

Outline of session

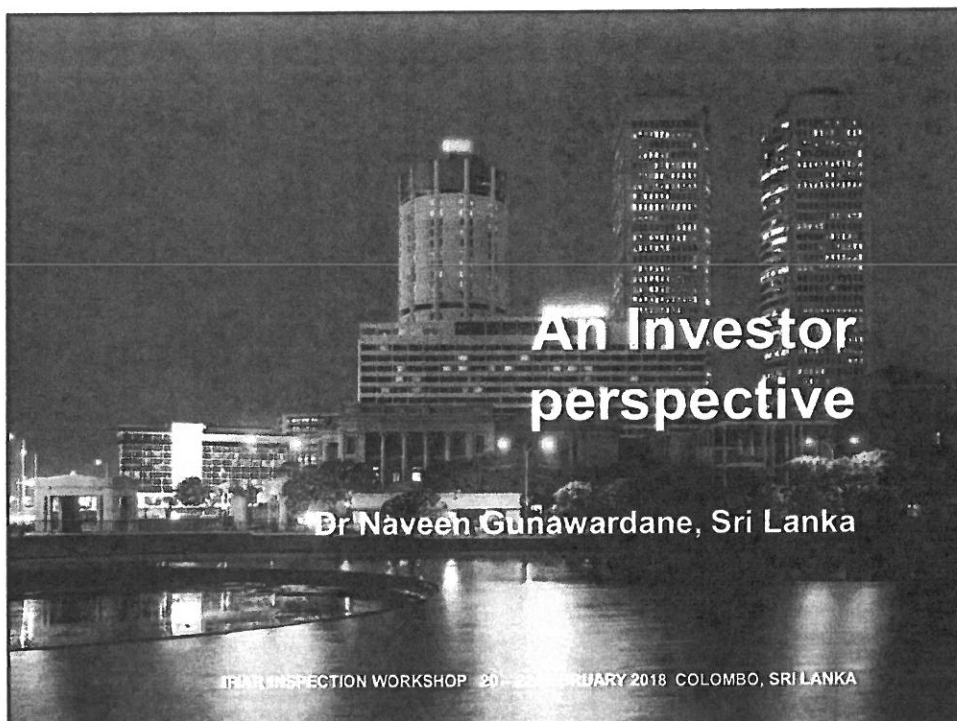
- ▶ Introduction by IFIAR Chair
- ▶ Investor perspective
- ▶ Audit Committee perspective
- ▶ Q&A

Introduction by IFIAR Chair

- ▶ Importance of Investor and Audit Committee communications
- ▶ Investor and Other Stakeholder Working Group
- ▶ IFIAR paper on Audit Committees
- ▶ Later break out session on Audit Committee Communications

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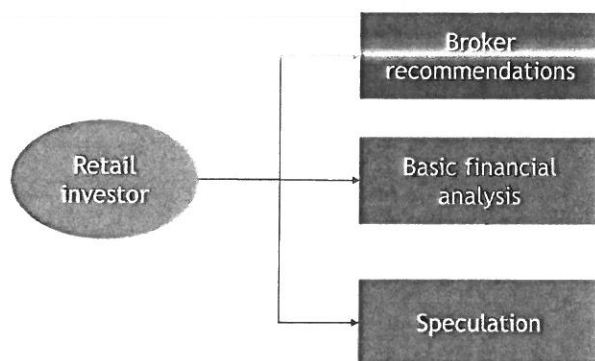
Outline

- ▶ Overview of the investment decision making process
- ▶ The importance of accurate financial information and financial statements
- ▶ Investor perspective on the role of the auditor and the audit opinion
- ▶ Investor awareness about audit regulators

Investment decision making process

- ▶ The investor space can be broadly split into two main categories:
 - ▶ Retail
 - ▶ Institutional
- ▶ The above two categories have very different approaches when it comes to making investment decisions and will have different expectations with regards to the annual reports, financial statements and the role of the auditor

Investment decision making process



A proper audit is absolutely crucial to help retail investors

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Investment decision making process

