



AOB 2013 Dialogue with Audit Firms

19 November 2013

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Agenda

- AOB Activities To-Date
- AOB 2013 Inspection Findings
- Root Cause Analysis
- AOB Remediation Framework
- Enforcement
- Conclusion and Key Messages
- Other matters



AOB Activities To-Date

Registration Statistics as at 30 September 2013

Profile of audit firms	No. of Audit Firms	No. of Auditors	No. of PIE	% of Market Capitalisation
10 partners and above	7	170	883	95.13
5 – 9 partners	8	44	130	0.88
2 – 4 partners	35	85	127	3.77
Sole proprietors	4	4	7	0.01
Total	54	301	1,147	99.79

Recognition of Foreign Auditor as at 30 September 2013

Profile of audit firms	No. of Audit Firms	No. of Auditors	No. of PIE	% of Market Capitalisation
Singapore	5	10	5	0.04
UK	1	2	1	0.02
Hong Kong	1	2	1	0.12
Total	7	14	7	0.18



AOB 2013 Inspection Findings

ISQC 1 Observations

ISQC 1 Observations – Key Takeaways

Areas	Common observations	Possible measures to address
Leadership responsibilities for quality within the Firm	<ul style="list-style-type: none">Weaknesses in the design or implementation of policy and procedures that demonstrate the leadership's emphasis on audit quality	<ul style="list-style-type: none">Establish written communication amongst the partners and with staff, defining the measures that may be imposed in the event that audit quality or professional conduct is compromised<ul style="list-style-type: none">Examples: Partnership Arrangement, quality charter, KPI balance scorecard, formal performance appraisalRegular reminders and communication by the leadership with staff to emphasise on the importance of audit quality

ISQC 1 Observations – Key Takeaways (cont.)

Areas	Common observations	Possible measures to address
Relevant ethical requirements	<ul style="list-style-type: none"> • Breach of partner rotation rule either due to insufficient number of partners within the firm to enable rotation or misinterpretation of the MIA By-Laws • Self review threat by helping clients to prepare financial statements or providing other services which may result in conflicts of interest • No independence declaration by partners and staff particularly at engagement level – tendency to fall back on annual independence declaration 	<ul style="list-style-type: none"> • Know the MIA By-Laws on independence requirements and get the interpretation right, otherwise consult • Establish proper monitoring mechanism to track partners rotation and independence declaration at both firm level and engagement level • For smaller practice with limited number of partners <ul style="list-style-type: none"> ➢ Consider merger with other firms ➢ Groom staff internally to become partners ➢ Otherwise, give up the engagement where rotation is not possible • Advise clients to seek assistance from another professional firm to provide relevant accounting services

ISQC 1 Observations – Key Takeaways (cont.)

Areas	Common observations	Possible measures to address
<p>Acceptance and continuance of client relationships and specific engagements</p>	<ul style="list-style-type: none"> • Business consideration override <ul style="list-style-type: none"> ➢ Acceptance decision driven by motivation to grow revenue/position or to attract staff ➢ Offering audit fees lower than the pre-decessor to secure business without due consideration of the actual costs involved to carry out a quality audit. 	<ul style="list-style-type: none"> • Apply caution when deciding to accept audit of PLCs – do you know why the previous auditor drop them? • Decisions should prioritise on having the right resource capacity (appropriate knowledge of industry and technical competencies and adequacy of staff of time) to manage the audit

ISQC 1 Observations – Key Takeaways (cont.)

Areas	Common observations	Possible measures to address
Human resources	<ul style="list-style-type: none"> Lack of emphasis on training and development for partners and staff, including identifying relevant trainings and monitoring of attendance 	<ul style="list-style-type: none"> Structured training plan – internal and external Ensuring relevant topics of training and not merely to meet CPE points Pooling of resources amongst audit firms
Engagement performance	<ul style="list-style-type: none"> Outdated audit methodology Partners failed to comprehend latest concepts and requirements of accounting, auditing and ethical standards Insufficient supervision/review by Engagement Partner (“EP”) Partner’s Workload Ineffective EQCR Documentation discipline 	<ul style="list-style-type: none"> EP to be involved throughout the job – get into the field Rebalancing of partners’ portfolio and workload Updated audit methodology that complies with ISA at all times AND emphasise on “THINKING AUDIT” rather than checklist filling exercise Enhancing the consultation process and role of EQCR Raising the commitment to enforce compliance on proper and relevant documentation Understanding client industry and associated risks

ISQC 1 Observations – Key Takeaways (cont.)

