mindful of their responsibilities to act in the public interest and ensure that audit quality is not compromised.

PIE clients' movement among registered and recognised audit firms during 2015

	As at 1 Jan		Delisted/	No. o incomir		No. o outgo		As at 31 Dec
Firm size	2015	New	Removed	Major	Other	Major	Other	2015
Major Audit Firms	806	17	(19)	-	7	-	(25)	786
Other Audit Firms	338	5	(7)	25	10	(7)	(10)	354
Foreign	6	1	-	-	-	-	-	7
PIE Without Auditor	1	1	-	-	-	-	-	2
TOTAL	1,151	24	(26)	25	17	(7)	(35)	1,149

Source: AOB

Major Audit Firms collectively audit approximately 94% of the PIEs listed on Bursa Malaysia by market capitalisation.

#### **RECOGNISED FOREIGN AUDIT** FIRMS AND INDIVIDUAL **AUDITORS**

As at 31 December 2015, the AOB recognised five foreign audit firms and 12 foreign individual auditors. Collectively, they audit seven foreign incorporated companies listed on Bursa Malaysia.

Chart 2 Recognition statistics from 2012 to 2015



Source: AOB

#### **INSIGHTS ON THE TOP 10 AUDIT FIRMS IN MALAYSIA**

To ensure AOB has clear understanding of the trends affecting the auditing industry, data collection from the top 10 audit firms in Malaysia by PIEs' market capitalisation commenced in 2014. Certain key statistics were shared with the leadership of relevant audit firms.

The top 10 audit firms welcomed and encouraged continued sharing of the statistics which for the first time allowed them to benchmark their performance among their peers and against Malaysia's audit industry average. This also facilitated identification of the audit firms' areas for improvement to further support audit quality. It is anticipated that continuous engagement with the audit firms will encourage increased quality of audit work through the strengthening of audit planning, execution, and communication.

In 2015, AOB collected statistics from the top 10 audit firms which collectively audited 938 PIEs covering 98.2% of the market capitalisation of PLCs, and 874 schedule funds covering 99.3% of the fund size in Malaysia as at 31 December 2015. Results of the analysis are presented below.

#### Audit fees vs salary costs

Chart 3 indicates some reduction in pressure to maintain margins from audit services. While fees are growing at a steady trajectory, the pressure on salary had relatively eased notwithstanding the overall salary cost was still on the uptrend. In 2015, audit fees' growth rate exceeded salary costs' growth rate by 3.7%, suggesting that the top 10 audit firms are moving towards a more appropriate audit pricing strategy.

In view of this, there needs to be continuous conversation between the auditors and stakeholders to ensure they are sufficiently remunerated to allow them to perform a good audit.

Chart 3 Growth rates in audit fees and salary costs



Note: The 2014 data was revised based on additional information provided by the firms.

Source: AOB Analysis - Top 10 audit firms in Malaysia

#### **Training**

Given the extensive involvement of non-executive audit staff as shown in Chart 4, audit firms are expected to regularly and consistently provide relevant technical and practical applications training to non-executive audit staff to support delivery of quality audit work. On an overall basis, the average training hours spent by the audit staff continue to be higher than the average of Malaysian Institute of Accountants' (MIA) mandatory Continuing Professional Education (CPE) training hours<sup>2</sup> of approximately 40 hours per calendar year basis.

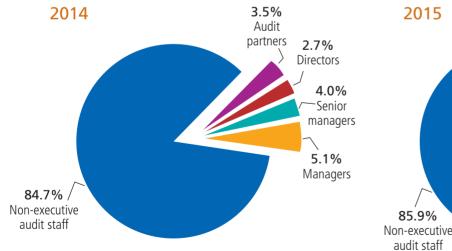
Chart 5 demonstrates the firms' emphasis on training for non-executive staff to ensure that they are equipped with the fundamental basics for audit. However, despite efforts in this area, some audit engagement teams continue to demonstrate a lack of sufficient technical competence in the execution of audit, thus raising concerns on the effectiveness of such training. This is supported by AOB's inspections and re-inspections which revealed deficiencies in fundamental audit areas. Engagement partners are expected to play an active role in reinforcing the knowledge acquired by staff during the execution of the audits to complement the learning process.

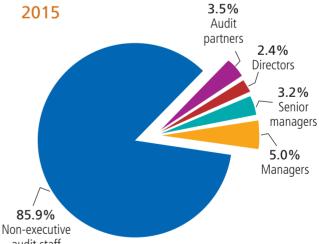
Chart 5 Average number of training hours



Source: AOB Analysis - Top 10 audit firms in Malaysia

Audit staff by level to total headcount





Source: AOB Analysis - Top 10 audit firms in Malaysia

MIA's mandatory CPE requirements are aligned to global standards and those of the International Federation of Accountants (IFAC).

#### **Human resources: Talent attrition**

In 2015, talent retention continued to be one of the biggest challenges faced by the top 10 audit firms. It is observed in Chart 6 that the average non-executive staff turnover rate is higher than that for directors and managers over the past three years.

AOB detailed analysis further reveals a falling nonexecutive audit staff average years of experience from three to two. (Chart 8)

Having non-executive audit staff with an average of two years' audit experience predominantly supporting the top 10 audit firms underscores the need for regular and consistent relevant technical and practical applications training to support delivery of quality audit work. This also clearly indicates that more guidance and experience sharing from more senior levels are needed to compensate for the lack of experience of the current audit engagement teams in order to continue to deliver quality audit work.

Based on the circumstances above, it is important to have an appropriate balance of audit staff to partner and manager ratio. Such ratio must allow for sufficient time involvement of senior personnel

Chart 7 Audit staff to partner and non-executive audit staff to manager ratios



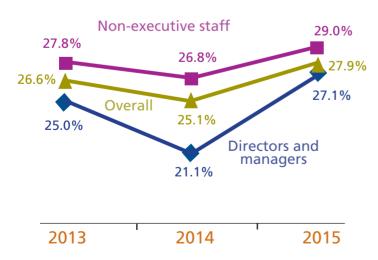


Source: AOB Analysis – Top 10 audit firms in Malaysia

to coach, direct and supervise the audit engagement team.

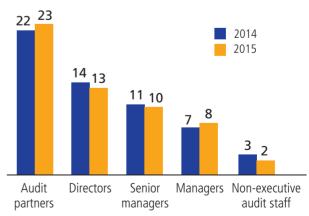
However, average ratios of non-executive staff to manager and partner continue to rise, as evidenced in Chart 7. This reduces opportunities for communication and guidance, generally contributing towards the increasing audit staff turnover rate.

Chart 6 Average audit staff turnover rate



Source: AOB Analysis - Top 10 audit firms in Malaysia

Chart 8 Average years of experience for audit staff



Source: AOB Analysis - Top 10 audit firms in Malaysia

#### **Human resources: Experience**

AOB detailed analysis revealed that audit partners in six of the top 10 audit firms have over 23 years of experience. While AOB realises that the number of years of experience may not be a reflection of the level of capability, experience can influence the ability to make professional judgements.

Hence, audit partners should actively share experiences with staff in order to further boost learning capabilities, ease the steep learning curve in today's increasingly complex environment and better prepare for challenges ahead.

Audit firms must also emphasise a culture of sharing of inspection findings with all audit staff. This practice increases the level of awareness and understanding, and improves the level of audit quality throughout the firm and its network on a consistent basis.

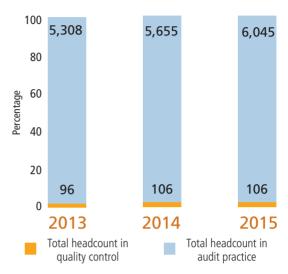
#### Monitoring and quality control

In efforts to comply with the International Standard on Quality Control (ISQC) 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements, registered audit firms are expected to have a robust and effective monitoring control framework in place. Over the last two years, the number of resources involved in quality control has remained fairly unchanged.

The year 2015 showed a slight decline in technical resources to 1% of total headcount in audit practice. However, despite the downward movement, technical resources have continued to have a higher headcount compared to training and risk management. The average number of resources in training and risk management has remained unchanged since 2013.

The AOB detailed analysis found that the total number of audit staff has grown by 14% over

Chart 9 Total headcount in quality control vs total headcount in audit practice



Source: AOB Analysis - Top 10 audit firms in Malaysia

the last two years. Taking into consideration that less than 2% of the top 10 audit firms' resources are serving the growing audit practice with regard to quality control matters, AOB is of the view that greater emphasis and capacity building is crucial in this area. If left unchecked, the downward trend in the headcount for quality control could ultimately affect the audit firms' ability to maintain consistent and good quality audits.

#### Partner workload

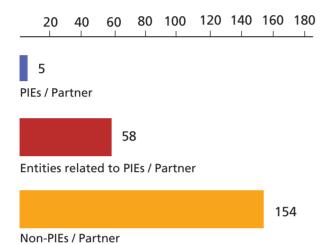
Balancing workload among audit partners is crucial to ensure that there is sufficient partner involvement for each audit engagement. AOB's inspections have found that an unreasonable workload contributes towards inconsistency of engagement performance which ultimately affects audit quality.

Chart 10 depicts that on average, a partner reviewed and signed 217 audit reports in 2015 which could range up to 24 PIES, 288 entities related to PIEs3,

Entities related to PIEs' refer to non-PIEs within the PIE Group which are audited by the Malaysian audit firm. Examples include, but are not limited to, subsidiaries, associates and joint ventures of PIEs.

or 1,330 non-PIEs per partner. Although non-PIES do not fall within the AOB's scope of inspection, auditors should be mindful that a higher non-PIE per partner workload can affect the performance of the same partner in PIE audit engagements.

Chart 10 Average number of clients per partner



Source: AOB Analysis - Top 10 audit firms in Malaysia

Table 3 Range of clients per partner

	PIEs / Partner	Entities related to PIE / Partner	Non-PIEs / Partner
Range	1 - 24	1 - 288	1 - 1,330

Source: AOB Analysis - Top 10 audit firms in Malaysia

#### **Conclusion**

The AOB observed that the top 10 audit firms had deployed more appropriate audit pricing strategies. With the appropriate pricing model, audit firms would have enough margins to ensure their audit work would be more effective without compromising quality.

Having non-executive audit staff with an average of two years' audit experience predominantly supporting the top 10 audit firms underscores the need for regular and consistent relevant technical and practical applications training to support delivery of quality audit work. Effectiveness of the training programmes should remain an area of focus for audit firms, as some audit engagement teams continue to demonstrate a lack of sufficient technical competence in the execution of audit.

Attraction and retention of talents continue to be essential to an audit firm's sustainability and ability to improve audit quality. To address the rising audit staff turnover rates, audit firms should review the effectiveness of their firms' talent attraction and retention strategies to ensure that they are aligned with employees' aspirations.

AOB reiterates the need for a balanced partner workload among audit partners. This would facilitate greater partner involvement per audit engagement, thereafter contributing towards better quality audits. In view that the percentage of audit partners to total audit practice headcount in the top 10 audit firms is constant at 3.5%, AOB emphasises the need for urgent development of the quality control functions to ensure that available resources are able to cater to the increasing needs of the growing audit practice. This is of paramount importance, in view of their role in the audit firms' monitoring control framework.

Many of the statistics collected and analysed by AOB are similar or have a similar outcome to intended output from current discussions on Audit Quality Indicators (AQIs). In line with the growing global and regional interest in AQIs, the AOB's Statistics Gathering and Analysis initiative is moving in tandem with the efforts undertaken by the ASEAN Audit Regulators Group (AARG).

## **AUDIT QUALITY**

Section 31V(1) of the SCMA mandates AOB to conduct regular inspections on auditors of PIEs and schedule funds with the aim of promoting high quality audits and fostering confidence in the quality and reliability of the financial statements of PIEs and schedule funds in Malaysia.

Regular inspections comprise both firm and engagement level reviews. A firm level review focusses on the review of an audit firm's quality control systems and practices and the degree of

compliance with the requirements of ISQC 1. An engagement review on the other hand, seeks to assess the degree of compliance by auditors with the relevant auditing and ethical standards as well as whether sufficient and appropriate audit evidence have been obtained in relation to the audit reports of PIEs and schedule funds. For firms that have been inspected in the past, subsequent inspections would include a follow-up review on the implementation of the firms' remedial action plans.

#### Impact from AOB's Regulatory Activities Box 1

Since its establishment in 2010, as part of evaluating the effectiveness of its regulatory activities, AOB monitors the subsequent impact to auditors as well as the respective PIE engagements. The following actions taken can be directly or indirectly attributed to AOB's activities to date.

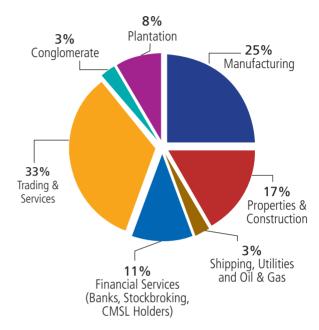
OBSERVATIONS	REMARKS
Changes of audit opinions	AOB observed instances of change in audit opinions subsequent to it regulatory activities. These changes in audit opinions were mainly in area affected or highlighted in the inspection findings as follows:
	<ul> <li>Change in unqualified audit opinion to a qualified or disclaime opinion;</li> <li>Change in unqualified audit opinion to one with added emphasis of matter paragraphs; and</li> <li>Enhanced disclosure of areas included in the emphasis of matter paragraphs.</li> </ul>
Changes in audit team composition	AOB observed instances of changes in audit team composition subsequento its inspection which include:
	<ul> <li>Change of audit engagement partners;</li> <li>Change of key audit team members including the Engagement Quality Control Reviewer (EQCR); and</li> <li>Resignation as auditors.</li> </ul>
	The change in engagement partners and key audit team members can be attributed to the stronger tone from the firms' leadership to immediatel rectify root causes of deficiencies on a particular engagement. AOB also observed resignation of certain audit firms as auditors of certain PIEs at a direct result of more stringent client retention assessments applied be firms affected by the AOB inspections.
Changes in audit procedures	AOB observed instances of additional impairment of assets, assets writ offs, and provision of expenses based on disclosure made in subsequer audited financial statements of inspected engagements.
	There were also instances of improved audit procedures or more reliable audit evidence obtained by audit teams based on AOB's subsequent engagements with the audit team as part of its remediation review process.
	There was also improvement on evaluation and documentation of formatechnical consultation in the working papers.
Others	Other remediation efforts also resulted in some prior year adjustment made to current financial statements. These initiatives demonstrated th firms' commitment to audit quality.
	Self-assessments were also initiated by other firms in their capacity t continue to serve as PIEs' auditors.

#### **INSPECTIONS**

AOB conducts annual inspections on audit firms that have more than 10 partners who collectively audit more than 50 PIEs with a total market capitalisation of above RM20 billion (collectively referred to as 'the Major Audit Firms'). The PLCs audited by Major Audit Firms constitute approximately 94% of the market capitalisation of the stock exchange.

Regular inspections of audit firms other than Major Audit Firms (collectively referred to as 'Other Audit Firms') are conducted on a pre-determined cycle and are risk-based. In 2015, AOB conducted regular inspections of six Other Audit Firms which included re-inspection of four audit firms. In total, AOB conducted regular inspections of 12 firms which audit approximately 97% of the market capitalisation of the PLCs and over 76% of the total number of PIEs.

Chart 11 Analysis by sector based on number of audit engagements inspected in 2015



Source: AOB

Table 4 Inspection coverage

	Major Audit Firms		Other Audit Firms	
	2015	2014	2015	2014
No. of firms inspected	6	6	6	4
No. of individual partners inspected	23	21	12	8
No. of audit engagements inspected	23	21	13	8

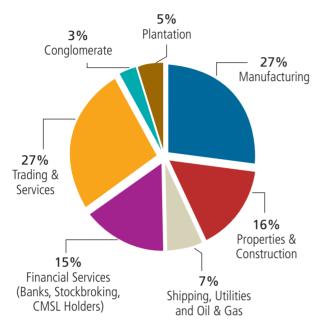
As part of capacity building efforts, AOB also engages in annual dialogues with Major Audit Firms and Other Audit Firms to drive awareness among the profession on current and emerging issues.

Consistent with AOB's strategy of building capacity, AOB also introduced the Small Firms Initiative during the year with the aim of ensuring that key messages on audit quality were delivered and understood by the smaller audit firms. AOB also sought to gain an understanding of challenges faced by smaller

audit firms in implementing the requirements of the ISQC 1 and efforts currently being taken or planned to be taken by the smaller audit firms to enhance audit quality. As part of this initiative, AOB engaged with six audit firms that have yet to be inspected, with another six identified to be engaged in 2016.