- ▶ Retail investors lack skills and resources for in-depth analysis
- ▶ A qualified audit opinion is far more useful in such an environment
- ▶ It becomes a far more important shield for an investor

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Investment decision making process

- ▶ Institutional investors will have their own proprietary investment decision making processes
- ▶ These can be based on fundamental analysis or quantitative(Quant)/technical strategies
- ▶ Ultimately most fundamental and Quant investment strategies will make use of the information in the financial statements

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Usefulness of information provided in financial statements

- ▶ Investors look at financial statements to predict the expected future performance of a company
- ▶ Investors require an understanding of the status quo only to the extent that it helps them understand the future

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Usefulness of information provided in financial statements

- ▶ In addition to accurate and compliant financial statements, investors also require sufficient disclosures on the following:
 - ▶ Revenues & margins
 - ▶ Cashflows and
 - ▶ Asset base

Usefulness of information provided in financial statements

- ▶ Consolidated line items are not useful in a company with multiple business lines and or subsidiaries / associates
- ▶ Different business lines have different drivers and face different risks
- ▶ Investors require sufficient information about the segments and the subsidiaries to project the future performance

Usefulness of information provided in financial statements

- ▶ The intrinsic value of a business is based on its ability to generate cash
- ▶ Accounting profit and valuation on accounting profit is done on the assumption that changes to accounting profit reflect in changes to cash generating ability
- ▶ Financial statements need to have disclosures to justify the above

Usefulness of information provided in financial statements

- ▶ Profitability is not absolute profit or margins alone
- ▶ Profitability has a price
- ▶ Asset base reflects the investment the investor has done
- ▶ An investor will prefer a company with a smaller absolute profit and margins if the profit / asset base is better than other companies

Investor perspective on the role of the auditor and the audit opinion

- ▶ Are investors losing confidence in auditors in light of the accounting scandals?
- ▶ Who's interest are the auditors serving?
- ▶ Is it audit committee truly independent?

Investor awareness about the audit regulator

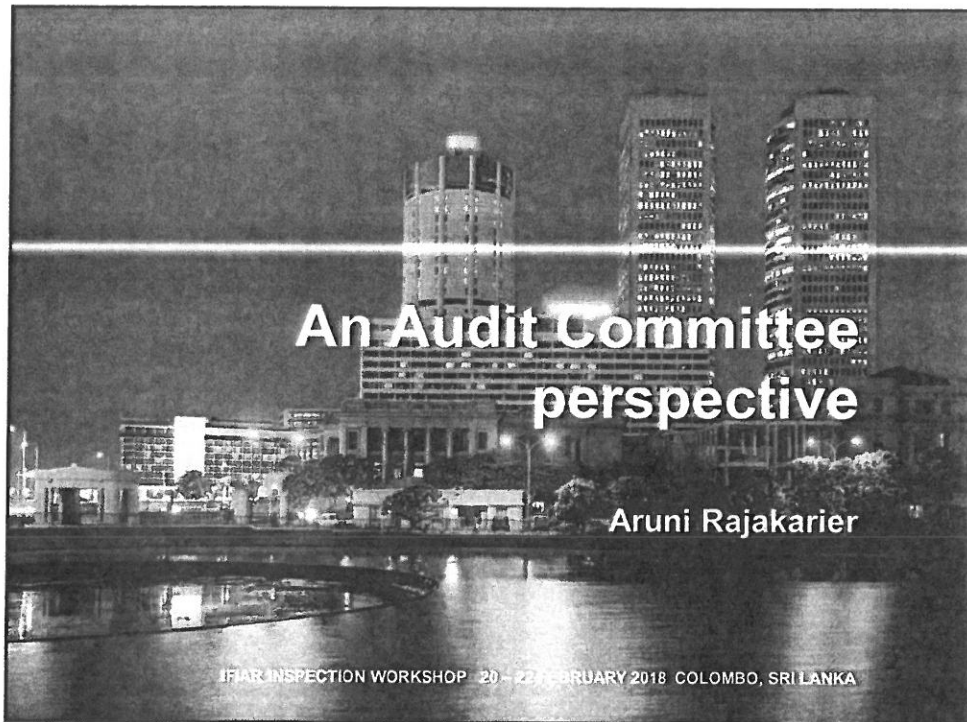
- ▶ Most of investors may not be aware that audit regulators exist
- ▶ An awareness program to be conducted (perhaps in conjunction with the capital market regulatory bodies) to inform and educate the investor community of the role of the audit regulators