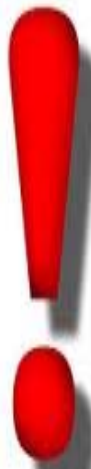
Areas	Common observations	What AOB expects
Monitoring	<ul style="list-style-type: none"> • No internal monitoring process in place • Monitoring process lacked robustness & rigor – including lack of resources, inexperience reviewers, checklist-based reviews, rating based on number of deficiencies rather than severity or impact on the basis of audit opinion 	<ul style="list-style-type: none"> • Set up a proper internal monitoring process that is adequately resourced with dedicated experience and technically sound personnel • Internal monitoring review to be based on substance of the issues – focus on areas/matters that affect the sufficiency of audit procedures and audit evidence and may have impact on basis of audit opinion rather than the administrative type of issues



CASE STUDY

Case Study 1: Assets Impairment

Common Observations:

- 
- Lack of verification and challenge of management's assumptions
 - No basis to support conclusion made by management
 - Inappropriate determination of recoverable amount and incorrect comparison of recoverable amount with carrying amount
 - Undue reliance of and lack of professional skepticism on management representation

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Case Study 1: Assets Impairment (cont.)

Example: Investment in a subsidiary which has been loss-making and in net current liabilities position

	Actual 2012	Projection 2013	Forecast 2014	Forecast 2015	Forecast 2016	Forecast 2017	Terminal value
Revenue	150	350	385	424	466	512	
Cost of sales	(135)	(245)	(270)	(296)	(326)	(359)	
Gross Profit	15	105	115	128	140	153	
<i>GP Margin</i>	10%	30%	30%	30%	30%	30%	
Admin and other cost	(65)	(85)	(94)	(10)	(11)	(12)	
(LBT) / PBT	(50)	20	21	25	27	29	
Tax (20%)	-	(4)	(4)	(5)	(5)	(6)	
(LAT) / PAT	(50)	16	17	20	22	23	1,300

Key assumption 1:
Increase in revenue in FYE 2013 due to one new customer

Key assumption 2:
Constant growth rate (g) of 10% year on year

Key assumption 4:
WACC (r) of 13%

Key assumption 3:
Calculated based on a growth rate of 11%

Value in Use = NPV = 773

Carrying amount of Sub A

100
500
600
173

Goodwill

AUDIT CONCLUSION:
NO IMPAIRMENT ON ASSETS AND GOODWILL [BACK]

Case Study 1: Assets Impairment (cont.)

Example: Investment in a subsidiary which has been loss-making and in net current liabilities position

	Actual 2012	Projection 2013	Forecast 2014	Forecast 2015	Forecast 2016	Forecast 2017	Terminal value
Revenue	150	350	385	401	429	459	
Cost of sales	(135)	(245)	(262)	(281)	(300)	(329)	
Gross Profit	15	105	112	120	129	138	
<i>GP Margin</i>	10%	30%	30%	30%	30%	30%	
Admin and other cost	(65)	(85)	(91)	(97)	(104)	(111)	
(LBT) / PBT	(50)	20	21	23	25	27	
Tax (20%)	-	(4)	(4)	(5)	(5)	(5)	
(LAT) / PAT	(50)	16	17	18	20	22	249

Value in Use = NPV =	178
Carrying amount of Sub A	100
Goodwill	500
	600
IMPAIRMENT	(422)

If r = 16%, g = 7%

AUDIT CONCLUSION: NO IMPAIRMENT ON ASSETS AND GOODWILL [BACK]

Key assumption 1:
Increase in revenue in FYE 2013 due to one new customer
↓
Supported by a mere "Letter of Intent"


Key assumption 2:
Constant growth rate (g) of 10% year on year
↓
Historical growth of company last 5 years = 5%, Forecasted for next 2 years – 7%

Key assumption 3:
Calculated based on a growth rate of 11%
↓
Basis to higher growth rate?