In addition, AOB recognises the important role of the technical and risk management departments of audit firms in supporting efforts of the firms

Chart 12 Analysis by sector based on number of audit engagements inspected to date (2010 to 2015)



Source: AOB

to achieve audit quality. Hence, in 2015, AOB conducted focus group discussions with selected technical and risk management staff of Major Audit Firms to understand key challenges faced by this group of individuals. AOB also sought to encourage capacity building through sharing of results from these discussions with the leadership of these firms.

#### **SMALL FIRMS INITIATIVE – ENCOURAGING CAPACITY BUILDING AMONG SMALLER FIRMS**

AOB adopts a two-pronged approach which consists of its inspection programme and regular engagements with the respective audit firms to encourage capacity building. In 2015, AOB carried out an initiative to engage with six smaller audit firms that have yet to be inspected.

The objectives of the Small Firms Initiative are as follows:

- Encourage smaller audit firms to strengthen their capacity;
- Create greater awareness among smaller audit firms' leadership on the requirements and importance of ISQC 1; and
- Obtain an understanding of challenges faced by small audit firms as well as relevant actions that have been taken by these firms to overcome challenges faced.

"Audit partners and audit teams need to be mindful that they are ultimately responsible for the quality of audits."

#### **FOCUS GROUP DISCUSSIONS -**STRENGTHENING FIRMS' **FUNCTIONS TO SUPPORT AUDIT QUALITY**

There are various functions within an audit firm that play an important role to support the achievement of audit quality. These include technical consultation, training, quality control, independence and risk management. In 2015, there were approximately 95 personnel involved in these functions of which 39 were selected for AOB's focus group discussions. The purpose was to obtain relevant feedback to strengthen firms' functions to support audit quality and understand challenges faced by these functions in this pursuit.

#### Box 2

#### **Key Insights of Small Firms**

#### **Profile of small firms**

The smaller audit firms engaged in 2015 comprise firms with one to four partners. A majority of these firms audit only one PIE. Nevertheless, some of these firms have expressed their willingness to increase the number of PIE audit clients and may consider doing so via mergers with other audit firms. The smaller audit firms need to consider the sufficiency and competence of resources before considering an increase in the number of PIF audit clients.

A majority of these firms hold the view that the firms' involvement with PIE audits would allow them to differentiate themselves from their competitors as well as attract new hires. Nevertheless, the same firms are also of the view that PIE audits are often more demanding than non-PIE audits, and if it is not properly managed, may lead to staff attrition due to workload.

#### Challenges

Common challenges faced by these firms are retention of staff, recruitment of competent audit staff, low audit fees and audit staff's written and verbal communication capabilities. These challenges are consistent with those of larger audit firms. These firms recognise that it is imperative to retain existing staff and have cited steps to promote better work-life balance; improve staff benefits and provide a better work environment such as flexible working hours and a lounge for staff to mingle and rest.

#### Common gaps in small firms' system of quality controls

For a majority of small audit firms engaged under the Small Firm Initiative, AOB noted that improvements in the design of quality control processes relating to compliance with ISQC 1 are required. A common gap is the lack of proper training programmes to ensure that audit staff have been equipped with relevant knowledge and skills to perform audits. Another common gap is the absence of a monitoring programme within the firm to ensure that the firm's quality control policies and procedures are operating effectively. In addition, some of the firm's policies and procedures do not sufficiently address matters relating to consultation on contentious technical accounting and auditing areas. For instance, some firms have a policy that requires the audit engagement team to consult when faced with 'difficult or contentious matters', without providing further elaboration or examples. Hence, the audit engagement team may not be appropriately guided on matters that should be escalated for consultation.

#### **ISQC I Compliance**

Smaller firms often cited their small size or small number of PIE audit clients as a reason for not putting in greater effort to ensure full compliance with the requirements of ISQC 1. In this respect, firms are reminded that compliance with the requirements of ISQC 1 is one of the key conditions for a firm to be registered with AOB.

The engagements with small firms have indicated that sharing of good practices and discussions held by AOB were beneficial towards improving their understanding of ISQC 1 requirements while setting the right tone to safeguard audit quality. In addition, these firms have expressed their commitment to address all existing gaps.

#### FEEDBACK FROM FOCUS GROUP **DISCUSSIONS – STRENGTHENING** FIRM'S FUNCTION TO SUPPORT **AUDIT QUALITY**

#### Workload and sufficiency of resources

Some senior level staff cited that they face increasing workload due to a combination of greater responsibilities and staff attrition. In addition, some staff shared that part of their workload is worsened by administrative work. Hence, these staff have highlighted the need for additional resources to be put in place to ease their administrative burden, thereby enabling them to focus on issues that matter.

#### Talent attraction and retention

Attracting the right talent to a support function role is a key challenge faced by most firms. This is mainly due to the common perception that career progression would be limited and remuneration would be much lower in a support function role compared to the professional audit practice. Further, a number of staff performing support functions for the audit practice were previously from the audit practice and had moved to playing a support role in order to achieve a better work-life balance. Nevertheless, the view is that work-life balance is no longer attainable in a support role as evidenced by the increasingly long working hours. This further reduces the attractiveness of a support function role.

Due to the specialised nature of the job function, competencies are developed over time through experience and learning on the job. Consequently, staff attrition can severely affect a firm's support function especially when there is strong dependency on a small group of staff. The process to fill vacancies with personnel that possess a similar level of capabilities and the relevant experience requires a longer period of time, if at all.

One key measure to help promote talent attraction and retention is for firms to provide due recognition through competitive remuneration. Other measures include investing in the professional development of staff such as providing them with opportunities to participate in external workshops, training and events.

#### Support from the network

Feedback obtained indicate that the Major Audit Firms have good support from their respective networks with respect to the system of quality control which includes training materials, updates on audit methodology and accounting matters, technical consultation processes and monitoring programmes. Audit firms should continue to work closely with their networks and where relevant, enhance quality control policies, procedures and processes to ensure that they are responsive and adaptable to local requirements.

#### **Technical consultation process**

Common challenges faced by the technical function staff are tight deadlines due to late submissions for technical consultation, audit engagement teams that are not sufficiently prepared with facts of the case when raising technical consultations, and quality of the written technical consultations. Further, some technical staff shared that they are inundated with verbal consultations from junior level audit staff on matters that could have been addressed within their respective audit engagement hierarchy.

In order to avoid overstretching the technical function within the audit firm and optimise the use of technical resources, audit partners and more senior members of the audit engagement teams need to take full responsibility in the technical consultation process rather than merely delegating such tasks to the technical function staff. This includes ensuring that all relevant facts and matters for technical consultation are first deliberated within the audit engagement team, with the technical consultation submissions having been adequately reviewed and escalated to the technical teams in a timely manner.

#### Monitoring programme

A number of the Major Audit Firms have implemented a hot review monitoring programme. General feedback indicated that this programme was beneficial in bringing about improvement in audit quality. Although this is a positive development, audit engagement partners and audit teams need to be mindful that they are ultimately responsible for the quality of audits and hence, should not be overly reliant on the hot reviewer to highlight issues with the audits.

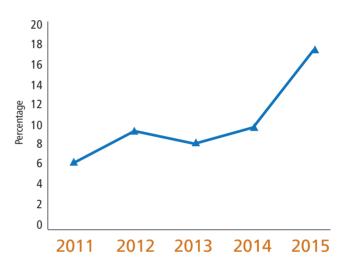
## KFY OBSERVATIONS FROM FIRM LEVEL **REVIEW OF MAJOR AUDIT FIRMS**

#### Leadership accountability and consistency of engagement performance

Overall, results of AOB's inspections in 2015 have shown that more efforts are required from the Major Audit Firms to promote consistent quality audits across engagements. While the reinspection revealed no recurring deficiencies in two Major Audit Firms, the number of inspected audit engagements with significant deficiencies remains high for all firms. As depicted in Chart 13, AOB has concerns over the upward trend in the number of engagements requiring significant improvement.

Some Major Audit Firms need to commit more resources to drive audit quality improvement and tighten monitoring to accelerate the pace of improvement. AOB deliberated the required actions to take in order to compel firms to improve audit quality. In 2015, AOB started to impose specific remedial measures at firm-level on some Major Audit Firms where the pace of improvement was inadequate. This was addition to the specific measures previously imposed on affected individual audit engagement partners.

Chart 13 Percentage of Major Audit Firms engagements with significant improvement required



Source: AOB

Operational responsibility may be delegated to drive audit quality related initiatives, but the audit firm's leadership is ultimately responsible for the overall system of quality controls. While audit firms' accountability, governance and remuneration framework have reflected this, effectiveness is still an issue.

The audit firm's leadership should make it clear to partners and staff that serious non-compliance of firm's policies and procedures that compromise audit quality would not be tolerated. While some Major Audit Firms have relied on punitive measures to drive partners' behaviour, it is equally important for the firm's leadership to also give due emphasis in fostering an environment that encourages attainment of audit quality, and not pursuing growth strategies at the expense of audit quality. These include careful portfolio allocation to allow partners to spend sufficient time on audit engagements, ensuring sufficient staffing on audit engagements, and assignment of staff on audit engagements that take into account the level of experience required.

#### Accountability of engagement partners and EQCRs

Despite various remedial measures that have been implemented by the Major Audit Firms, consistency of engagement performance continues to be an issue.

To a certain extent, this reflects the lack of accountability and sufficient involvement of both engagement partners and EQCR.

In previous years, heavy workload faced by partners was cited by the firms as a contributing factor, and this remains an ongoing challenge. Additionally, the varying risk appetite of engagement partners can affect their level of involvement on audit engagements. For example, a partner with a higher risk appetite may be less involved in the supervision and review of an audit engagement resulting in poor audit quality. This situation is worsened when the audit engagement team is not sufficiently competent in addressing key audit risk areas, and complex or judgmental aspects of an audit.

There is a need for engagement partners to take stronger accountability over audit engagements under their purview. Engagement partners need to work more closely with the audit engagement team throughout the audit, from audit planning, execution to completion, and sharing their knowledge and experience with the team. In addition, engagement partners can play an important role to reinforce lessons learned from the firm's training to members of the engagement teams in order to ensure correct on-the-job application of the firm's methodology and ultimately, prevent or minimise recurring inspection findings.

For partners who face heavy workloads and have difficulties coping, they should be responsible to identify this as an issue and not hesitate to alert the firm's leadership of their situation. The firms also need to play their role through periodical review of partners' workload, with input from the partners, and where necessary, initiate a rebalancing of portfolios so that all audit partners are not burdened with an unreasonable workload and are provided with sufficient time to properly supervise and review audit engagements under their purview.

While the Major Audit Firms have a performance evaluation framework that takes into consideration audit quality, there is a need for the Major Audit Firms to assess whether the consequential impact on the remuneration of both the engagement partners and EQCR is sufficiently effective to encourage the right partner behaviour.

#### Rigour in evaluation for acceptance of new audit clients and audit engagements

AOB continues to observe the following recurring findings with respect to the evaluation for acceptance of new audit clients and audit engagements:

- Instances where approvals for acceptance of new audit clients and engagements were granted prior to completion of professional clearance checks; and
- Instances where approvals for new client and engagement acceptance were granted after the consent to act letters were issued to the PIEs.

Firms should reinforce the importance of complying with firm's policies and procedures on the evaluation for acceptance of new audit clients and audit engagements as a mechanism to safeguard the firm against a variety of risks. In addition, firms should perform close monitoring and take appropriate actions to deal with instances of non-compliance.

#### **Independence and ethics**

During the inspections, the following observations were made:

- Reduction in instances where the MIA By-Laws (On Professional Ethics, Conduct and Practice) 5-year rotation requirement was breached by key audit partners; and
- Instances where non-audit fees as a proportion of audit fees were relatively high for some PIEs audited by Major Audit Firms. There were cases where total fees for non-audit services rendered to a PIE group exceeded total audit fees. AOB reminds firms that instances of high proportion of non-audit fees relative to audit fees may lead to adverse public perception on auditor independence.

Independence of the auditor forms the basis of public's trust in the auditing profession. As such, firms should safeguard this trust by continuously encouraging partners and staff to maintain an independent mind, act with integrity and exercise professional scepticism.

In addition, firms should remain mindful that independence in appearance is equally important as a firm's reputation as an independent audit firm hinges on this. When members of the public perceive a firm to be not truly independent even when there is no actual independence violation, this perception can be equally damaging. Hence, a firm should avoid situations that could create a misperception over its independence.

#### **Technical consultation process**

The Major Audit Firms have clear policies on consultation and an established framework for consultation. However, for one Major Audit Firm, AOB noted that consultations were not performed for certain matters although required by the firm's policy.

Consultations on difficult or contentious matters are vital to mitigate risk of an inappropriate audit opinion being rendered by the firm. Firms should reinforce the message that consultation is a critical process that should be properly conducted and approved in accordance with firm's policies, with robust documentation maintained within the audit engagement file.

#### Effectiveness of the firms' monitoring of the system of quality control

The Major Audit Firms generally have established policies and procedures adopted from their network for the monitoring of audit quality. Annually, these firms undertake reviews of firm level quality control processes and reviews of selected completed audit engagements as mandated by their network. In recent years, some Major Audit Firms saw the need to implement a hot review programme to facilitate coaching of audit engagement teams, timely detection of issues as well as monitoring over the effectiveness of various audit improvement initiatives.

Nevertheless, the following shortcomings were noted:

- Occurrence of recurring findings involving four Major Audit Firms.
- Instances where the firm's engagement reviewers had failed to identify significant deficiencies noted by AOB on inspected engagements that were also subjected to the firm's monitoring review programme.

The above may be attributed to the following:

- Insufficient time allocated for an engagement review and hence, a reviewer may attempt to achieve breadth of review at the expense of depth of review; and
- A reviewer's key focus areas may differ from AOB's which adopts a risk-based approach in inspection that focusses on financial statement line items that are of higher risk, involves judgment or significant estimation. On the other hand, a firm's monitoring process tends to focus on compliance with the firm's audit methodology and may be checklist driven.

An effective monitoring system is essential towards supporting the achievement of audit quality. In view of the shortcomings noted by AOB, firms are advised to observe the following good practices:

- Ensure sufficient time is allocated for reviews and that competent resources are committed to the monitoring programme;
- Adopt a monitoring programme that is more risk-based rather than checklist driven which tends to place greater emphasis on procedural matters; and
- Conduct thematic reviews that focus on recurring issues in audit to determine whether remedial actions taken were effective and identify other areas of improvement required.

## KFY OBSERVATIONS FROM FIRM I FVFI REVIEW OF OTHER AUDIT FIRMS

#### Tone at the top

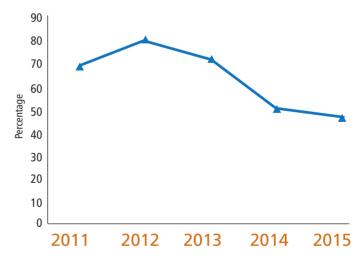
For Other Audit Firms, there were varying degrees of emphasis by the leadership of these firms in setting a strong tone at the top to promote audit quality. For two firms which were inspected in the past, AOB noted that major improvements to the firms' system of quality controls can be attributed to a strong tone at the top by the firms' leadership. As a consequence, there was no recurring finding arising from AOB's re-inspection of both firms.

Although Chart 14 depicts a decreasing trend over the years in the number of inspected engagements with significant improvement required, the percentage remains high at 45% in 2015. AOB also has concerns over two re-inspected Other Audit Firms where the pace of improvements and effectiveness of the firms' remedial action plans were found to be unsatisfactory. In these two cases, AOB's view is that the firms' respective leadership have failed to demonstrate that they have given sufficient emphasis on the need for audit quality, professional scepticism as well as technical competence. As a consequence, one firm had its registration with AOB revoked while other firm was given a warning with specific remedial measures being imposed on the firm and certain individual audit engagement partners.

For the Other Audit Firms that were inspected for the first time, AOB observed gaps with respect to the creation of strong links between audit quality and performance evaluation as well as remuneration for partners or staff. As such, the incentive to encourage the right behaviour among partners and staff was not be sufficiently strong.

...one firm had its registration with AOB revoked while another firm was given a warning with specific remedial measures being imposed on the firm...".

Chart 14 Other Audit Firms' engagements with significant improvements required



Source: AOB

The firms' leadership need to take ownership in promoting a culture within firms that gives due emphasis to audit quality. In sending a strong message that poor audit quality would not be tolerated, the leadership needs to follow through with decisive actions to demonstrate its seriousness in tackling poor audit quality. As remuneration is an important tool to drive behaviour, it is necessary for a clear linkage to be established between quality of engagement performance with performance evaluations and remuneration of partners and staff.