Investor awareness about the audit regulator

- ▶ Explore the possibility of filing the audit regulators reports in a manner similar to how the company's financials are filed
- ▶ Remedial actions taken by the company based on the audit regulators report also to be highlighted "somewhere"

Investor awareness about the audit regulator

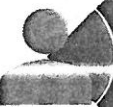
- ▶ Investors cannot have confidence in the audit regulators or your processes unless they are aware of what you have done!




Outline

- ▶ Audit Committee Chair
- ▶ Key concerns in an Audit
- ▶ Communications with Auditors
- ▶ Extended Audit Report

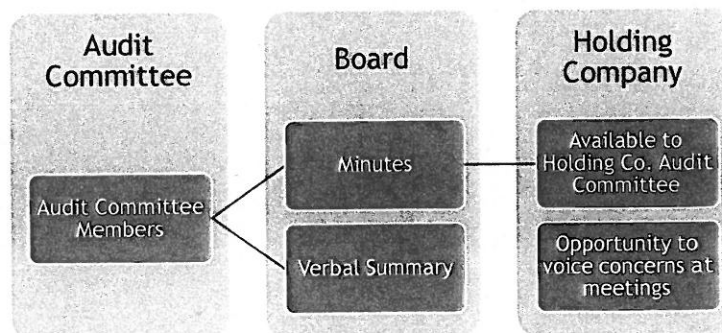
Audit Committee Chairs

 Independent Non-Executive Director

 Member of the Board

 Appointed by Shareholders

Communication & Sharing Responsibility



Communications with Audit Regulator

- ▶ Welcome initiatives of SLAASMB to keep Audit Committee Members informed
- ▶ Annual Report with names of companies reviewed with no issues, those where concerns were raised and those that have not submitted financial statements
- ▶ Recommend communications from SLAASMB to be also copied to the Audit Committee Chair and Chairman through independent means

Key Concerns in an Audit

- ▶ Value of Audit
- ▶ Scope of Audit
- ▶ Audit Quality
- ▶ Communications with Board
- ▶ Communications with Audit Regulator

2. Financial Statements

Value of Audit

2.1 Adverse Opinion

In my opinion, because of the significance of the matters described in paragraph 2.2 of this report, the financial statements do not give a true and fair view of the financial position of the [REDACTED] as at 31 December 2014 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Sri Lanka Accounting Standards

The following observations are made.

(a) Sri Lanka Accounting Standard No.1.

- (i) Since the vehicles owned by the Board are utilized for sales and distribution activities, a portion out of the expenditure of Rs.37,514,257 meant for the utilization should be absorbed into the marketing and distribution expenditure on a fair basis. Nevertheless, contrary to that, the total expenditure had been shown under the establishment and administrative expenditure. Further, an expenditure amounting to Rs.44,014,105 for the communication, printing, and stationeries should have been categorized and shown under sales, marketing and distribution expenditure and establishment and administrative expenditure on fair basis according to the objective of the utilization, whereas the total expenditure had been shown under sales, marketing and distribution expenditure.
- (ii) An adequate disclosure had not been made with regard to the loan amounting to Rs.325,000,000 obtained by the Board from the [REDACTED] Account during the year under review that had been shown in the statement of changes in equity.