Key assumption 4:
WACC (r) of 13%
↓
Entire group's average WACC, not specific to Sub A which actual cost of capital = 16%

Case Study 2: Estimates – Property Development

Common Observations:

- 
- Understanding of the PIE's process and controls on accounting estimates relating to property development costs
 - Rigor to challenge the management's budgeting process and basis or assumptions or data used to support the estimated costs and allocation of common costs
 - Review of budgets by comparing to actual cost incurred on a totality basis to identify potential cost overrun
 - Review of provision for cost to completion
 - Expected losses recognised based on percentage of completion
 - Professional skepticism on loss making projects on a continuous basis

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Case Study 2: Estimates – Property Development (cont.)

Example: Review of budgets - Project A (55% completed)

Direct construction costs	Budgeted (RM'm)	Actual (RM'm)	Variance (RM'm)
Preliminary expenses	5.5	5.4	0.1
Main building works	40.3	49.6	(9.3)
Architectural works	7.7	-	7.7
M&E works	6.2	-	6.2
Common cost	0.8	-	0.8
	60.5	55.0	5.5
Contingency	2.4	-	2.4
Total	62.9	55.0	7.9

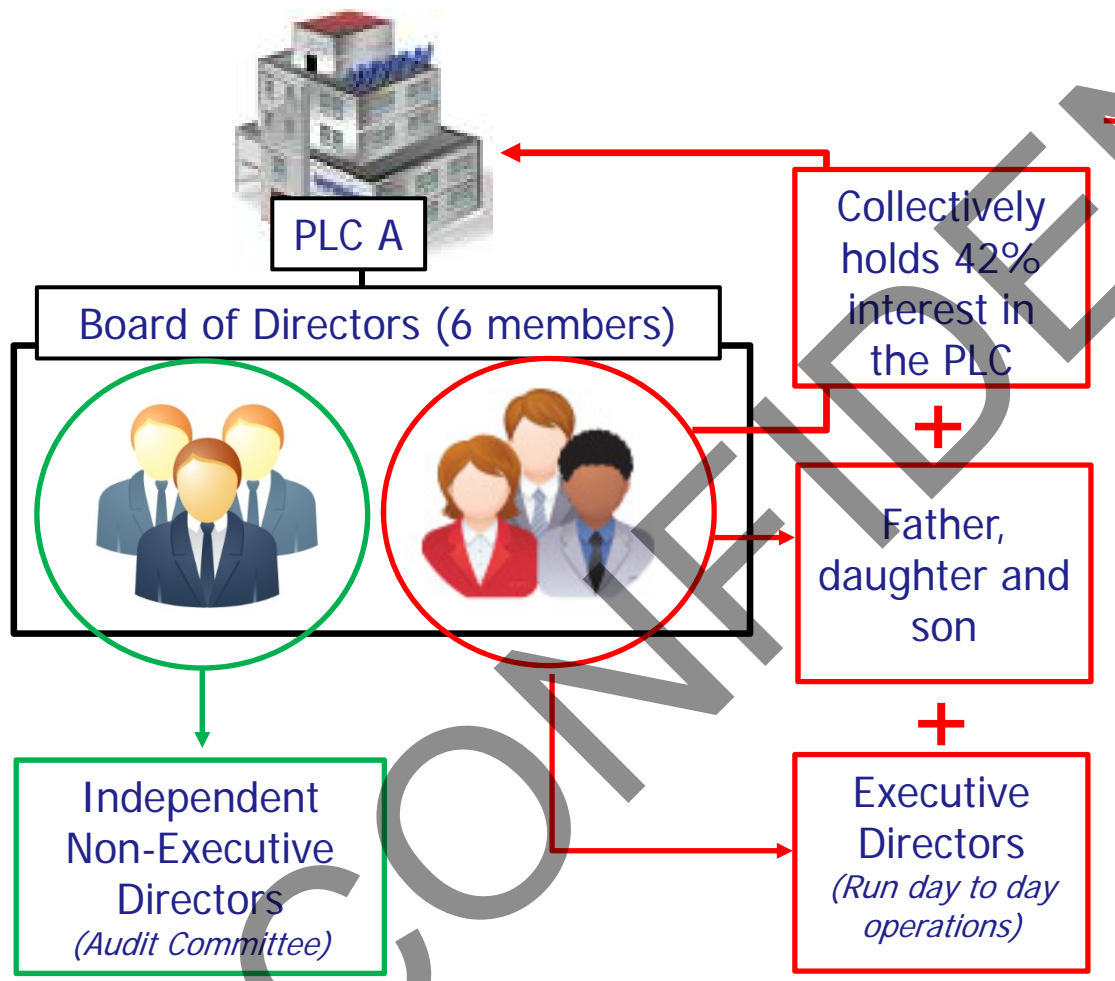
2. Common cost allocated between 5 phases using "land area" → **no challenge on the basis of allocation**
3. Contingency estimated as 4% of cost → **no challenge on why 4%**