# **Independence and ethics**

While the Other Audit Firms have established policies and procedures to address independence and ethical matters, the following shortcomings were noted:

- Some audit engagement team members did not confirm their independence at the beginning of an audit engagement which is necessary to facilitate the independence assessment of the audit team by the engagement partner as required by the International Standards on Auditing (ISA); and
- At one firm, AOB noted that the firm's monitoring process detected that an audit director had held shares in a PIE client of the firm. However, there was no evidence that appropriate consideration and follow-up action were taken by the firm on the matter. Subsequent to AOB's query on this matter, the firm had instructed the audit director to dispose off his shares in the PIE. Further, the audit director was rotated out from the audit of the PIE concerned.

Firms need to enforce strict compliance with independence and ethical requirements as the auditor's ability to uphold integrity, objectivity and professional behaviour are fundamental in the performance of an audit. Failure to uphold auditor independence can impair the public's trust in the audit firm and adversely affect a firm's reputation and business.

# Client and engagement acceptance process

In 2015, AOB observed movement of audit clients from Major Audit Firms to Other Audit Firms. In the review of Other Audit Firms' processes for the acceptance of new clients and new audit engagements, the following gaps were noted:

- An instance where approvals for acceptance of new audit clients and engagements were granted prior to completion of the firm's internal independence clearance checks; and
- Instances where approvals for new client and engagement acceptance only occurred after consent to act letters were issued to the PIEs.

The above raises concern on whether a proper evaluation was undertaken to consider potential threats to independence and possible risks to the firm arising from the integrity of the management, complexity of the PIE and the competency of the firm to undertake the audit prior to accepting the new audit client and engagement.

The client and engagement acceptance evaluation process should not be treated as mere administrative processes. These serve as important safeguards to prevent firms from accepting problematic clients and engagements. Hence, firms need to apply sufficient rigour in their acceptance evaluation process which should give due consideration to the possible risks, firm's capacity, competence, reasonableness of audit fee and the ability of the firm to comply with relevant ethical requirements.

Firms should be mindful not to draw comfort that a prospective client that was previously audited by a larger firm is of lower risk. Firms may easily overlook significant audit risks involved with a prospective client when the client and engagement acceptance evaluation process is not sufficiently robust and where the main focus is only on audit fees. The subsequent repercussions arising from an audit that failed to properly address the risks associated with a new client may be wide ranging and severe.

# **Emphasis on training**

For some of the smaller audit firms, AOB observed that the firm's investment in training to ensure continued competence of the partners and staff was lacking. For one firm, AOB noted that Clarified ISA training was only conducted in 2014 although the standards have been effective since December 2009. For two other firms, training on the firm's audit methodology and recent changes to the accounting standards had not been carried out. Further, these firms had not implemented a process to monitor the attendance of their staff at training sessions. Hence, there are concerns that partners and staff who are not sufficiently competent due to lack of training are assigned to audits resulting in poor audit quality.

Structured training plays an important role in ensuring that partners and staff have strong knowledge of relevant auditing and accounting standards in order to conduct an effective audit. Firms should perform an assessment on the training needs for the firm's partners and staff, and ensure that sufficient training has been provided so that they are sufficiently competent. In order to ensure effectiveness of training, engagement partners should take an active role to reinforce the knowledge acquired by staff during the execution of the audits.

# **Engagement performance**

Arising from the review of Other Audit Firm's policies and procedures on engagement performance and the review of selected audit engagements, the following shortcomings were noted:

### Competency of the audit engagement team and the extent of engagement partner and EQCR involvement

Results of engagement reviews revealed that some audit engagement teams have not demonstrated sufficient technical competence in the execution of audit. This may be a result of the lack of proper training of the audit engagement team. In addition, AOB observed that there was insufficient supervision and review by some engagement partners. The extent of EQCR involvement and rigour of EQCR review may be insufficient in view that some EQCRs have failed to identify certain significant deficiencies noted by AOB during the course of the audit. These factors had led to unsatisfactory performance of audit engagements.

#### Audit methodology and audit templates

AOB noted instances where some Other Audit Firms were using outdated audit methodology and templates. As such, some audits conducted were not fully compliant with the ISAs.

#### Methodology on audit sampling

For some Other Audit Firms, there was insufficient guidance on audit sampling. This resulted in inconsistent practices with respect to the determination of sample size among audit engagement teams as well as insufficient number of samples being selected for testing.

### **Policy on consultation**

For two Other Audit Firms, the firms' consultation policies have not provided definitions or guidance as to what would constitute a 'significant, difficult or contentious issue'. Consequently, audit teams may not be appropriately guided on matters that should be escalated for consultation.

### Assembly of final audit engagement files

Two Other Audit Firms did not establish procedures for the assembly of final audit engagement files within 60 days from the date of the audit report. Consequently, there were concerns that some audit engagement teams did not assemble the audit engagement files on time due to lack of emphasis by the firm.

ISQC 1 requires firms to establish relevant policies and procedures to provide reasonable assurance that audit engagements have been performed in accordance with professional standards, regulatory and legal requirements, and that audit reports issued are appropriate.

In relation to this, firms are reminded to give due attention to the following matters:

- Ensure that the assignment of partners and staff has taken into consideration the required level of experience and expertise, especially for more difficult or complex audits.
- Ensure greater partner involvement through monitoring of time spent by the engagement partners. They should spend more time to supervise and review work performed by the audit engagement teams;
- A firm's audit methodology drives the way how an audit is executed. Hence, it is important that the firm's audit methodology be reviewed periodically to ensure that it remains current with the latest auditing and accounting standards.
- Audit sampling is a fundamental aspect of an audit. Therefore, firms should ensure that proper guidance is established for audit sampling so that conclusions derived from audit procedures performed are based on a determined sample size which is adequately supported.
- Establish a process to monitor the assembly of final audit engagement files to ensure that this is performed on a timely basis.

# Monitoring quality control policies and procedures

The system of monitoring for Other Audit Firms remains an area of concern. AOB identified the following gaps during the 2015 inspections:

- For three Other Audit Firms, a monitoring programme to evaluate firm level controls was not been established while in one Other Audit Firm, review of selected engagements was not performed. This is not in compliance with ISQC 1 which requires firms to conduct an evaluation of the firm's system of quality controls including a periodic inspection of a selection of completed engagements so as to ensure that they are adequate and operating effectively; and
- For one Other Audit Firm, the rigour of the firm's internal engagement reviews was in question in view that the firm's reviewer failed to identify significant deficiencies for one PIE that was reviewed by both AOB and the firm.

Firms should implement a robust internal monitoring programme as it helps in the identification of areas for improvement and the determination of whether the firm's policies and procedures relating to its system of quality controls are operating effectively. Firms should not consider external reviews such as those conducted by AOB or MIA as a substitute for the firm's own internal monitoring programme.

In developing an internal monitoring programme, firms should ensure that it is conducted by experienced reviewers, and is sufficiently extensive to meet its intended objectives, with findings evaluated and root causes identified so that appropriate remedial measures could be designed and implemented. In addition, all findings should be communicated to the relevant personnel.

# KEY OBSERVATIONS FROM ENGAGEMENT LEVEL REVIEW OF MAJOR AUDIT FIRMS AND OTHER **AUDIT FIRMS**

AOB's inspection activities continued to be essential in fostering high quality independent audits of PIEs and schedule funds as well as promoting the integrity of the auditing profession. Over the years, AOB observed positive developments on the firms' commitment towards audit quality. AOB also observed a stronger tone from the top especially in investing and focussing on audit quality. Despite the firms' continued positive efforts, certain audit areas continue to be a challenge for both Major Audit Firms and Other Audit Firms.

For Major Audit Firms, some of the findings in the key audit areas were significant and resulted in certain close call situations where AOB was required to impose further additional measures on the audit firms and individual partners. AOB urges firms to ensure that their audit engagement teams' thought process and intended objectives are clearly

"For major Audit Firms, some of the findings in the key audit areas were significant and resulted in certain close call situations where AOB was required to impose further additional measures on the audit firms and the individual partners."

supported with documentary evidence in the audit working papers. In instances where audit evidence obtained was deemed insufficient but can be mitigated by corroborative evidence from other areas in the working papers, it is equally important that this be clearly documented and justified to support the overall audit opinion.

For Other Audit Firms, documentation discipline on the nature, extent and timing of audit procedures for key audit areas remains an issue, particularly when there was no significant change of identified risk areas for many years. In such cases, the tendency was for firms to assume that transactions were routine and free from material misstatements without re-assessing and performing a detailed evaluation of such instances. There were also instances that planning documentation on certain key audit areas and evaluation of fraud risk was weak and were unable to support the actual audit procedures performed.

# **Effectiveness of Engagement Quality Control Review Process**

In most engagements reviewed that contained significant deficiencies, AOB continues to have concerns over the effectiveness of the engagement quality control review process across engagements for both Major Audit Firms and Other Audit Firms. The critical role of the EQCR should include providing a check and balance to the audit process through his or her independent and objective evaluation of key judgement areas and significant matters. The following are common observations that may attribute to the ineffectiveness of the EQCR review:

EQCR lacks the relevant industry knowledge;

- Insufficient time available during the performance of audit engagement; and
- Lack of EQCR commitment throughout the duration of the audit engagement.

The lack of EQCR's involvement was more prevalent for Other Audit Firms particularly when the EQCR role was outsourced to other auditors who were not part of the same firm. On certain instances, AOB observed limited evidence available to support the EQCR's involvement throughout the audit. Consequently, when the EQCR was engaged during the inspection process, the responses received regarding the inspection findings were not convincing.

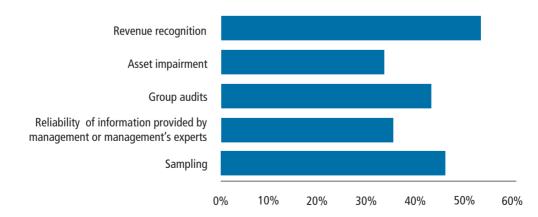
The EQCR plays a critical role to provide a check and balance to the audit process. Despite the fact that it is encouraging to see certain Major Audit Firms establishing an accountability framework for their EQCR as part of ongoing efforts to further strengthen their monitoring processes, firms need to be mindful that the primary responsibility of the audit engagement performance still lies with the audit engagement partners. In order to achieve better audit quality, engagement partners need to work together and allow the EQCR to challenge key areas of judgment and other significant matters. Such practices can be performed by getting the EQCR involved in critical discussions as well as ensure all relevant information needed by EQCR is provided in a timely manner.

# Common deficiencies for Major Audit Firms and Other Audit Firms

The following are the common significant deficiencies observed for both Major Audit Firms and Other Audit Firms:

- Revenue recognition;
- Asset impairment;
- Group audits;
- Sampling; and
- Reliability of information provided by management or management's experts.

Chart 15 Inspected engagements with common significant deficiencies



# **Revenue recognition**

Common findings observed from AOB's 2015 inspections are as follows:

- Insufficient evaluation of potential agency relationship within revenue transactions;
- Determination of percentage of completion for property development revenue was not supported;
- Shortcomings in testing the cut-off assertion;
- Revenue recognition not identified as fraud risk and not rebutted; and
- Substantive analytical procedures not performed in accordance with ISA requirements.

Revenue is one of the critical areas to users of financial statements, particularly in assessing the overall performance of an entity. Thus, significant risk often exists within revenue that warrants special audit consideration by auditors. AOB continued to observe significant deficiencies within this area. For instance, AOB still observed an absence of assessment performed on potential agency relationship transactions. For transactions that have been practiced for many years, firms should always ensure such practices are appropriate in accordance with the relevant accounting standards. If it was evaluated in previous year audits, firms should consider re-evaluating its prior assessment to determine the continued relevance of the conclusion reached in the past.

Over the years, AOB observed continuous development by Major Audit Firms when applying substantive analytical procedures as its primary procedure in order to meet the requirements of ISA 520 Analytical Procedures. For Other Audit Firms, AOB still observed that the substantive analytical procedure was performed in the form of variance analysis which is limited to comparing the current year figures with those of the prior years.

AOB has concerns that certain firms place high level of reliance on the PIE's group-wide control process resulting in a lack of substantive testing performed on certain material account balances or transactions where the assigned risk was low. AOB reminds firms on the need to comply with ISA 330 The Auditor's Responses to Assessed Risks requirements on substantive procedures where regardless of the assessed risks of material misstatement, auditors are obliged to design and perform substantive procedures for each material class of account balance, transactions, and disclosure.

# **Asset impairment**

Common findings observed from AOB's 2015 inspections are as follows:

- Indicators of impairment were not identified and addressed;
- Cash generating units were inappropriately excluded when performing impairment assessment for
- Lack of verification and challenge of management's assumptions used in their cash flow projections;
- Reliability of information used to support fair value less cost to sell as recoverable amount was not addressed.

AOB findings in this area were mainly from the review of audited PIEs with higher risks of asset impairment such as loss making entities and entities with low asset turnover compared to the industry average. As highlighted in the previous annual report, AOB reiterates the need for auditors to critically evaluate the value-in-use cash flow projections prepared by management for the purpose of impairment testing. Firms should professionally challenge the key assumptions used, particularly if the assumptions are critical to support the recoverable amount such as the computation of significant terminal value. AOB also observed where fair value less cost to sell using market transacted prices was used to determine the recoverable amount instead of value-in-use, the relevance and reliability of the source of evidence used was not properly addressed.

When reviewing the cash flow projections prepared by the audit clients, firms need to raise professional scepticism in questioning the reliability of evidence used as well as critically challenge the assumptions used to support the impairment assessment. Despite the existence of larger "headroom" to support the recoverable amount, auditors need to ensure that the recoverable amount is appropriately supported and appropriate in accordance with relevant accounting standards.

# **Group audits**

AOB findings on group audits were mainly in relation to complex and large PIEs with multiple components and business operations audited by Major Audit Firms. The findings observed from AOB's 2015 inspections are as follows:

- Insufficient evaluation of the work performed by component auditors, including the tendency to rely on the work performed by component auditors, particularly when those component auditors are within the local Firm's own network;
- Insufficient evaluation of the scope of work performed by the auditors of a service organisation before relying on the work performed, particularly when the auditors of the service organisation are within the Firm's global network;
- Consistency in the application of planned audit procedures by the component auditors;
- Lack of follow up on matters highlighted to the component auditors during the review of component auditors' working papers; and
- Lack of follow up on reporting deliverables required by the group auditors.

AOB has concerns on the effectiveness of remediation efforts applied by the Firms in relation to this area since majority of the above findings were highlighted in the AOB's previous annual reports. For certain Major Audit Firms that audited large group of PIEs operating locally, AOB observed instances where different engagement partners were assigned to audit certain key components of the PIE Group in order to manage the engagement partners' workload. In this respect, AOB observed tendency for the group auditors to merely rely on the work performed by component auditors within its local network without further evaluation of the sufficiency of work performed.

In auditing large PIEs with multiple components, effective co-ordination and communication between group and component auditors are crucial to ensure the effective outcome from the audit. Early engagement and communication with component auditors is also important particularly if the components reside in different jurisdictions or have different financial year ends.

# Sampling

The AOB continued to observe findings on sampling. Common findings observed from the inspections are as follows:

- Inappropriate basis of sampling;
- Potential exceptions from test samples were not identified and properly evaluated;
- Incorrect projection of potential misstatements; and
- Untested population.

Continued observations of the above have raised concerns on the effectiveness of the firms' remediation plans, particularly when identifying the root cause of AOB's findings. For Major Audit Firms, there were still instances of lack of clarity in respect of the basis of sampling used in accordance with its respective sampling methodology, for example when judgment was applied to determine the minimum and maximum number of samples as well as the relevant application of appropriate sampling methodology for certain types of testing objectives.

For Other Audit Firms, in the absence of specific sampling methodology and tools, the basis of sampling used is often not clearly explained or supported. On many instances, the basis of sampling by selecting key items or high value items is not representative of the population being tested, leading to a material untested population.

When firms apply dual-purpose testing by performing test of control and test of details on the same sample, the design of the audit procedures need to be performed by considering the purpose of each test separately. This includes consideration of the relevant assertions and test objectives which may not be achieved simultaneously. In addition, the sufficiency of samples selected is crucial to support the extent of procedures performed. The effective application of dual-purpose testing is also dependent on the firm's effective application of its audit methodology and guidance that should comply with relevant auditing standards.