Value of Audit

- ▶ New Audit Report will enhance the value as it will highlight key audit matters
- ▶ Scope for increased use of non-financial information in audit which will strengthen companies
- ▶ Management letter to address material issues
- ▶ Presentation of communications

Scope of Audit

- ▶ Digitisation will bring in new challenges
- ▶ Auditors get access to 100% records of companies, allowing them to conduct comprehensive analytics not on samples but on entire population
- ▶ Role of Audit Committee in determining the scope



Ensure areas for audit attention cover Audit Committee concerns

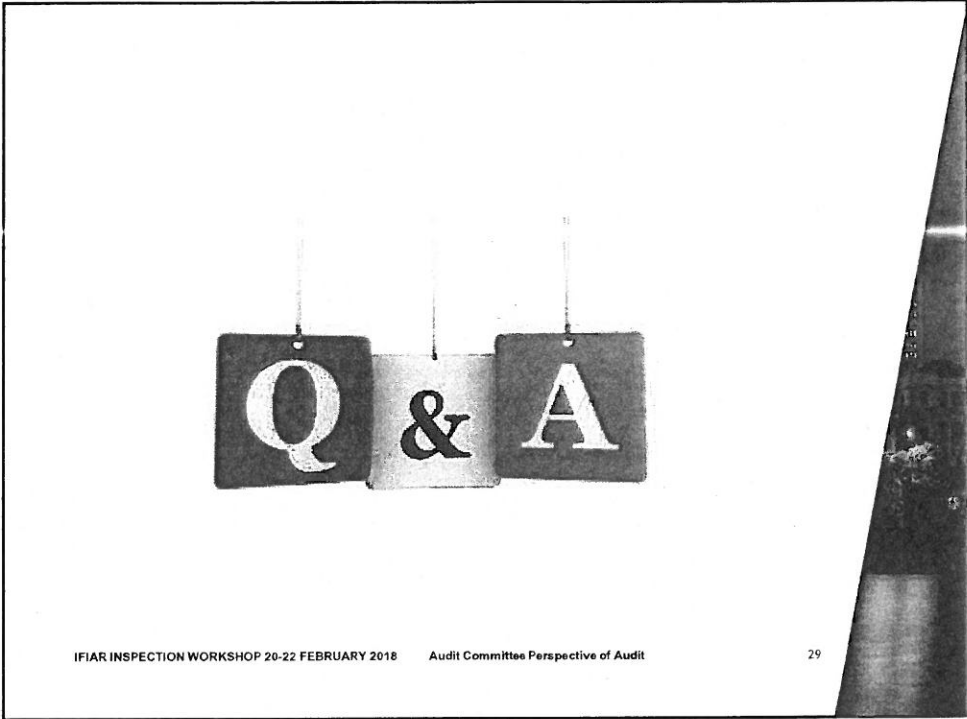
Technology being used is appropriate

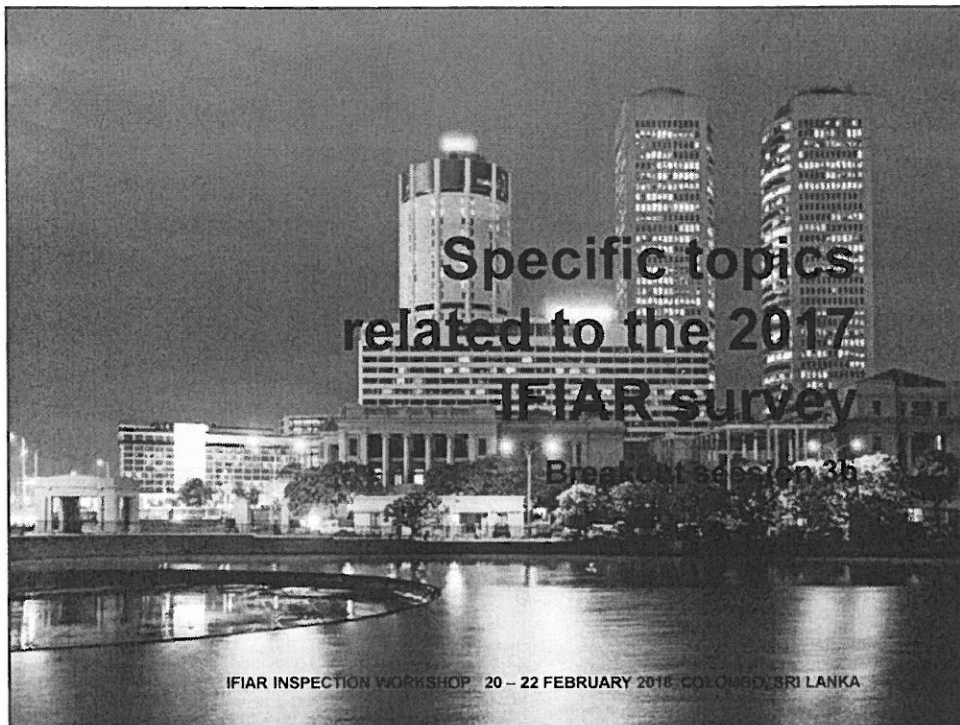
Review time plans to ensure there is time for review and feedback