1. No audit procedures performed to **understand** the management's budgeting process

4. Compare budget to total cost incurred to-date → **did not identify cost overrun at main building cost**
5. Contingency cost RM2.4m insufficient to cover cost overrun in main building works. No revision of budgeted cost → **completeness of budgeted cost not addressed**
6. Budgeted revenue = RM65.0m → If budgeted cost revised to RM69.7m, **foreseeable losses of RM4.7m not identified**

RM14.7m

Case Study 3: Risk of Management Override of Controls



AOB's identified deficiencies

- Risk of management override not identified [ISA 200.15 & ISA 315.14]
 - Did not apply appropriate professional skepticism
- Risk of management override was identified and considered a risk, however no additional procedures [ISA 240.33]
 - Journal entry testing – nature, extent, and timing

Case Study 4: Sampling and Untested Population

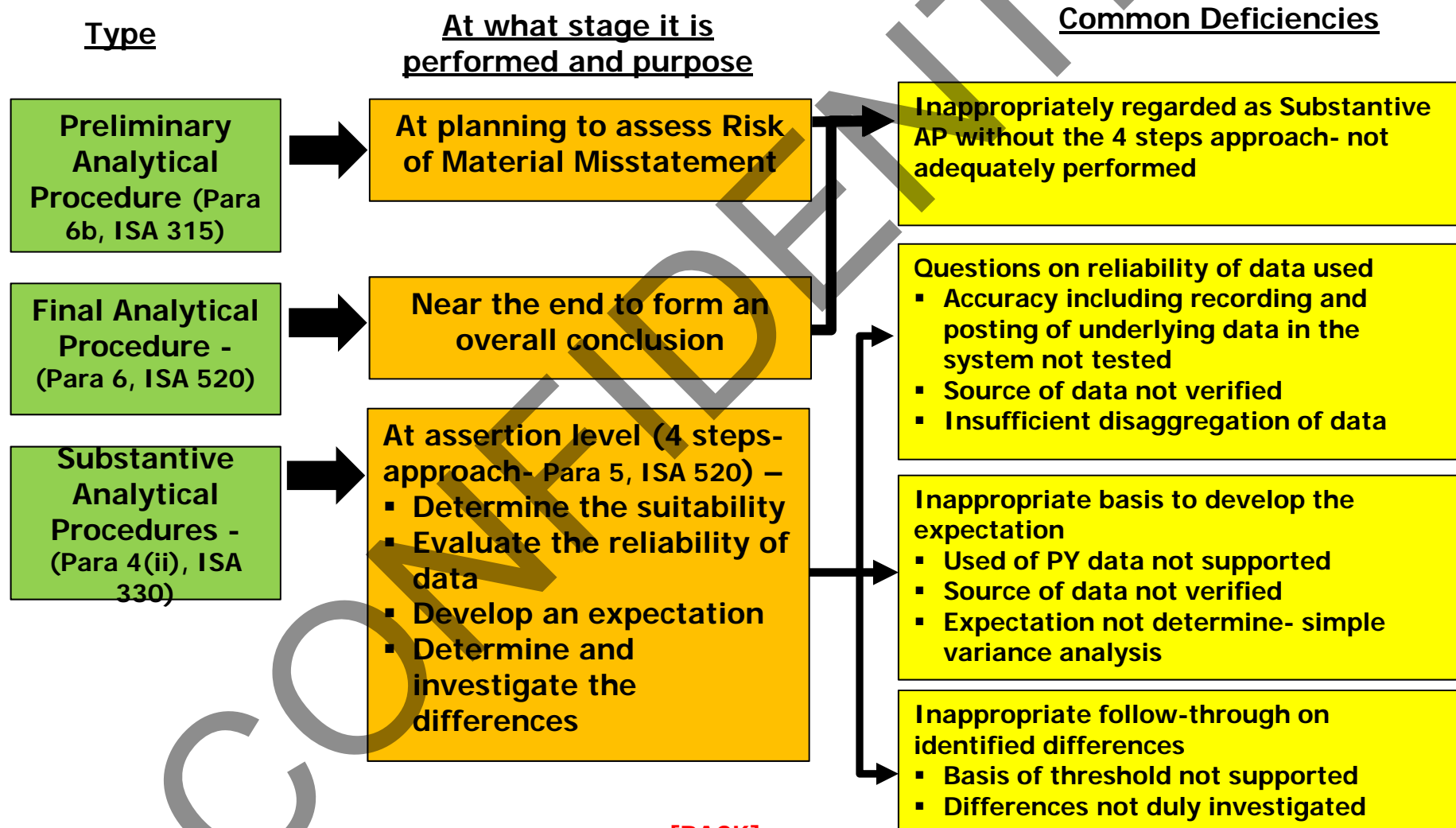
Example: Substantive testing on revenue to address occurrence, accuracy and completeness assertions