# Reliability of information provided by management or management's experts

Depending on the nature of the PIEs, firms may consider using or relying on reports and data provided by management or management's experts as part of its audit strategy. In addition, there were many instances of firms relying on the work of managements' experts on certain specialised areas such as valuation of properties.

Common findings observed from AOB's 2015 inspections are as follows:

- Reliability and accuracy of the reports and data produced by management was not addressed;
- Insufficient evaluation of the competence, capabilities and objectivity of the experts;
- Lack of understanding of the experts' work and relevance of the methods used; and
- Insufficient evaluation of the appropriateness and sufficiency of the experts' work.

When using and relying on the reports produced by management, AOB observed instances where the firms did not further verify the reports' reliability and accuracy. There were also instances of lack of communication between the financial auditors and IT auditors on their respective roles in verifying the reliability of the reports produced by the entity's accounting system before the financial auditors can rely on the reports.

Where reliance was placed on the work performed by a professional valuer, AOB continued to observe that certain Other Audit Firms did not evaluate the competence, capabilities and objectivity of experts. For Major Audit Firms, there was a lack of supporting evidence and clarity as well as ambiguity on the relevance of methods and assumptions applied by the expert to arrive at the valuation amount. This was particularly when details of the valuation computation had not been included in the expert's report. For instance, AOB observed the auditors did not evaluate the appropriateness of not recognising an upward valuation produced by an expert for an investment property in further detail. This includes challenging management's intention for not recognising the increase in value. As highlighted in previous annual reports, AOB urges the firms to adhere to the requirements of ISA and regularly consider whether it needs to engage and have more meaningful communications with the valuer to gain an understanding and obtain comfort on the methods used by the professional valuer.

Where the firms have engaged its IT auditors to perform review and testing on key IT-related areas of a business entity for the purpose of relying on controls testing or to address the reliability of the reports produced by the entity, effective co-ordination and communication between financial auditors and IT auditors are crucial in achieving the intended audit objectives.

#### Box 3 Reliance of valuation report

In view of the rapidly evolving and increasingly complex entities as well as enhanced requirements of accounting standards in the valuation area, it is inevitable for auditors to rely on information provided by experts to support the basis of the accounting standards applied by the management. In most instances, the management engaged its own experts to determine the appropriate valuation of an asset, particularly property assets.

Based on ISA 500 Audit Evidence, where reliance was made using the work of the management's expert, the auditors were required to perform the following:

- Evaluate the competence, capabilities and objectivity of that expert;
- Obtain an understanding of the work of that expert; and
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The area remains a challenge for auditors, particularly in evaluating the appropriateness of the expert's work to be used as audit evidence for the valuation of property. In determining the valuation, the following approaches were broadly applied by the experts:

- Comparison approach compare like-for-like with adjustment for dissimilarities; a.
- Income approach using discounted cash flows, investment method and residual methods; and b.
- Cost approach replacement cost model with consideration of physical deterioration, functional or technical obsolescence, and economic or external obsolescence.

AOB observed that although the valuation approach was disclosed in the experts' report, the detailed mechanics on how the valuation was computed was often not disclosed. This was particularly an issue when experts had effected adjustments in their valuation computation. Firms need to consider whether it needs to engage and communicate with the expert to gain an understanding and obtain comfort on the methods used by the experts in the valuation.

Firms need to raise their professional scepticism especially when encountering the following:

- Valuations that have a significant impact to the entities' financial statements (e.g. large recognition of gain from valuation of assets);
- Valuation report that is outdated but still utilised by the entity as basis to account for a b. particular asset;
- The expert's report contains a specific caveat that may question the appropriateness of the C. valuation (e.g. the expert did not performed physical sighting of the asset);
- d. The valuation report is merely an 'update valuation' that contains an upward valuation amount without further details of the valuation approach;
- The reference for comparisons used are questionable (e.g. different location, outdated e. transacted market price, etc.); and
- f. The actual valuation amount is beyond the range of comparative values used by the expert.

#### Box 4 Evaluating appropriate accounting treatment

The rapidly evolving and increased complexity of various businesses and products in a borderless market brings along challenges to auditors who need to equip themselves with the right tools and knowledge in order to handle various accounting issues that surface as a result of its clients' business activities. Certain business arrangements and transactions entered by the entity were designed to meet its business strategy and objectives. Thus, the terms and conditions of the arrangements were often key to better understand a transaction and subsequently identify the correct application of accounting in accordance with the accounting standards.

The following are examples of accounting issues that were observed by AOB during its inspections:

ACCOUNTING AREA	OBSERVATIONS
Appropriate classification of investment in cash funds as cash and cash equivalents instead of available for sale assets	Malaysian Financial Reporting Standard (MFRS) 107 Statement of Cash Flows defined cash equivalents as "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value".  Due to the nature of the types of investment products available in the existing market, AOB observed that there is a tendency for entities to classify its investments in cash funds as part of cash and cash equivalents
	without further evaluation performed by auditors to support its appropriate classification. This is particularly a concern when the cash funds were denominated in units and needs to be converted to its relevant market prices as at reporting date.
Evaluating the existence of an agency relationship within revenue transactions	ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements specifies that auditors need to evaluate the relevant type of revenue, revenue transactions or assertions that carries risk of material misstatements based on the presumption that there are risks of fraud in revenue recognition.
	Despite revenue always being associated with fraud risk, AOB observed instances of the potential existence of an agency relationship within revenue transactions that was not clearly evaluated by the auditors particularly in certain types of industries like manufacturing and poultry farming. MFRS 118 Revenue states that "in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission".

#### Box 4 Evaluating appropriate accounting treatment (Continued)

The lack of understanding by auditors on the nature of the arrangements or transactions will further lead to a lack of appropriate evidence in the working papers to support the auditors' evaluation on the appropriateness of the accounting treatment. As the responsibility for the preparation of the financial statements lies with the entities' management, auditors should constantly remind the entities to provide them with adequate information such as relevant agreements to evaluate the implications of terms and conditions in arrangements. Where professional judgment was applied in the evaluation, the accounting application should also reflect the substance of the arrangements and transactions. AOB also observed a lack of depth in the analysis performed in the formal technical consultation raised by auditors to appropriately support the conclusions reached.

AOB urges the entities' management and audit committees to take ownership of the relevant accounting application for its entities. Where there is ambiguity on the right application of accounting, entities should initiate the assessment rather than wait for auditors to identify such areas and then provide a view on the matter. Such assessments and relevant information should be provided to auditors in a timely manner to avoid inordinate delay in the audit process.

AOB will continue to evaluate auditors' performance on the area of accounting application particularly when there is a new issuance or revision of accounting standards.

# Box 5

# Audit innovation – Leveraging data analytics in the execution of audits

Companies are increasingly leveraging information technology to support their business and this has resulted in a larger volume of transactions to be processed electronically. Companies are embracing 'Big Data' and making use of information from varied sources to support their business operations and decision making.

Audit firms do recognise that the conventional audit approach of examining a sample of transactions for such companies may not suffice. Consequently, most Major Audit Firms are looking at leveraging data analytics to achieve audit efficiency and effectiveness. Data analytics has two key benefits. Firstly, it facilitates deeper analysis which helps auditors to improve their understanding of the transactions and balances underlying the financial statements. Secondly, data analytics has the potential of providing a higher degree of assurance. For example, data analytics software can be used to perform testing on a complete population.

In order to fully leverage the benefits of data analytics, upfront investments on software and tools would be required. Audit engagement teams would also need to engage IT and data specialists to assist the performance of data analytic procedures.

Training for auditors would be necessary so that they can better understand the work of other experts as well as acquire new skills in data analytics to perform some of the simpler analyses on their own.

Audit innovations often necessitate a re-design of audit procedures. Audit teams need to be mindful that in pursuing audit innovation to achieve audit efficiency, gaps in audit execution are not created along the way.

### **REMEDIATION**

# **Overall progress**

Of nine re-inspected firms in 2015, AOB observed that four firms recorded no recurring findings while the number of recurring findings for two firms reduced. It is encouraging to see the current results as this may be attributed to stronger tone from the top in driving various efforts to remediate AOB findings.

Partners' workload continues to be highlighted as one of the main root causes by the Major Audit Firms as heavy workload would lead to partners having less time to review and supervise their respective audit engagements. Thus, firms continue to review their partners' workload and address any identified issues by re-balancing client portfolios among partners as well as withdrawing from clients that could pose certain unwanted risks to the firm as a whole.

For smaller firms, there continues to be a need for the firms' partners and staff to enhance their technical competence in accounting and auditing. Due to

"...four firms recorded no recurring findings while the number of recurring findings for two firms reduced."

gaps in infrastructure and resources, improving at the right pace is always a challenge for these firms. Nevertheless, AOB recognises the efforts of these firms in providing and monitoring adequate training as well as making enhancements to the firms' available audit guidance and monitoring framework.

The following are examples of remediation actions and other efforts undertaken by the Major Audit Firms and Other Audit Firms that are relevant to uphold audit quality:

Table 5 **Major Audit Firms** 

AREAS	EFFORTS
Tone at the top/ Firm's structure	<ul> <li>Incentives to reward partners for achieving good quality review results</li> <li>Re-balancing portfolio of clients (e.g. reducing staff to partner ratio)</li> <li>Identifying and 'ring-fencing' high-performance individuals to reduce risk of burnout</li> </ul>
Acceptance of new audit clients and engagements	<ul> <li>Improvised procedures on client acceptances and continuing to be more selective in accepting clients</li> <li>Reducing the number of identified clients</li> </ul>
Talent recruitment, development and retention	<ul> <li>Tightening reward recognition model (e.g. promotion and experience)</li> <li>Staff secondment programme to global and regional network firms</li> <li>Ongoing reviews of other staff benefits (e.g. optical, dental, forced leave, etc.)</li> <li>Critically review feedback obtained from staff survey</li> </ul>
Monitoring	<ul> <li>Increased hot reviews of files</li> <li>Introduction of more stringent and visible action on findings raised by AOB and firm's internal review</li> <li>Increase EQCR's accountability (e.g. impact on performance of EQCR as well as engagement partner)</li> </ul>

#### Table 5 (continued) **Major Audit Firms**

AREAS	EFFORTS
Technical competency in accounting and auditing	<ul> <li>Rebranding of accounting technical department services and realignment of technical responsibilities</li> <li>Concerted efforts to recruit full-time technical staff</li> <li>Offering technical roles to audit practice managers</li> <li>Identifying Subject Matter Experts among audit practice managers to further support the technical function and link their contribution as part of their KPIs</li> </ul>
Others	<ul> <li>Introduction of data analytics initiatives on large/complex engagements</li> <li>Capacity building and greater use of internal experts (e.g. IT assurance, corporate finance valuation, etc.)</li> <li>Centralisation of the administrative function of the firm – in relation to engagement performance (e.g. bank confirmation process)</li> </ul>

Table 6 **Other Audit Firms** 

AREAS	EFFORTS
Tone at the top/ Firm's structure	<ul> <li>Improved design of ISQC1</li> <li>Merger activities among small and medium firms to manage resources and partner rotation requirements</li> <li>Better succession planning – identification of future firms' leadership</li> <li>Increase number of partners</li> </ul>
Acceptance of new audit clients and engagements	Clients' acceptance policy – based on firm's capacity and capability
Technical competency in accounting and auditing	Emphasis on training – closer monitoring of minimum hours
Talent recruitment, development and retention	<ul> <li>Scholarships for professional examination</li> <li>Ongoing reviews of monetary staff benefits (e.g. salary and allowances)</li> <li>Work-life balance (e.g. lounge, refreshments provided during peak periods, annual family day, etc.)</li> </ul>

# **Recurring findings**

AOB continued to observe the overall reduction in recurring findings on engagements reviewed during the year. The key recurring findings observed are as follows:

Impairment assessment of assets/goodwill;

- Sampling and untested populations;
- Application of substantive analytical procedures;
- Evaluation of appropriate revenue recognition;
- Follow-up on confirmation procedures;
- Testing the reliability of system generated reports;
- Evaluation of appropriateness of experts' work;
- Evaluation of appropriate classification of cash and cash equivalents;

- Identification of fraud risk in respect of revenue recognition;
- Identification and evaluation of related parties and related party transactions; and
- Revenue cut-off procedures.

These recurring findings were also prevalent for two Other Audit Firms that were re-inspected in 2015. AOB urges the firms to emphasise greater communication and provide effective training to the relevant staff.

Despite continuous efforts to drive audit quality, AOB still has concerns over the effectiveness of certain firms' overall remediation actions particularly when their leadership is not strong enough to drive efforts in promoting audit quality. Firms should be aware that AOB will publish the inspection report, if a firm fails to take relevant remedial measures relating to the findings raised by AOB in accordance with section 31V(7) of the SCMA.

In addition, the recent changes in the SCMA provide AOB the avenue to disclose and share findings from its inspection activities with PIEs and schedule funds in accordance with section 31ZD(3) of the SCMA as well as the ability to direct auditors to take any remedial measures in relation to the inspection findings in accordance with section 31V(5A) of the SCMA.

#### **Root causes**

As highlighted in the previous annual report, AOB still observed the tendency of firms to suggest lapses in documentation as the cause for a variety of identified deficiencies without gaining a clear understanding of the actual reasons. As a result, the remediation action plans are not meaningful in addressing the actual root causes of deficiencies. AOB emphasises the importance for the firms'

leadership to drive an honest assessment and process of identification of the actual root causes followed by taking the appropriate measures to monitor the effectiveness of the remediation plan.

The following are main root causes that continue to be observed based on AOB's analysis of both Major Audit Firms and Other Audit Firms:

- Insufficient emphasis by the firms' leadership to drive audit quality messages and in certain cases inconsistent messages on quality sent by the firms' leadership to their own firms;
- Lack of timely involvement and insufficient supervision and direction by the engagement partners due to the heavy workload of the engagement partners;
- Firm's monitoring and communications process including the design and implementation of remediation actions may not be effective;
- Insufficient resources due to continuous high attrition rates;
- Training for the relevant areas were not provided to the staff on a timely basis;
- Lack of technical competencies in both accounting and auditing;
- Lack of application of professional scepticism in applying professional judgement;
- Lack of understanding on the correct application of firms' own audit methodology; and
- Lack of technical support to safeguard audit quality, which includes having an established technical consultation process and regular internal monitoring reviews.

The climate of change in the economy and volatility of the existing market provide firms with additional pressures to maintain their presence as well as continue with their business strategies. Apart from high attrition rates encountered by the firms annually, the scarcity of individuals with relevant accounting technical skills in the existing market is a concern. Further, the high demand in both domestic and international markets for our

local talents will potentially create a vacuum in our local market. Thus, firms need to be more innovative in introducing various initiatives to keep and maintain talent within the firms as well as attract external talents which include continuous review of rewards and compensation that are commensurate with the expectation of staff performance.

## CONCLUSION

Results of AOB's 2015 inspections findings revealed that for a majority of the Major Audit Firms, greater determination would be required to improve audit quality and preserve consistency of performance. To a certain extent, this may be attributed to a lack of partner involvement to supervise and review audit engagements. Firms need to better manage partner workload through a more robust client portfolio assignment process. Firms are also advised to strengthen efforts to promote effectiveness of their system of quality controls particularly in the area of partner accountability framework, human resources, training and monitoring functions.

> "To achieve desired improvements in audit quality, a culture that gives prominence to audit quality should permeate throughout the firm from the top to the middle and bottom layers."

For the Other Audit Firms that were re-inspected, results of the inspections vary with some firms displaying good improvement while some show an overall decline in audit quality. For these firms, competency of some engagement partners and their audit engagement teams requires further improvements. Additionally, first time inspections of some Other Audit Firms revealed numerous design and implementation gaps with the firm's system of quality controls. AOB would like to stress the need for structured training to ensure that partners and their staff remain competent and updated with the latest standards on accounting and auditing. These firms should continuously invest in relevant resources, infrastructure, systems and quality control processes in order to uphold audit quality.

To achieve desired improvements in audit quality, a culture that gives prominence to audit quality should permeate throughout the firm from the top to the middle and bottom layers. The firm's leadership needs to set the stage by taking full accountability to drive audit quality initiatives and continuously reinforce the message for partners and staff to maintain the required levels of professional scepticism and objectivity throughout the audit. Equally important is the alignment of partners' behaviour with the tone of the leadership as this can influence the effectiveness of various initiatives and messaging from the leadership on audit quality to the audit staff. Indeed, leadership by example is a key success factor for the promotion of audit quality. In some firms that performed well during an inspection, AOB observed that strong tone at the top and quality culture have positively influenced partners' behaviours and the audit engagement teams.

Audit firms should not be reluctant to make the necessary investments to support audit quality as AOB has observed instances where firms which have made such investments are not financially worse off.