Revenue population	Performance materiality set by the auditor	Basis of sampling	No of samples selected	Total amount for samples selected
RM15,275,800	RM400,000	Items > RM100,000	48	RM10,984,300

Any deficiencies noted?

Auditor's common argument of no deficiencies	AOB's identified deficiencies	What can auditors do differently to avoid these audit deficiencies?
<p>Samples selected are material items</p> <p>Samples coverage is already high, ie. 72% [RM10,984,300/RM15,275,800]</p>	<ul style="list-style-type: none"> • Selective examination of specific items cannot be projected to provide audit evidence concerning the remainder of the remaining population [ISA 500.10 (A55)] • Untested population of RM4,291,500 is > PM [RM15,275,800 - RM10,984,300] • Materiality is based on PM and not samples coverage 	<ul style="list-style-type: none"> • Extend samples until untested population is < PM • Avoid pure targeted or key items testing – includes random or some other more appropriate means of selecting samples • Key item testing, to be supplemented by – <ul style="list-style-type: none"> ➤ Test of controls – must be relevant to assertions to be addressed ➤ Substantive analytical review <p style="text-align: right;">[Click here]</p>

Case Study 4: Analytical Procedures (AP) and Common Deficiencies



Case Study 5: Reliability of evidence provided by management

Example: Valuation of properties

Statement of Financial Position as at
31 December 2012 (in RM' million)

Management's basis to support
valuation and accepted by auditor

PPE:

Factory and office building A

3



Full valuation report for a
condominium unit belonged
to another subsidiary

Ascribed Value: RM3.2 million



AUDIT CONCLUSION:
"Higher than
Carrying Amount,
Hence No Impairment"

Leasehold Land B (vacant)
(lease expiring: Year 2025)

15

Total

18



BUT

Land held for development:

Freehold Land C

30

Freehold Land D

20

Total

50

1.

No evaluation to support the basis of comparison, ie.
comparing a **factory cum office** to **condominium**

Case Study 5: Reliability of evidence provided by management (cont.)

Example: Valuation of properties

Statement of Financial Position as at
31 December 2012 (in RM' million)

Management's basis to support
valuation and accepted by auditor

PPE:

Freehold Land and building A
(use as office and factory) 3

Leasehold Land B (vacant)
(lease expiring: Year 2025) 15

Total 18

Land held for development:

Freehold Land C 30

Freehold Land D 20

Total 50



One page fax letter from the
valuer's offices
Ascribed Value: RM16 million

**AUDIT
CONCLUSION:**
"Higher than
Carrying Amount,
*Hence, no
Impairment*"

BUT

1. Fax copy signed by a clerk from the valuer's office but not evaluated by the auditor as to the quality and reliability
2. Contained limitation clause stating that "...provided lease term is extended another 50 years...".

Case Study 5: Reliability of evidence provided by management (cont.)

Example: Valuation of properties

Statement of Financial Position as at
31 December 2012 (in RM' million)

PPE:

Freehold Land and building A
(use as office and factory) 3

Leasehold Land B (vacant)
(lease expiring: Year 2025) 15

Total 18

Land held for development:

Freehold Land C 30

Freehold Land D 20

Total 50

Management's basis to support
valuation and accepted by auditor



iProperty website
Asking price for a
similar land:
RM45 million



**AUDIT
CONCLUSION:**
"Higher than Carrying
Amount,
*Hence No
Impairment*"

BUT

1. No justification of using iProperty to support the valuation for Freehold Land C, particularly on the reliability of the "asking price"
2. No evaluation if the property in iProperty was comparable to Freehold Land C, for example, the physical condition and hence, no considering of adjusting the value to reflect such differences

Case Study 5: Reliability of evidence provided by management (cont.)

Example: Valuation of properties

Statement of Financial Position as at
31 December 2012 (in RM' million)

PPE:

Freehold Land and building A (use as office and factory)	3
Leasehold Land B (vacant) <i>(lease expiring: Year 2025)</i>	15
Total	18

Land held for development:

Freehold Land C	30
Freehold Land D	20
Total	50

Management's basis to support
valuation and accepted by auditor



Valuation report specific to this
land

Date of report: 31.12. **2010**

Abscribed value: **RM22 million**

BUT

1. No evaluation of the continue relevance of the outdated valuation report
2. Contained limitation clause stating that "...commercial land free from encumbrances...", however Freehold Land D is an agriculture land

AUDIT CONCLUSION:
"Higher than
Carrying Amount,
*Hence, no
Impairment*"



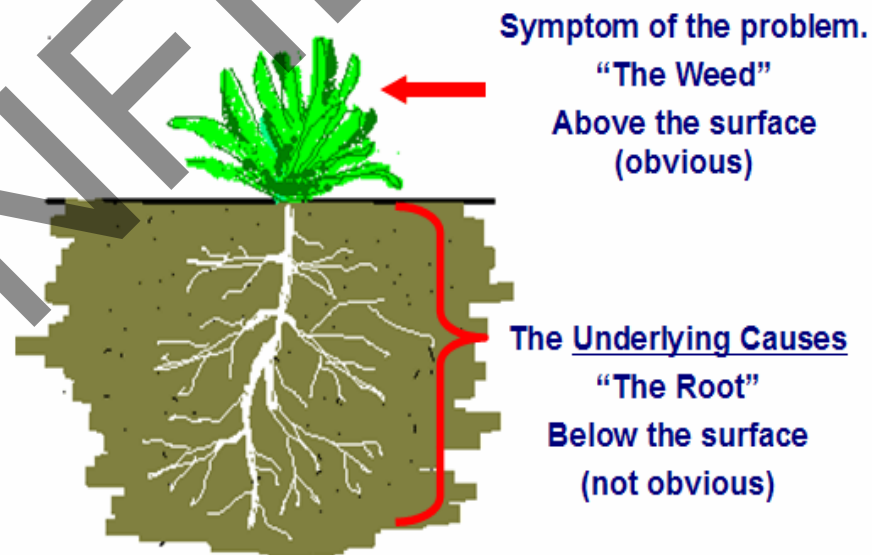
Root Cause Analysis

Why Root Cause Analysis?

- IFIAR 2012 Summary Report of Inspection Findings –
 - *"many findings recur year after year in the same inspection theme areas, suggests that audit firms should take steps to develop a robust root cause analysis to gain a clearer understanding of the factors that underlie the inspection findings and take appropriate actions to remediate those findings"*
- Benefits of root cause analysis –
 - Sustainable remediation & minimise recurrence
 - Consistency in result/performance

Root Cause Analysis

- Owning up to actual root causes
- Correct identification of root cause – Effective remediation plan to prevent recurring findings



Summary of Possible Root Causes

Common possible root causes	Remediation plans taken by audit firms to address root causes
<ul style="list-style-type: none"> • Performance not driven by audit quality • Business consideration • Lack of emphasis on monitoring/training/staff development • Outdated audit methodology • Insufficient supervision/review by Engagement Partner • Ineffective EQCR • Documentation discipline 	<ul style="list-style-type: none"> • Strengthening the governance structure, tightening the audit quality improvement plan • Enhancing the consultation process • Formulating a structured communication plan on audit quality • Enhancement to performance evaluation of partners and staff • Rebalancing of partners' portfolio and workload • Enhancing the role of the EQCR • Structured training plan and relevant changes to audit methodology, policies and procedures • Tighten the approach to professional skepticism • Raising the commitment to enforce compliance on proper and relevant documentation