During the year, there was movement of PIEs from one audit firm to another. Firms should not compromise audit quality in the pursuit of business growth by accepting new clients beyond what the firms are capable of handling. Client acceptance that is primarily driven by audit fees may be detrimental to the firm especially when the firm does not have the capabilities to conduct the audit or has failed to appropriately identify and address the underlying risks associated with the audit.

In 2016, AOB will continue to engage audit firms on any key emerging issues relating to the audit profession as well as encourage improvements in audit quality through dialogues with audit firms on good practices, conduct of inspections and closer monitoring of the implementation progress of the firms' remedial action plans.

# **ENFORCEMENT**

Effective oversight of independent audits is critical to promote confidence in the quality and reliability of audited financial statements and is also premised on efficient and effective enforcement.

Enforcement actions seek to achieve two primary goals. Firstly, it is aimed to hold accountable and sanction those who breach laws and regulations and secondly, to send a strong signal which deters others from committing the same offence.

AOB has always been mindful of achieving the desired outcome in respect of the enforcement action in the most efficient and effective way. AOB's enforcement philosophies are firmly rooted in strategies that focus on the principles of proportionality and efficiency.

# SIGNIFICANT ENFORCEMENT **MILESTONES**

AOB continues to review the impact of its enforcement activities and is of the view that stricter enforcement is warranted given that over the years, AOB has been actively engaging auditors to communicate its expectations of auditors and its focus on audit quality. Despite this, the pace of improvement towards audit quality is still a concern. While we are mindful that the business environment is constantly evolving and becoming increasingly complex, audit quality should not be compromised.

Similarly, auditor independence is fundamental for audit quality. It is about objectivity and professional scepticism, and reinforces an auditor's mandate to ensure high quality independent auditing. In this respect, non-compliance with independence requirements will no longer be excused or tolerated.

Moving forward, there will be greater focus and accountability on the audit firm's leadership in situations where there are issues relating to engagement reviews in addition to an inquiry being initiated against an engagement partner. In this respect, in situations where monetary penalties are intended to be imposed for breaches noted in an engagement review, the monetary penalty will be imposed on the audit firm for substandard quality engagement performance. This is to send a strong signal to the leadership of the audit firm that consistency of performance and effectiveness of remediation plans are important aspects in order to achieve audit quality. The audit firm's leadership should promote an internal culture recognising that quality is essential in performing engagements.

The year also saw AOB facing legal challenges in respect of its enforcement process. There were multiple proceedings including four judicial review applications against AOB initiated by an auditor who was sanctioned by AOB. The auditor was reprimanded and imposed a penalty of RM50,000 for failure to comply with auditing standards in the engagement performance of a PIE.

All these legal proceedings were successfully concluded in favour of AOB. While we recognise that legal challenge is inevitable, the outcome of these proceedings further reinforces the fact that AOB's enforcement mechanism is sound with sufficient safeguards in place.

## **SUITABILITY OF AUDITOR**

For the very first time, AOB revoked the registration of an audit firm and two of its partners under section 31Q(1)(a)(B) of the SCMA for failure to remain fit and proper to audit PIEs.

The audit firm and its partners were found to have failed to comply with auditing standards in the engagement performance of two PIEs. The audit firm also failed to implement the remedial actions as reported by AOB in respect of past inspection findings. AOB had taken enforcement actions previously against the same audit firm and its partner for breaching the conditions of their registration imposed by the AOB under section 310(3) of the SCMA.

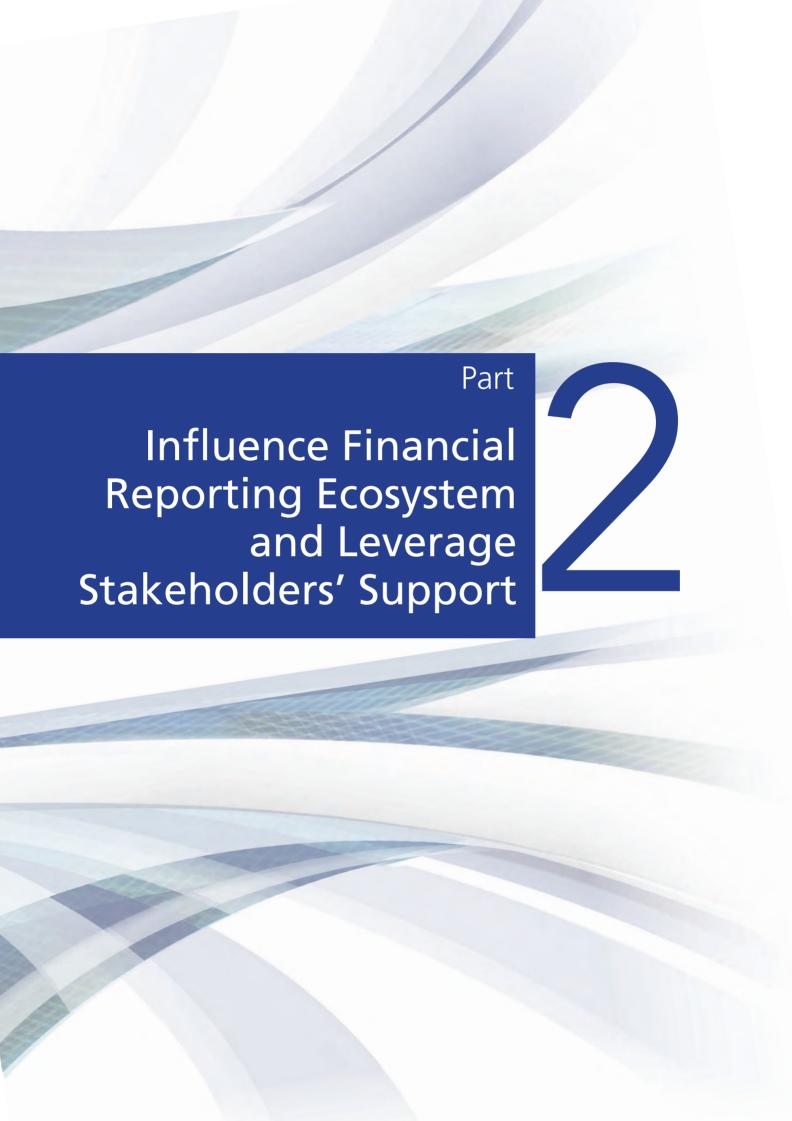
Revocation of registration is not an action that AOB views lightly as the auditor is found not to be fit and proper to act as an auditor of PIEs. This further attests to AOB's commitment to push forward audit quality changes to bolster market confidence.

A	OB ACTIONS IN 2	2015			
No.	Nature of misconduct	Parties involved	Brief description of misconduct	Action taken	Date of action
1.	Breached AOB's registration condition imposed under section 31O(3) of the SCMA.	Lee Kok Wai Partner of Crowe Howarth, engagement partner in the audit of a PIE for the financial year ended 31 October 2010.	Failure to comply with certain requirements of the ISA in discharging his professional duties in the performance of an audit of the PIE.	1) Reprimand; 2) Monetary penalty of RM50,000.	16 January 2015
2.	Breached AOB's registration conditions imposed under section 310(3) of the SCMA read together with the following paragraphs of the AOB's Handbook on Registration:  (a) Paragraph 5.04(c) - requirement for an audit firm to comply with auditing and ethical standards in Malaysia.  (b) Paragraph 5.04(b) - requirement for an audit firm to carry out its practice honestly, competently and with due care.  (c) Paragraph 5.04(e) - requirement for an audit firm to ensure that persons who audit the financial statements of a PIE on its behalf are appropriately qualified, sufficiently trained and competent.	Wong Weng Foo & Co	<ol> <li>Wong Weng         Foo &amp; Co failed         to comply with         requirements         of ISQC 1 in         discharging         professional duties         in the performance         of audit of PIEs.</li> <li>Wong Weng         Foo &amp; Co failed         to carry out its         practice honestly,         competently and         with due care.</li> <li>Wong Weng Foo &amp;         Co failed to ensure         that the auditor         who audits the         financial         statements of PIEs         is appropriately         qualified,         sufficiently trained         and competent. As         a result, there were         recurring and         numerous         significant         deficiencies in the         audit of two         public-listed         entities for the         financial years         ended 31         December 2013         and 30 June 2014.</li> </ol>	Revocation of registration with AOB pursuant to section 31Q(1)(a)(B) of the SCMA.	2 December 2015

A	AOB ACTIONS IN 2015 (continued)								
No.	Nature of misconduct	Parties involved	Brief description of misconduct	Action taken	Date of action				
3.	Breached AOB's registration conditions imposed under section 310(3) of the SCMA read together with the following paragraphs of AOB's Handbook on Registration:  (a) Paragraph 5.05(d) - requirement for an individual auditor to comply with auditing and ethical standards in Malaysia.  (b) Paragraph 5.05(c) - requirement for an individual auditor to carry out his/her practice honestly, competently and with due care.	Wong Weng Foo Managing Partner, Wong Weng Foo & Co.	1. The Managing Partner failed to comply with the relevant requirement of ISQC 1 in discharging his professional duties as Managing Partner, Wong Weng Foo & Co.  2. The Managing Partner failed to carry out his practice honestly, competently and with due care.	Revocation of the Managing Partner's registration with AOB pursuant to section 31Q(1)(a)(B) of the SCMA.	2 December 2015				
4.	Breached AOB's registration conditions imposed under section 310(3) of SCMA due to specific breaches of auditing standards in relation to performance of the audit of financial statements of two public-listed entities for the financial years ended 31 December 2013 and 30 June 2014.	Abdul Halim Husin Partner, Wong Weng Foo & Co, engagement partner in the audit of two public-listed entities for the financial years ended 31 December 2013 and 30 June 2014.	The Partner failed to comply with certain requirements of ISA in discharging his professional duties in the performance of the audit of two public-listed entities.	Revocation of Partner's registration with AOB pursuant to section 31Q(1)(a)(B) of the SCMA.	2 December 2015				

#### Note:

As at 31 December 2015, all the auditors above have appealed to the SC against the decision made by AOB. The appeals are pending.





# INFLUENCE FINANCIAL REPORTING **ECOSYSTEM AND LEVERAGE** STAKEHOLDERS' SUPPORT

# THE FINANCIAL REPORTING **ECOSYSTEM AND QUALITY OF** FINANCIAL REPORTING

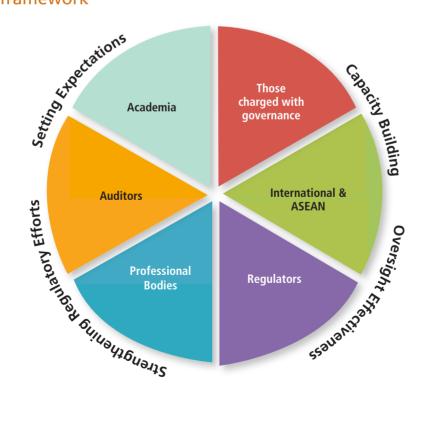
The advancement of financial reporting is a shared responsibility among key players of the financial reporting ecosystem. These include preparers, board of directors, audit committees, auditors, professional bodies, investors and regulators. All stakeholders in this ecosystem are interconnected. Commitment and co-operation are crucial to ensure that high quality financial reporting is achieved.

High quality financial reporting has to start with a strong financial reporting function supported by good quality audit coupled with a robust oversight framework. (Diagram 1)

# **REACHING OUT TO THE** FINANCIAL REPORTING **ECOSYSTEM**

AOB continued to be actively involved in relevant external events which include forums, conferences,

Diagram 1 Oversight framework



Source: AOB

industry dialogues, talks and roundtable discussions organised by various stakeholders. These avenues allowed AOB to create awareness among key stakeholders and promote views on the importance of audit oversight in the capital market. With the increasingly competitive environment, AOB further stressed the need to be ready for the implementation of the New Auditor's Report, and other current trends and developments.

In recent years, AOB has repeatedly pushed for greater collaboration and co-ordinated efforts among key stakeholders within the financial reporting ecosystem. AOB's involvement in the Committee to Strengthen the Accountancy Profession (CSAP) and the formation of the Steering Committee takes this into consideration, and is a joint working effort among regulators, industry and the accounting profession to address issues of common relevance.

In 2015, AOB introduced the 'AOB Conversation' series, targeted at members of the academia, directors, audit committee members and auditors. The series provided a platform for meaningful discussion, and sharing of experiences and best practices between participants and various subject matter experts. For audit committees, AOB shared practical examples on how their role could be enhanced while improving audit quality, and explored ways they could have more meaningful and thought provoking conversation with their auditors.

# CAPACITY BUILDING AND **BRIDGING EXPECTATION GAPS**

AOB has constantly strived for capacity building through annual dialogues and engagements with the leadership of audit firms of PIEs and schedule funds, both at the Malaysian and ASEAN level.

In 2015, AOB hosted the AARG Dialogue and 5th Annual Meeting with the Audit Firms. This year's discussion focussed on the use of AQIs to spur deeper conversations on audit quality matters between audit firms and stakeholders such as audit committees, as well as challenges and opportunities arising from the implementation of the New Auditor's Report.

Greater capacity building efforts were also focussed on Other Audit Firms through the Small Firm Initiative (addressed in Part 1) and the 'AOB Conversation with Auditors of PIEs and Schedule Funds'. In today's changing economic landscape, AOB is mindful of the firms' challenges in keeping abreast with current industry developments. Understanding this, AOB invited subject matter experts to share experiences, knowledge and practical tips to facilitate auditors' work with these firms' partners.

In efforts to strengthen accountancy education, AOB jointly organised an event themed 'Practical Issues in Accounting and Auditing' with the Malaysian Accountancy Research and Education Foundation and the University of Malaya. This event allowed those from the academia a rare insight into market needs and required skill sets of the industry. Participants were also given the opportunity to understand challenges in building talent to fulfil these needs.

## SHARING GLOBAL **PERSPECTIVES**

AOB continued to participate and contribute at the International Forum of Independent Audit Regulators' (IFIAR) 9th Inspection Workshop and AARG Inspection Workshop. These annual events allow AOB to exchange information and ideas regarding practical issues related to inspection techniques, observations and experiences with fellow regulators. AOB is thus better equipped to tackle global and regional audit quality issues.

Involvement in IFIAR 2015 Plenary Meeting further promoted collaboration between audit regulators, and initiated the creation of a new governance structure and permanent secretariat for IFIAR. This was followed by the 1st IFIAR Enforcement Workshop which provided IFIAR members the opportunity and platform to discuss matters related to investigation, adjudication and other enforcement issues.

During the year, AOB also responded to the 2015 IFIAR Survey of Inspection Findings. The survey provides a platform for knowledge sharing and collaboration in pursuit of its members' common

objective of high-quality audit performance. Prior participation has allowed AOB to benchmark Malaysia's level of audit quality with those from other IFIAR member jurisdictions.

AOB has submitted its application to participate in the IFIAR Multilateral Memorandum of Understanding (MMOU) concerning Co-operation in the Exchange of Information for Audit Oversight. Given the global nature of capital markets, AOB anticipates that this will further facilitate international co-operation related to audit oversight.

**NEW AUDITOR'S REPORT** 

AOB has closely followed the progress of the Auditor Reporting Project undertaken by the International Auditing and Assurance Standards Board (IAASB). The project, initiated in response to multiple calls from various stakeholders for more relevant information to be provided based on the audit performed, culminated in the issuance of the New and Revised Auditor Reporting Standards on 15 January 2015 which will be effective from 15 December 2016.

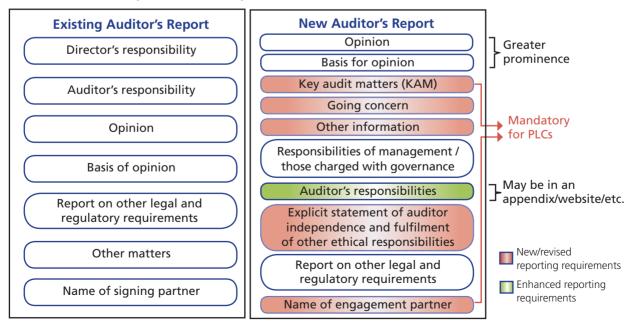
AOB views major changes to the current auditor's report introduced collectively by these standards as a

It is thus more crucial than ever for auditors to understand their clients' business models as Kev **Audit Matters (KAM)** disclosures should be quided by the entity's business model.

game-changer to enhance the quality of financial reporting in Malaysia. Thus, the New Auditor's Report was a major agenda for AOB in 2015, both on a national and ASEAN front.