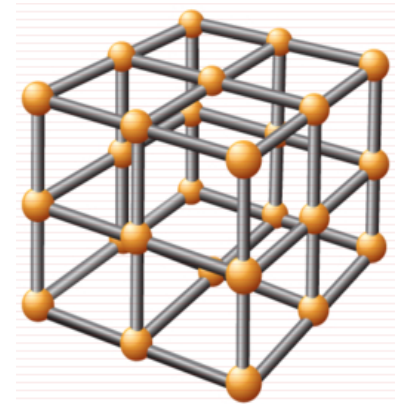
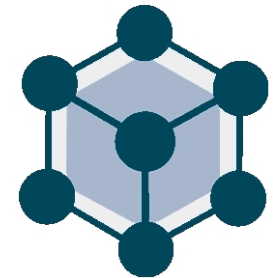


AOB Remediation Framework

AOB Remediation Framework

Introduction

- Audit firms are required to report to AOB the remedial measures on findings raised in the inspection report in accordance with Section 31V(6) of SCA, 1993
- Objective and desired outcome – enhancement of overall audit performance to improve the reliability of the auditors' opinion on financial statement
- Sanctions as last resort



AOB Remediation Framework (cont.)

“A holistic approach that addresses both firm and engagement deficiencies”

Key areas of remediation

- Firm Structure, Policy and Procedures
- Audit Methodology*
- Training*
- Human resources
- Independence Review (Includes EQCR Role)
- Communication
- Monitoring quality*
- Engagement Review Deficiencies#
- Performance Measures for Remediation**

* To incorporate:

- how professional skepticism is emphasised
- Engagement partners' involvement

To identify actual root cause of the deficiencies noted

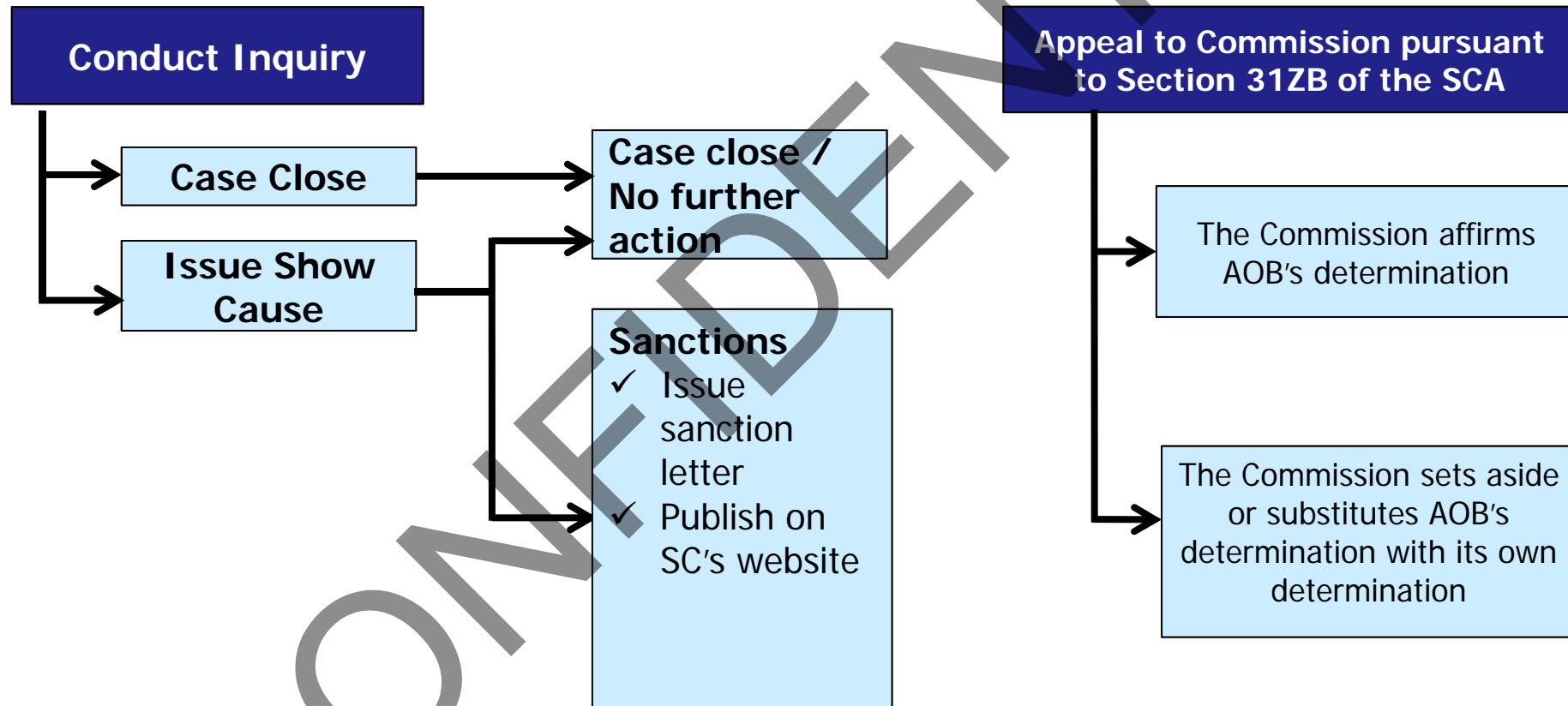
** To focus on the outcome and effectiveness of the remediation plan