The AOB highlights that the drafting of the New Auditor's Report should be tailored to the entity, and continues to caution against the use of boilerplate disclosures to ensure continued relevance and communicative value to achieve the desired impact on stakeholders. It is thus more crucial than ever for auditors to understand their clients' business models as Kev Audit Matters (KAM) disclosures should be guided by the entity's business model.

Diagram 2 The auditor's report – A comparison



Source: AOB

**6** A critical success factor for smooth implementation of the New Auditor's Report is the involvement and commitment of all stakeholders in the financial reporting ecosystem. "

""

A critical success factor for smooth implementation of the New Auditor's Report is the involvement and commitment of all stakekolders in the financial reporting ecosystem. In cognisance of this and implementation complexities in relation to the New Auditor's Report, a Steering Committee was established in June 2015. Chaired by the SC, with AOB playing an active role as the secretariat, the Steering Committee comprises key individuals<sup>1</sup> representing the regulators, profession and PLCs. The Financial Reporting Quality Task Force formed in 2014 was subsumed into this Steering Committee.

The Steering Committee was formed to identify issues and risks in relation to the implementation of the New and Revised Auditor Reporting Standards, and to develop strategies and provide guidance on those issues and risks identified.

From various outreach activities conducted, it is noted that stakeholders are generally looking forward to the New Auditor's Report which is envisaged to be more informative and transparent.

With the New Auditor's Report, users of financial statements would have a clearer understanding with regard to audit procedures that had been carried out and how these affect audit quality. AOB strongly believes that this will assist to further close the audit expectation gap which has been a longstanding challenge to the industry and profession.

However, AOB strongly reminds that KAM descriptions should maintain focus on the matters themselves, and not be a mere description of the audit procedures that had been carried out. KAM disclosures also should not affect the scope, depth or type of audit procedures currently performed by auditors.

> **L**...KAM descriptions should maintain focus on the matters themselves, and not be a mere description of the audit procedures that had been carried out. ""

Auditors should be cognisant of the approaching effective date and work closely with respective clients to manage implementation of the New Auditor's Report at the audit planning stage or earlier. This is to reduce the likehood of surprising stakeholders and inadvertently causing unwarranted market reaction, while ensuring that financial reporting timelines are met.

Members of the Steering Committee consist of representatives from SC, Bank Negara Malaysia (BNM), Bursa Malaysia, Companies Commission of Malaysia (SSM), Federation of Public Listed Companies Bhd (FPLC), Institute of Internal Auditors Malaysia (IIAM), Malaysian Institute of Accountants (MIA), and The Malaysian Institute of Certified Public Accountants (MICPA).

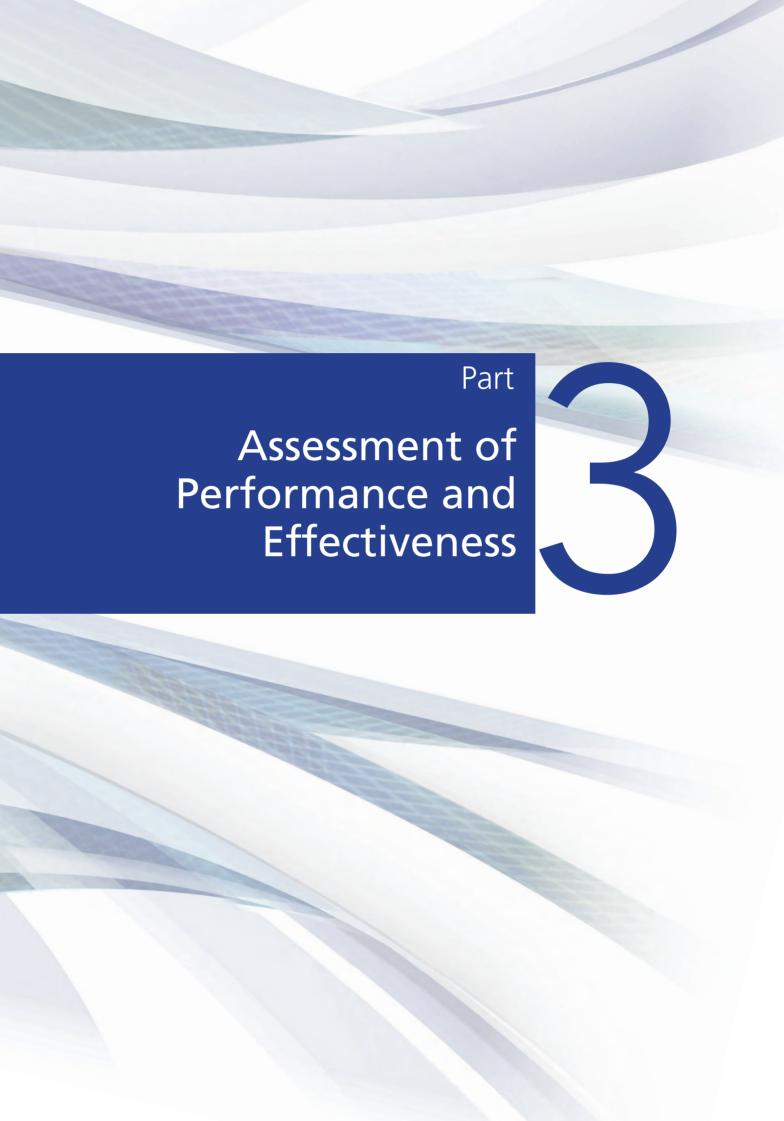
Table 1 Key initiatives spearheaded by the Steering Committee

AOB / SC

MIA-MICPA JWG / profession

	2015 2016											
Activities	Mar	Apr	Мау	Jun	Aug	Sep	Oct	Nov	Jan	Feb	Mar	Jun
MIA-MICPA Joint Working Group (JWG)  – Formation and meetings												
MIA-MICPA JWG Presentation to Bursa Malaysia on the New Auditor Reporting Standards												
<ul> <li>AOB Conversation with:</li> <li>Audit Committees</li> <li>Academia – Practical Issues in Auditing and Accounting</li> <li>Auditors of PIEs and Schedule Funds</li> </ul>												
AARG 5 <sup>th</sup> Dialogue and Annual Meeting with the Audit Firms												
MIA AASB briefing note to Bursa Malaysia listed issuers on the New Auditor's Report												
Steering Committee – Formation and meetings [Members: SC, BNM, Bursa Malaysia, SSM, FPLC, IIAM, MIA, MICPA]												
MIA-MICPA JWG Meeting with Bank Negara on the New Auditor Reporting Standards												
Corporate Governance Breakfast Series with Directors Future of Auditor Reporting – The Game Changer for Boardroom												
Bursa Malaysia Consultation Paper No. 2/2015 Proposed Review of the Listing Requirements relating to— (i) Disclosure and Corporate Governance Requirements; and (ii) Post-listing Disclosure Obligations for Mineral, Oil and Gas Listed Issuers												
CAANZ-MICPA Audit Forum for Practitioners Future of Auditor Reporting – The Practical Impact												
<b>MIA International Accountants Conference 2015</b> Panel discussion – <i>The New Auditor's Report</i> : A Game Changer?												
MIA-IFAC Regional Small and Medium-sized Practice Forum Panel discussion – The New Auditor's Report												
<b>AuditWorld 2015</b> Panel discussion – What You Need to Know About the New Auditor's Report												
New Auditor's Report – Sharing the UK Experience  Directors of PLCs  Auditors of PIEs and schedule funds												
The New and Revised Auditor Reporting Standards: Implications to Financial Institutions												

Other regulators





# **ASSESSMENT OF PERFORMANCE** AND EFFECTIVENESS

AOB's strategic framework incorporates a threeyear (2013-2016) outlook of the market and regulatory landscape. The strategic framework links AOB's service areas to its mission of enhancing the confidence in the quality and reliability of audited financial statement of PIEs and schedule funds.

While AOB continues with its core functions i.e. registration, inspection and enforcement, it is mindful and attentive to any changes to its operating environment, industry, emerging issues and global developments in financial reporting and auditing. This allows AOB to reassess its focus areas and continuously refine and recalibrate the following strategic outcomes:

- Confidence in audited financial statements:
- Audit opinion based on sufficient and appropriate evidence;
- Externalisation of professional values and ethics;
- Resourceful and capable audit practices; and
- High quality financial reporting practices by the PIEs.

In 2015, significant developments were made where AOB focussed and prioritised activities to achieve the strategic outcomes in the most effective and efficient manner. AOB will continue to ensure that its regulatory mandate and overall aim of the strategic framework is achieved.

# 2015 KEY PERFORMANCE REVIEW

### **AOB strategic outcomes**

#### Confidence in audited financial statements

#### **Activities**

- Revocation of registration of one audit firm and its two individual auditors.
- Enforcement action taken against one individual auditor.
- Participation in public events to reinforce key messages on audit quality to key stakeholders.

### Performance assessment for 2015

- Sent a strong signal to the profession and capital market that non-compliance of regulation and standards will not be taken lightly.
- No major audit failure reported during the year among the companies with large market capitalisation.

# 2015 KEY PERFORMANCE REVIEW (continued)

### **AOB strategic outcomes**

#### **Activities**

#### Performance assessment for 2015

### Audit opinion based on sufficient and appropriate evidence

- 12 audit firms and 35 individual auditors were inspected under the regular inspection conducted during the year.
- Monitored the subsequent impact to auditors as well as the respective PIE engagements as part of evaluating the effectiveness of AOB's regulatory activities since its establishment in 2010.
- The following actions taken by auditors can be directly or indirectly attributed to AOB's activities:
  - Changes of audit opinions
  - Changes in audit team composition
  - Changes in audit procedures
  - Restatement of financial statements

### **Externalisation of** professional values and ethics

Continued monitoring of audit partner rotation requirement and EQCR requirements which are fundamental in ensuring that auditor independence and audit quality are maintained.

- Positive improvement with significantly fewer cases of non-compliance, showing the importance of independence and audit quality to the audit firms.
- Strengthened self-discipline among major firms.

### Resourceful and capable audit practices

- Continuous engagement with audit firms to ensure they have quality control framework in place.
- Firms were required to identify root causes for deficiencies highlighted by AOB during inspection.
- Firms were required to measure the effectiveness of remediation plans.
- Continued sharing of key statistics with the leadership of the top 10 audit firms in Malaysia by PIEs' market capitalisation.
- Drive best practices via dialogues with audit firms' leadership to ensure continuous capacity building and right infrastructure, tone from the top and culture to support audit quality.
- Participated as observer in meetings held by the Auditing and Assurance Standards Board (AASB) and Ethics Standards Board (ESB) of MIA.

- The upward trend in the number of registered individual auditors and reduction in the number of partnerships with less than two partners are indicative of the audit firms' improved commitments to capacity building and succession planning.
- During the year, six auditors were subjected to specific remediation measures as a continuous effort to support resourceful audit practices.
- Remediation plans were taken more seriously as a result of non-recurring findings for four audit firms inspected.
- Facilitated performance benchmarking among peers and against Malaysia's audit industry average and identification of areas for improvement to further support audit quality.
- Facilitated mutual understanding among AOB, industry and the profession with regard to perceptions and challenges faced in relation to current accounting and auditing issues.

# 2015 KEY PERFORMANCE REVIEW (continued)

### **AOB strategic outcomes**

### **Activities**

#### Performance assessment for 2015

#### High quality financial reporting practices by **PIEs**

- Organised various events to reach out to academia, audit committees, directors, and auditors of PIEs and schedule funds.
- Participated in events to engage directors and members of audit committees as a reminder of their role in enhancing the quality of financial reporting.
- Held dialogues to promote behavioural and cultural changes for continuous enhancement of quality practices.
- Established a Steering Committee to identify issues and risks in relation to the implementation of the New Auditor's Report, and to develop strategies and provide guidance on those issues and risks identified.
- Drive messages on investment in talents and relevant infrastructure to support effectiveness and high quality financial reporting functions.

- Provided a platform for interactive sharing sessions on accounting and auditing issues between practitioners and academicians.
- Promoted views on the importance of audit oversight in the capital market.
- Highlighted the importance of assessing organisational level of preparedness in addressing changes that affect the financial reporting ecosystem.
- Reinforced audit committees' understanding of their key responsibilities in overseeing the financial reporting function and provided greater insight on current developments and impending New Auditor's Report.
- Generated greater awareness and discussion on the New Auditor's Report at the board and audit committee levels in anticipation of its implementation.
- Highlighted the urgent and critical need to address talent-related issues as a CSAP Recommendation which was submitted to the Minister of Finance.

# Box 1

# Amendments to Part IIIA of the Securities Commission Malaysia Act 1993 (SCMA)

In ensuring securities laws in Malaysia remain practical and compatible with constant changes in the capital market, the SC made several amendments to the provisions relating to AOB under Part IIIA of the SCMA which came into force on 15 September 2015.

The significant change to Part IIIA of the SCMA includes the extension of AOB's regulatory reach to include schedule funds. AOB's oversight functions have also been expanded to cover any person who prepares a report in relation to financial information of PIEs or schedule funds. This refers to a Reporting Accountant who prepares reports on financial information that is incorporated into a prospectus.

In respect of registration, there is no longer a need for the renewal of registration of auditors. Registered auditors are now required to submit an annual declaration as at 30 June each year and the registration fee payment of RM5,000 per individual auditor by the anniversary of their respective registration dates. AOB now also has the power to revoke or suspend registration, or to withdraw or suspend recognition of auditors when there is a failure by the auditor to pay any fee as specified by AOB.

In relation to AOB's inspection regime, the amendments clarified that an inspection is conducted to assess the sufficiency and appropriateness of audit evidence obtained by an auditor relating to the audited financial statements of PIEs or schedule funds. Furthermore, AOB is now authorised to direct an auditor to take remedial measures to rectify the matters raised in the inspection report where audit evidence obtained is insufficient and inappropriate to support the audit opinion.

AOB now has the power to share its inspections or inquiry findings with any PIE or schedule fund, should it consider that such action may enhance the quality and reliability of the audited financial statements. The sharing will facilitate the board of directors of a PIE or fund managers to have meaningful conversations with their auditors in driving audit quality.

The amendments are in tandem with SC's continuous review on securities laws to achieve AOB's objective of fostering high quality independent auditing of PIEs and schedule funds in Malaysia.





# SUPPORT ADOPTION AND IMPLEMENTATION OF STANDARDS

AOB has closely monitored developments at both international and local fronts since its establishment in 2010. In recent years, AOB has also stepped up its involvement on a regional basis via its AARG involvement. Examples include activities relating to the AOB's Statistics Gathering and Analysis initiative and the New Auditor's Report as discussed in Parts 1 and 2 of this annual report.

This Part is an overview of AOB's involvement in the standards setting arena, as well as how certain global developments are reflected in Malaysia's environment. This is in line with AOB's mission to foster high quality independent auditing to promote confidence in the quality and reliability of audited financial statements of PIEs and schedule funds in Malaysia.

# **DEVELOPMENT AND IMPLEMENTATION OF** STANDARDS AND REGULATIONS

In 2015, AOB contributed its comments on the draft pronouncements listed in Table 1.

As in previous years, AOB has also continued to participate as an observer in meetings held by the AASB and the ESB of MIA.

These platforms facilitate mutual understanding between AOB and the industry and profession with regard to perceptions and challenges in relation to current auditing and accounting issues. This also allows AOB to provide input on areas of concern in line with efforts to strengthen the accounting profession and ultimately, influence audit quality.

Table 1 **AOB** comments on draft pronouncements

to be commented on a rare promounted			
Comments submitted to	Draft Pronouncements		
International Auditing and Assurance Standards Board (IAASB)	Proposed ISA 800 (Revised) Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks and ISA 805 (Revised) Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement  Proposed ISA 810 (Revised) Engagement to Report on Summary Financial Statements		
International Ethics Standards Board for Accountants (IESBA)	Improving the Structure of the Code of Ethics for Professional Accountants  Proposed Changes to Part C of the Code Addressing Presentation of Information and Pressure to Breach the Fundamental Principles  Responding to Non-compliance with Laws and Regulations		
Malaysian Accounting Standards Board (MASB)	[Draft] MFRS Glossary in Bahasa Malaysia		
Public Company Accounting Oversight Board (PCAOB)	Concept Release on Audit Quality Indicators		

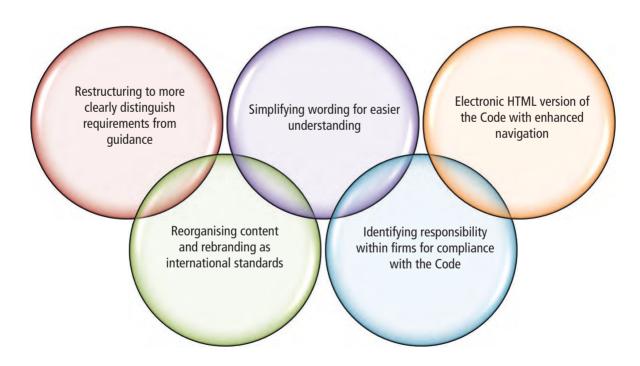
# Improving the structure of the IESBA Code of Ethics for **Professional Accountants**

IESBA issued a consultation paper on Improving the Structure of the Code of Ethics for Professional Accountants (the Code) in November 2014 as a result of the various feedback highlighting challenges in its usability. The proposed improvements summarised in Diagram 1 aim to address these concerns and provide a platform for future development and maintenance of the Code.