Enforcement

Enforcement and Appeal Process Flow



Range of Sanctions

The range of sanctions available to AOB is set out in section 31Z(2) and section (3) of the SCA –

Section 31Z(2)

- a) Directive to comply
- b) Reprimand
- c) Remedy the breach
- d) Undertake relevant professional education to improve audit quality
- e) Assign a reviewer to oversee an audit that is undertaken by the person concerned
- f) Prohibit the person concerned from accepting any PIE as its client for a period not exceeding 12 months
- g) Prohibit the person concerned from auditing of PIE not exceeding 12 month or permanently
- h) Impose monetary penalty not exceeding RM500,000

Section 31Z(3)

- a) Undertaking to comply

Enforcement Action on Audit Firms and Auditors

Nature of action taken	2011	2012	2013*
Public Reprimand – failure to comply with auditing and ethical standards in the performance of audit engagements	-	1	4
Public Reprimand and Fine – failure to comply with auditing and ethical standards in the performance of audit engagements	-	1	2
Total	-	2	6

* As at 30 September 2013

- Failed to support audit conclusion on more than one material financial statement line item with relevant or reliable audit evidence
- Breached the standards of ethics and professional conduct as required by the MIA By-Laws



Conclusion and Key Messages

Conclusion and Key Messages

Aspects	Key Messages
AOB is into its 5 th year of inspection on 2014	<ul style="list-style-type: none"> • Delivering quality audit • Ensuring all framework to support audit quality is in place
Risk appetite in taking on PIE audits	<ul style="list-style-type: none"> • Balancing business, capacity and quality • Do not accept client for marketing purposes • Accept only if you have the capacity – time, resources and accounting & auditing technical competencies • Under-cutting fees will make it more difficult to achieve audit quality without sacrificing your profit margin
Accounting and auditing technical competencies	<ul style="list-style-type: none"> • Appropriate and up-to-date audit methodology – using on the shelf auditing guide/template/checklist would requires customization • Attend appropriate trainings to enhance on this aspects, both partners and staff
Performing an audit	<ul style="list-style-type: none"> • Thinking audit – template and checklists are just tools, they do not replace your professional judgment • Be involved – Engagement partner need to get on field and provide direction, supervision and review throughout the audit

Conclusion and Key Messages (cont.)

Aspects	Key Messages
Monitoring mechanism - EOQR	<ul style="list-style-type: none"> EOQR must be experience to perform work effectively with substance
Monitoring mechanism – Internal quality review	<ul style="list-style-type: none"> Costly but this is an important tool to enhance audit quality Hire qualified and dedicated resources You need to invest for long term sustainability
Addressing audit deficiencies – whether identified by AOB or through your internal quality reviews	<ul style="list-style-type: none"> Admit to the audit deficiencies if you truly want to improve audit quality Specific and knowing the actual root causes – denial would not help you to get the right remedial measures Implement remedial measures in substance, not doing it for the sake of “meeting regulator’s expectations”
AOB’s approach to enforcement	<ul style="list-style-type: none"> Observations which have impact on basis of audit opinion Not documentation issue – therefore do not hide behind the documentation excuse



THANK YOU