Overall, AOB has no objection to the proposed changes outlined in the consultation paper. In particular, AOB welcomes the proposed amendments to clarify responsibility within firms for compliance with the **66...** firms shall be required to establish relevant policies and procedures to assign responsibility for compliance with the Code to a specific individual..."

Code, whereby firms shall be required to establish relevant policies and procedures to assign responsibility to a specific individual rather than relying on a cross reference to ISQC 1.

Diagram 1 Proposed improvements to the IESBA Code of Ethics for Professional **Accountants** 



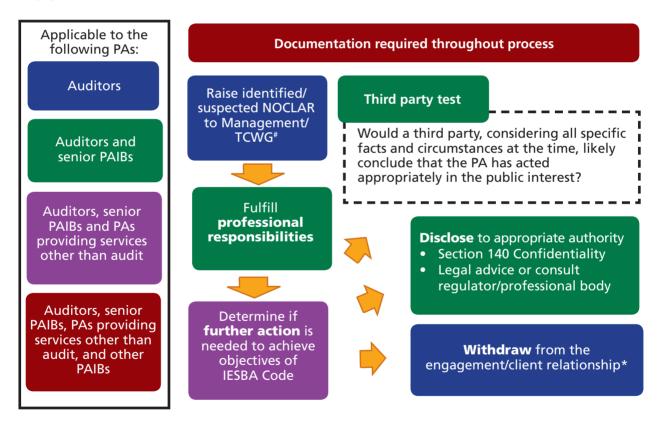
Source: IESBA Consultation Paper on Improving the Structure of the Code of Ethics for Professional Accountants

# Responding to Non-Compliance with Laws and Regulations

The enhanced standard on Responding to Non-Compliance with Laws and Regulations released for re-exposure in May 2015 by IESBA introduces a response framework to guide auditors, other professional accountants (PAs) in public practice, and professional accountants in business (PAIBs) in deciding how best to act in the public interest when they come across an act or suspected act of noncompliance with laws and regulations (NOCLAR).

AOB commends the proposed response framework for placing renewed emphasis on the tone at the top, and acknowledging that PAs in public practice providing services to audit clients (auditors) have greater responsibility to take action to respond to identified or suspected NOCLAR than other PAs in public practice. Similarly, senior PAIBs are acknowledged as having greater responsibility than other PAIBs in responding to identified or suspected NOCLAR, given their decision-making ability and the expectations of them by virtue of their posts. (Diagram 2)

Diagram 2 Proposed response framework when coming across identified or suspected **NOCLAR** 



- \* Withdrawal is not a substitute for taking other appropriate actions under the Code.
- # Those charged with governance

Source: IESBA exposure draft on Responding to Non-Compliance with Laws and Regulations

In response to the re-exposure, IAASB also published an exposure draft on Proposed Amendments to the IAASB's International Standards – Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations. The proposed amendments will enable ISAs to operate in concert with the Code while minimising confusion among jurisdictions that use both.

# **GLOBAL INITIATIVES IN** REFORMING THE AUDIT MARKET AND PRACTICES

It is important to instil a culture of audit quality across audit firms in an effort to promote confidence in the quality and reliability of audited financial statements of PIEs and schedule funds in Malaysia. To this end, AOB closely monitors global developments and regularly engages with its stakeholders to ensure that Malaysia is ready at the forefront of such developments.

Below, AOB explores AQIs, a key emerging issue which has recently garnered substantial attention in the international arena.

# **Audit Quality Indicators**

In recent years, global momentum has increased with regard to the refinement and use of AQIs, in line with efforts to identify and analyse key aspects of audit quality. It is anticipated that this could provide additional insights for audit committees, investors and other stakeholders of the financial reporting ecosystem. For some jurisdictions, the use of AQIs is also viewed as a means to encourage audit firms to compete on the basis of quality.

# **66...**AQIs operate in an integrated manner along with contextual information."

AOB has continuously tracked developments in this area which include A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality issued by IAASB as well as the Center for Audit Quality (CAQ)1 Approach to AQI.

In 2015, a major development in relation to AQIs comes in the form of the Concept Release on Audit Quality Indicators issued by the PCAOB in July 2015. Through the Concept Release, PCAOB sought to promote audit quality through a portfolio of quantitative measures of public company auditing. Diagram 3 depicts 28 potential AQIs proposed which have been grouped into three categories and respective sub-categories.

Functioning as a 'balanced portfolio' of audit quality, it is clear that AQIs operate in an integrated manner along with contextual information. In this respect, AOB agrees that AQIs' greatest use may well be as generators of questions and triggers of discussions that can strengthen audit planning and execution while creating an environment conducive to sustained audit quality and its recognition.

The CAQ is affiliated with the American Institute of Certified Public Accountants.

Diagram 3 PCAOB's proposed AQI categories and sub-categories



Source: PCAOB Concept Release on Audit Quality Indicators

In responding to PCAOB's Concept Release, AOB identified the following key considerations in the usage of AQIs:

# **Practicability of AQIs**

The implementation and use of AQIs must be carefully considered to ensure that the benefits of data collection and analysis of the AQIs continue to outweigh the costs.

In particular, there is a need to consider the value expected to be attained against the level of detail required, frequency and availability of data to be captured, parties involved in the collection and analysis of the data, and the practicability of making the AQI results available in the public domain potentially without the necessary contextual information, e.g. AQIs derived from public information collected and published by data aggregators.

# Qualitative analysis and judgement required for context

AQIs, while quantitative, can and often will require qualitative analysis and judgement of the persons using the indicators to provide the necessary context to understand the interactions of the AQIs as a group, in order to facilitate more informed discussion and decision making.

As such, users of AQIs should be mindful at all times of AQIs' quantitative nature, and that without the necessary and relevant accompanying context, there is a risk that the understanding behind the principles and contexts within which AQIs are determined are lost in implementation. Under such circumstances, AOB cautions that a seemingly unfavourable AQI result may not necessarily signify an audit failure.

# **Regular evaluation of AQIs**

Regular evaluation of identified AQIs is needed to ensure their continued relevance. With the current fast-paced environment that auditors and companies operate and compete in, it is of paramount importance that AQIs evolve at the same pace.

# **Comparability of AQIs**

Comparability is acknowledged as one of the challenges of the AQI project, and that since AQIs are not benchmarks, even comparability of AQIs in two audits may not imply comparable audit quality. This applies even in audits of companies of ostensibly the same size.

Users of AOIs should bear in mind that comparability would further increase in complexity where tiering of firms and/ or companies is practiced, e.g. by market capitalisation. Usage of AQIs may then instead become less meaningful, in particular if the results are reduced to a single set of weighted figures, without the necessary accompanying contextual information.

# AQIs should not be a benchmark for fee negotiation

AQIs are envisaged to stimulate competition by audit firms based on quality.

However, AOB has concerns with regard to a potential unintended consequence where less-than-satisfactory AQI results may be used by management or audit committees, etc. to penalise the audit firm by way of reduction of audit fees, which could in turn negatively impact the firm's resourcing capabilities and quality of audit performed thereafter.

**66** ...AOIs should at all times be used wisely and objectively, and not as a benchmark to negotiate for lower audit fees.

While AOB recognises that ultimately each audit committee will have to judge for itself whether and how it wishes to use AQIs in its decisionmaking, AOB strongly cautions that AQIs should at all times be used wisely and objectively, and not as a benchmark to negotiate for lower audit

# Tone at the top and leadership

AOB is of the view that the managing partner must drive both business and quality of the network/firm as a whole.

Hence, to complement analysis of AQIs, AOB is of the view that leadership and tone at the top should be measured based on the consistency of performance of the firms' individual partners as a result of internal or external inspection activities. How this consistency of performance then relates back to the global and country leaderships' explanations on the performance of their network partners is equally crucial.

In Malaysia, AQIs have always been a part of AOB's key considerations in carrying out its oversight activities. In 2014, AOB commenced data collection from the top 10 audit firms in Malaysia by PIEs' market capitalisation.

More information on AOB's Statistics Gathering and Analysis initiative and the results of 2015's analysis are presented in Part 1 of this annual report.

# Statement on Governance

# **MEMBERS OF THE AUDIT OVERSIGHT BOARD**



Seated from left: Datuk Nor Shamsiah Mohd Yunus, Nik Mohd Hasyudeen Yusoff, Chok Kwee Bee Standing from left: Dato' Gumuri Hussain, Goh Ching Yin, Cheong Kee Fong, Dato' Zahrah Abd Wahab Fenner



Nik Mohd Hasyudeen Yusoff

Appointed 1 April 2010

Nik Mohd Hasvudeen Yusoff is the Executive Chairman of AOB. He is also the SC's Executive Director for Market and Corporate Supervision.

He is presently 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 formerly President of the MIA and also former Vice-President of the ASEAN Federation of Accountants. He had also served on the MASB, the Listing Committee of Bursa Malaysia and the Operational Review Panel of the Malaysian Anti-Corruption Commission.

He holds a Bachelor of Business from Curtin University of Technology and is a fellow of CPA Australia



**Goh Ching Yin** Appointed 1 April 2010

Goh Ching Yin is the Executive Director for Market Development of the SC.

Helming the portfolio, Goh is responsible for strategy and risk, markets and products, economics and market analysis and data management. His team conceptualises and formulates capital market strategy, products, market mechanisms and the SC's business plan; providing policy analysis of key issues and input to the government on wider issues affecting the capital market and broader economy. The team also identifies and manages macro risks to the SC's regulatory objectives, and provides oversight on initiatives to develop private equity, venture capital, derivatives and multi-lateral arrangements.

Prior to joining the SC in March 2007, Goh led a career that spanned 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, and corporate insolvencies and auditing. He holds a Master's in Business Administration from the Cranfield School of Management, Cranfield University, UK.



**Dato' Gumuri Hussain** 

Appointed 1 January 2012

Dato' Gumuri Hussain is a fellow of the Institute of Chartered Accountants in England and Wales, member of the MIA and MICPA. He is also a Board member of the SC.

He was the former Chairman of SME Bank from 2005 to 2013. He was also the Managing Director and Chief Executive Officer (CEO) of Penerbangan Malaysia Bhd from 2002 to 2004. Prior to this, he was a Senior Partner and Deputy Chairman of Governance Board of PricewaterhouseCoopers Malaysia. He has served as the Non-Executive Director of Bank Industri & Teknologi Malaysia Bhd, Rangkaian Hotel Seri Malaysia Bhd, Malaysian Airline System Bhd and Sabah Bank Bhd.



**Datuk Nor Shamsiah Mohd Yunus** 

Appointed 1 April 2010

Datuk Nor Shamsiah Mohd Yunus is currently the Deputy Governor in BNM. She is responsible for the supervision division that supervises commercial banks (conventional and Islamic banks), investment banks, insurance companies (conventional and takaful) and development financial institutions. She also oversees Strategic Human Capital Management, corporate shared services and the financial intelligence and enforcement functions. She sits as one of the members at the BNM Board of Directors. She is also a member of the Monetary Policy Committee, Financial Stability Policy Committee and Joint Policy Committee.

Datuk Nor Shamsiah represents BNM in a number of regional and international fora in the areas of banking supervision and anti-money laundering. 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 of Accountancy from University of South Australia and is a fellow of CPA Australia.



Cheong Kee Fong Appointed 1 April 2010

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 SSM and a member of the Finance Committee on Corporate Governance Working Group II on Corporate Governance in Malaysia. Cheong was also a member of the FRF from 1997 to 2001, SSM and its Audit Committee from 2002 to 2005.

Cheong 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 Supreme Court, Singapore.



**Chok Kwee Bee** Appointed 1 April 2010

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 Outsource Partner Programme.

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. She also sits on the board of Hong Leong Bank Bhd, Aemulus Holdings Bhd and several portfolio companies. She was previously a member of the SC Capital Market Advisory Council, member of the Exchange Committee of Labuan International Financial Exchange and also a past Chairman of the Malaysian Venture Capital and Private Equity Association.



Dato' Zahrah Abd Wahab Fenner Appointed 3 June 2015

Dato' Zahrah Abd Wahab Fenner is the CEO of the SSM. Prior to her appointment as CEO on 1 January 2015, she was the Deputy CEO (Services), a post she held since the establishment of SSM in 2002. While serving as the Deputy CEO (Services), her portfolio comprised the Corporate Development and Policy Division, Corporate Resource Division, Information Communication and Technology, Compliance Division, SSM Training Academy and the Corporate Communications Section.

Dato' Zahrah who graduated with a Bachelor of Accounting (Honours) from Universiti Kebangsaan Malaysia, is a Chartered Accountant and a member of MIA. She is also a member of the Approval and Implementation Committee of the Iskandar Regional Development Authority and a member of the Public Sector Accounting Committee of MIA for the term 2015/2016.

Dato' Zahrah was appointed as a board member for the Certification of Certified Integrity Officers which is an appointment of two years commencing from March 2015 and is also a member of the FRF by virtue of her position as CEO of SSM. Further, Dato' Zahrah is a member of the Labuan Financial Services Authority and member of the Board of Trustees, National Welfare Foundation of Malaysia.

Dato' Zahrah began her career as an Advisor Accountant with the Royal Malaysian Customs and Excise Department and served the department from 1984 to 1992 where she advised on matters relating to the valuation and standard international practices of the open market. Dato' Zahrah was attached to the Ministry of Foreign Affairs as the Principal Accountant from 1992 to 1995 and was responsible for the financial accounts and auditing of the Malaysian Embassies and High Commissions worldwide. Subsequent to that, she joined the Registrar of Companies in 1995 and served as the Chief Accountant.

# STATEMENT ON GOVERNANCE

The Audit Oversight Board is established under the auspices of the SC under the SCMA to provide independent audit oversight over PIEs and schedule funds and to ensure our regulatory framework for auditors is on par with international standards. AOB is responsible to oversee the auditors of PIEs and schedule funds and to protect the interests of investors by promoting confidence in the quality and reliability of audited financial statements of PIEs and schedule funds in Malaysia. AOB's responsibilities, powers and authorities are clearly defined and transparently set out in Part IIIA of the SCMA.

# ABOUT THE AUDIT OVERSIGHT **BOARD**

The Board of SC appoints AOB members, comprising an executive chairman and six other non-executive members.

Nik Mohd Hasyudeen Yusoff was appointed as Executive Chairman on 1 April 2010. A profile of AOB members is featured on pages 70 to 72.

The terms of office held by AOB members shall not exceed three years. The Executive Chairman is eligible for reappointment following the end of his three-year term, while a non-executive AOB member shall be eligible for reappointment for not more than two terms.

Under section 31C(6) of SCMA, not more than two non-executive members of AOB shall be members of the MIA, who are registered under the Accountants Act 1967 as a chartered accountant, a licensed accountant or an associate member.

A person is disqualified from holding the office of a Board member if he or she is:

- Convicted of an offence under the law involving fraud or dishonesty, corruption, any other offence punishable with imprisonment for more than two years or failure to disclose interest in any matter under discussion by the AOB:
- Declared a bankrupt;
- Fails to attend three consecutive meetings of the Board without leave;
- Of unsound mind or is otherwise incapable of discharging his or her duties.

The SCMA requires an AOB member to manage conflict of interest by disclosing his or her interest in any matter under discussion. Once the disclosure has been made, he or she having an interest in the matter:

- Shall not take part nor be present in any deliberation or decision of AOB; and
- Shall be disregarded for the purposes of constituting a quorum of AOB.

# **RESPONSIBILITIES OF THE BOARD**

The Board is responsible in assisting the SC in discharging its functions under the SCMA. The responsibilities include:

- 1. Implement policies and programmes in ensuring an effective audit oversight system in Malaysia;
- Register or recognise auditors of PIEs or schedule funds for the purposes of the SCMA;
- 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 or schedule funds:
- Liaise and co-operate with oversight bodies outside Malaysia to enhance the standing of the auditing profession in Malaysia and internationally;
- Carry out inspection on any person who prepares a report in relation to financial information of PIEs or schedule funds, in relation to capital market activities, as may be required to be prepared under the securities laws or guidelines issued by SC; and
- Perform such other duties or functions as AOB determines necessary or appropriate to promote high professional standards of auditors and to improve the quality of audit services provided by auditors.

## **AOB MEETINGS**

In 2015, AOB held seven Board meetings. The attendance by the Board members is stated below:

Board member	Number of meetings attended
Nik Mohd Hasyudeen Yus	off 7
Goh Ching Yin	4
Dato' Gumuri Hussain	7
Datuk Nor Shamsiah Moh	d Yunos 3
Cheong Kee Fong	7
Chok Kwee Bee	7
Dato' Zahrah Abd Wahab (Appointed 3 June 2015)	Fenner 2

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 balanced deliberation of issues and transparent decision making.

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

# **COMMITTEE OF AOB**

Section 31EA of the SCMA provides that 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 SCMA.

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 AOB. The Registration Committee recommends to the Board, wherein the Board deliberates and decides, for matters pertaining to registration or recognition.

The members of the Registration Committee are:

- Nik Mohd Hasyudeen Yusoff
- Goh Ching Yin

# **ORGANISATION STRUCTURE SECURITIES COMMISSION MALAYSIA Members of AOB EXECUTIVE CHAIRMAN** Enforcement, **Registration and Regulation and** Inspection Research **Quality Assurance**



# **Audit Oversight Board**

Financial Statements for the year ended 31 December 2015

# STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2015

	Note	2015 RM	2014 RM
Assets			
Current assets Other receivables Cash and cash equivalents	4 5	87,489 176,701	87,655 1,118,651
Total assets		264,190	1,206,306
<b>Reserves</b> Funds from the Securities Commission Malaysia (SC) Accumulated deficit	6 7	15,500,000 (15,258,510)	12,500,000 (11,379,980)
Total reserves		241,490	1,120,020
Current liabilities Other payables and accruals	8	22,700	86,286
Total liabilities		22,700	86,286
Total reserves and liabilities		264,190	1,206,306

The notes set out on pages 83 to 92 are an integral part of these financial statements.

Dato' Seri Ranjit Ajit Singh

Chairman

Securities Commission Malaysia

Date: 28 January 2016

Nik Mohd Hasyudeen Yusoff

Executive Chairman Audit Oversight Board

# STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR **ENDED 31 DECEMBER 2015**

	Note	2015 RM	2014 RM
Income Registration fees Finance income from fixed deposits Other operating income	9	1,904,778 30,527 –	1,829,766 88,653 40,000
Operating expenditure		1,935,305	1,958,419
Administrative expenses	10	(5,813,835)	(5,217,599)
<b>Deficit before tax</b> Tax expense	13	(3,878,530)	(3,259,180)
Deficit for the year/Total comprehensive expense for the year		(3,878,530)	(3,259,180)

The notes set out on pages 83 to 92 are an integral part of these financial statements.

# STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2015

	2015 RM	2014 RM
Cash flows from operating activities  Deficit before tax	(3,878,530)	(3,259,180)
Adjustment for: Finance income	(30,527)	(88,653)
Operating deficit before changes in working capital Change in other receivables Change in other payables and accruals	(3,909,057) 166 (63,586)	(3,347,833) (6,805) 56,286
Net cash used in operating activities	(3,972,477)	(3,298,352)
Cash flows from investing activities Finance income Increase in restricted deposits	30,527 –	88,653 (40,000)
Net cash from investing activities	30,527	48,653
Cash flows from financing activity Funds received from the SC	3,000,000	3,500,000
Net cash from financing activity	3,000,000	3,500,000
Net (decrease)/increase in cash and cash equivalents	(941,950)	250,301
Cash and cash equivalents at 1 January	1,058,651	808,350
Cash and cash equivalents at 31 December	116,701	1,058,651
Cash and cash equivalents comprise:		
Cash and bank balances Deposits placed with a licensed bank	76,701 100,000	118,651 1,000,000
Less: Restricted deposits	176,701 (60,000)	1,118,651 (60,000)
	116,701	1,058,651

The notes set out on pages 83 to 92 are an integral part of these financial statements.

## **NOTES TO THE FINANCIAL STATEMENTS**

#### 1. General

On 1 April 2010, the 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:

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

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. The SC will continue to provide the necessary financial support to the AOB for the foreseeable future.

#### 2. **Basis of preparation**

#### Statement of compliance (a)

The financial statements of the AOB have been prepared in accordance with Malaysian Financial Reporting Standards (MFRSs) and International Financial Reporting Standards.

The following are accounting standards, amendments and interpretations that have been issued by the Malaysian Accounting Standards Board (MASB) but have not been adopted by the AOB.

# MFRSs, Interpretations and amendments effective for annual periods beginning on or after 1 January 2016

- Amendments to MFRS 5, Non-current Assets Held for Sale and Discontinued Operations (Annual Improvements 2012-2014 Cycle)
- Amendments to MFRS 7, Financial Instruments: Disclosures (Annual Improvements 2012-2014 Cycle)
- Amendments to MFRS 10, Consolidated Financial Statements, MFRS 12, Disclosure of Interests in Other Entities and MFRS 128, Investments in Associates and Joint Ventures -Investment Entities: Applying the Consolidation Exception
- Amendments to MFRS 11, Joint Arrangements Accounting for Acquisitions of Interests in Joint Operations
- MFRS 14, Regulatory Deferral Accounts
- Amendments to MFRS 101, Presentation of Financial Statements Disclosure Initiative
- Amendments to MFRS 116, Property, Plant and Equipment and MFRS 138, Intangible Assets – Clarification of Acceptable Methods of Depreciation and Amortisation
- Amendments to MFRS 116, Property, Plant and Equipment and MFRS 141, Agriculture Agriculture: Bearer Plants
- Amendments to MFRS 119, Employee Benefits (Annual Improvements 2012-2014 Cycle)
- Amendments to MFRS 127, Separate Financial Statements Equity Method in Separate
- Amendments to MFRS 134, Interim Financial Reporting (Annual Improvements 2012-2014 Cycle)

MFRSs, Interpretations and amendments effective for annual periods beginning on or after 1 January 2018

- MFRS 9, Financial Instruments (2014)
- MFRS 15, Revenue from Contracts with Customers

## MFRSs, Interpretations and amendments effective for a date yet to be confirmed

Amendments to MFRS 10, Consolidated Financial Statements and MFRS 128, Investments in Associates and Joint Ventures – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture

The AOB plans to apply the abovementioned standards, amendments and interpretations that are applicable and effective from the annual periods beginning on or after 1 January 2016 and 1 January 2018, respectively.

The initial application of the accounting standards, amendments or interpretations are not expected to have any material financial impacts to the current period and prior period financial statements of the AOB.

#### (b) **Basis of measurement**

The financial statements have been prepared on the historical cost basis other than as disclosed in Note 3.

#### (c) **Functional and presentation currency**

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

#### (d) Use of estimates and judgements

The preparation of the 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, and have been applied consistently by the AOB, unless otherwise stated.

#### (a) **Financial instruments**

#### (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

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.

#### (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 control of the asset is not retained or substantially all of the risks and rewards of ownership of the financial asset are transferred to another party. 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 the 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, 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 fair value with original maturities of three months or less, and are used by the AOB in the management of their short term commitments. 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.

If, in a subsequent period, the fair value of the financial asset increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed, to the extent that the asset's carrying amount does not exceed what the carrying amount would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal is recognised in profit or loss.

#### (d) Income

#### (i) Registration fees

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

#### (ii) Finance income

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

#### (e) **Employee benefits**

#### (i) Short-term employee benefits

Short-term employee benefit obligations in respect of salaries, annual bonuses, paid annual leave and sick leave are measured on an undiscounted basis and are expensed as the related service is provided.

A liability is recognised for the amount expected to be paid if the AOB has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

#### (ii) State plans

The AOB's contributions to statutory pension funds are charged to profit or loss in the financial year to which they relate. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available.

#### (f) Fair value measurement

Fair value of an asset or a liability is determined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market or in the absence of a principal market, in the most advantageous market.

For non-financial asset, the fair value measurement takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

When measuring the fair value of an asset or a liability, the AOB uses observable market data as far as possible. Fair value are categorised into different levels in a fair value hierarchy based on the input used in the valuation technique as follows:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities that the AOB can access at the measurement date.
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3: unobservable inputs for the asset or liability.

The AOB recognises transfers between levels of the fair value hierarchy as of the date of the event or change in circumstances that caused the transfers.

4.	Other receivables	2015 RM	2014 RM
	Deposits and prepayments	87,489	87,655
5.	Cash and cash equivalents	2015 RM	2014 RM
	Cash and bank balances Deposits placed with a licensed bank	76,701 100,000 —————————————————————————————	118,651 1,000,000 ————————————————————————————
		170,701	1,118,651

Included in deposits placed with a licensed bank is RM60,000 (2014: RM60,000) restricted to be utilised for planning and implementing capacity building programmes in relation to the accounting and auditing profession.

The cash and cash equivalents are placed with a licensed bank which is under common control by the Government of Malaysia (a party that has an indirect influence on the AOB).

#### 6. **Funds from the Securities Commission Malaysia**

	2015 RM	2014 RM
Cash contribution: At the beginning of the year Addition	12,500,000 3,000,000	9,000,000 3,500,000
At the end of the year	15,500,000	12,500,000

#### 7. **Accumulated deficit**

	2015 RM	2014 RM
At the beginning of the year Deficit for the year	(11,379,980) (3,878,530)	(8,120,800) (3,259,180)
At the end of the year	(15,258,510)	(11,379,980)

8.	Other payables and accruals		
		2015 RM	2014 RM
	Amount due to the SC Accruals	_ 22,700	65,086 21,200
		22,700	86,286
	The amount due to the SC is unsecured, interest free and repayable or	n demand.	
9.	Finance income from fixed deposits		
		2015 RM	2014 RM
	Finance income of financial assets that are not at fair value through profit or loss	30,527	88,653 ———
10.	Administrative expenses	2015	2014
		RM	RM
	The administrative expenses consist of: Auditors' remuneration	20,000	20,000
	Honorarium payment	45,076	45,372
	Non-executive members' allowance	86,000	81,000
	Other miscellaneous charges	231,144	296,085
	Rental of premises	342,018	328,350
	Staff costs	5,089,597	4,446,792
		5,813,835	5,217,599

# 11. Financial instruments

# 11.1 Categories of financial instruments

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

- Loans and receivables (L&R); and (a)
- (b) Financial liabilities measured at amortised cost (FL).

2015	Carrying amount RM	L&R RM	FL RM
<b>Financial assets</b> Other receivables, excluding prepayments Cash and cash equivalents	80,684 176,701	80,684 176,701	_ _
	257,385	257,385	
Financial liabilities Other payables and accruals	(22,700)	-	(22,700)
2014 Financial assets			
Other receivables, excluding prepayments Cash and cash equivalents	80,850 1,118,651	80,850 1,118,651	_ _
	1,199,501	1,199,501	_
<b>Financial liabilities</b> Other payables and accruals	(86,286)	-	(86,286)

# 11.2 Gains arising from financial instrument

	2015 RM	2014 RM	
Gains on: Loans and receivables	30,527	88,653	

# 11.3 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.

# 11.4 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.

# 11.5 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

# 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
2015			
Financial liabilities			
Other payables and accruals	22,700	22,700	22,700
2014			
Financial liabilities			
Other payables and accruals	86,286	86,286	86,286

## 11.6 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.

## 11.6.1 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:

	2015 RM	2014 RM
Fixed rate instruments	VIAI	LIVI
Financial assets	100,000	1,000,000

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.

# 11.7 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.

# 12. Fund management

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.

# 13. Tax expense

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.

# 14. Authorisation of financial statements

The financial statements for the year ended 31 December 2015 were authorised by the SC for issuance and signed by the Chairman of the SC and Executive Chairman of AOB on 28 January 2016.

# 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 80 to 92 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 28 January 2016.

Vignaswaran A/L Kandiah

28A Jalan Tun Muhammad Fuad 1 Taman Tun Dr. Ismail 60000 Kuala Lumpur Tel No: 03-77338715 / 03-77258715 H/P: 016-6993625

# INDEPENDENT AUDITORS' REPORT TO THE AUDIT OVERSIGHT BOARD. **SECURITIES COMMISSION MALAYSIA**

# **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 2015, and the statements of profit or loss and other comprehensive income, and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, as set out on pages 80 to 92.

# Commission Members' Responsibility for the Financial Statements

The Commission Members of the Securities Commission Malaysia (Commission) are responsible for the preparation of financial statements so as to give a true and fair view in accordance with Malaysian Financial Reporting Standards and International Financial Reporting Standards. The Commission Members are also responsible for such internal control as the Commission Members determine is 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 about 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 give a true and fair view of the financial position of the AOB as of 31 December 2015 and of its financial performance and cash flows for the year then ended in accordance with Malaysian Financial Reporting Standards and International Financial Reporting Standards.

# **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.

Firm Number: AF 0758 **Chartered Accountants** 

Petaling Jaya, Malaysia

Date: 28 January 2016

Loh Kam Hian

Approval Number: 2941/09/16(J) **Chartered Accountant** 

# **ACRONYMS AND ABBREVIATIONS**

AARG **ASEAN Audit Regulators Group** 

**AASB** Auditing and Assurance Standards Board

**AOB** Audit Oversight Board AOI Audit Quality Indicator

**ASEAN** Association of Southeast Asian Nations

**BNM** Bank Negara Malaysia CAO Center for Audit Quality CEO Chief Executive Officer

CMSI Capital Markets Services Licence

CPA Australia Certified Practising Accountant Australia CPF Continuing Professional Education

**CSAP** Committee to Strengthen the Accountancy Profession

**EQCR Engagement Quality Control Reviewer** 

ESB **Ethics Standards Board** 

**FPLC** Federation of Public Listed Companies Bhd

FRF Financial Reporting Foundation

**IAASB** International Auditing and Assurance Standards Board **IESBA** International Ethics Standards Board for Accountants

**IFAC** International Federation of Accountants

**IFIAR** International Forum of Independent Audit Regulators

IIAM Institute of Internal Auditors Malaysia ISA International Standard on Auditing ISOC International Standard on Quality Control

JWG Joint Working Group KAM Key audit matters

**MASB** Malaysian Accounting Standards Board **MFRS** Malaysian Financial Reporting Standards MIA Malaysian Institute of Accountants

MICPA The Malaysian Institute of Certified Public Accountants

**NOCLAR** Non-compliance with laws and regulations

**PAIB** Profession accountants in business

**PCAOB** Public Company Accounting Oversight Board

PIE Public-interest entity **PLC** Public-listed company

SC Securities Commission Malaysia SCA Securities Commission Act 1993

**SCMA** Securities Commission Malaysia Act 1993 SSM Companies Commission of Malaysia

UK United Kingdom

# **DEFINITIONS**

Auditor An individual auditor or audit firm who is registered or recognised under

section 310 of the SCMA as a registered auditor or recognised auditor of a

PIE or schedule fund.

Major Audit Firms Audit firms with more than 10 partners and audit more than 50 PIEs with a

total market capitalisation of above RM20 billion.

Other Audit Firms Audit firms other than Major Audit Firms.

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

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

- (b) a bank licensed under the Financial Services Act 2013;
- (c) an insurer licensed under the Financial Services Act 2013;
- (d) a takaful operator licensed under the Islamic Financial Services Act 2013:
- (e) an Islamic bank licensed under the *Islamic Financial Services Act* 2013:
- (f) a financial institution prescribed under section 212 of the *Financial Services Act 2013* or section 223 of the *Islamic Financial Services Act 2013*;
- (g) a developmental financial institution prescribed under the Development Financial Institutions Act 2002;
- a holder of the Capital Markets Services Licence for the carrying on of the regulated activities of dealing in securities, dealing in derivatives or fund management;
- (i) an exchange holding company approved under the securities laws;
- (j) an exchange approved under the securities laws;
- (k) a central depository approved under the securities laws;
- (l) a clearing house approved under the securities laws;
- (m) a self-regulatory organisation recognised under the securities laws;
- (n) a private retirement scheme administrator approved under the securities laws;
- (o) a trade repository approved under the securities laws;
- (p) the Capital Market Compensation Fund Corporation;
- (q) any other person as the Minister may prescribe by order published in the *Gazette*

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

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

PART 6: Financial Statements and Others | 97