Review teams and expertise allocated

Expectations of Auditor

- Opinion on financial statements that is consistent with audit findings
- Effectiveness of internal controls
- High degree of professional skepticism
- Potential areas of concern including emerging threats, risk of fraud
- Advice regarding future changes enabling client to prepare well ahead of time
- Communication of issues in a timely manner
- Use of closed door meeting to express concerns





Disclaimer

- ▶ The views expressed are those of the speakers and do not necessarily reflect the views of the audit regulator, its members, or staff

Introduction

- ▶ Objective of this session is to allow participants to share experiences, observations, and learnings about:
 - ▶ certain areas of audit with high numbers of audit deficiencies, according to the IFIAR Survey results
 - ▶ differences in findings rates in regions and/or inspection program size
- ▶ Opportunity for questions and discussion

What Did IFIAR Survey? – And Who Participated

Information Collected

- Quality Control Inspection Findings
- Findings from inspections of listed Public Interest Entities (PIEs)
- Findings from inspections of systemically-important financial institutions (SIFIs)
- Supplemental information on nature of findings for key recurring areas of findings
- Observations on Root Cause Analysis

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Breakout session 3b – Specific Topics Related to the 2017 IFIAR Survey

Definition of a Finding*

Significant, observed

- audit deficiencies
- accounting deficiencies and/or
- quality control deficiencies

that were communicated in writing to an inspected firm in a formal inspection report.

*IFIAR Survey of Inspection Results for Audit Firms (IFIAR Survey)

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Definition of a Finding* (cont'd)

For audit engagement findings related to a financial statement balance or disclosure:

- The firm did not obtain sufficient audit evidence to support its opinion or
- The firm did not identify or address a material, or likely potential material, error in the application of an accounting principle.

With respect to all other themes:

- A departure from auditing standards or requirements,
 - including standards on quality control and ethics and independence requirements,
- that may or did have an effect on audit quality, either due to the significance or systemic nature of the departure.

*IFIAR Survey of Inspection Results for Audit Firms (IFIAR Survey)

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Participation Statistics

Firms Inspected for Quality Control

	2017	2016	2015	2014	2013	2012
IFIAR Members Submitting Findings	32	33	33	30	30	23
Audit Firms Inspected	111	127	101	125	134	109

Listed PIE Audit Inspections

	2017	2016	2015	2014	2013	2012
IFIAR Members Submitting Findings	33	34	29	29	30	22
Audit Firms Inspected	120	121	98	122	113	98
Listed PIE Audits Inspected	918	855	872	948	969	961
Inspected Listed PIE Audits with at Least One Finding	366	363	376	449	-	-
Frequency of Inspections with at Least One Finding	40%	42%	43%	47%	-	-

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What Did the Survey Data Show? Quality Control

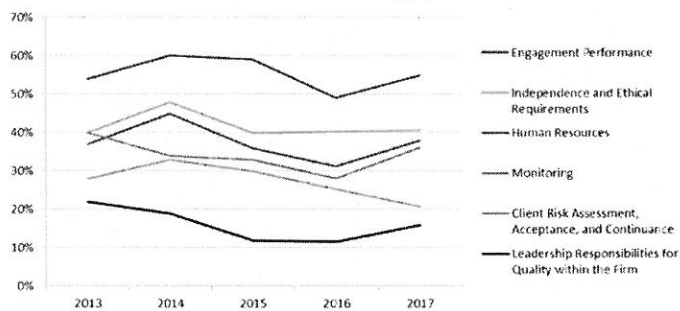
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Quality Control

Percentage of Inspected Audit Firms with Quality Control Finding(s)



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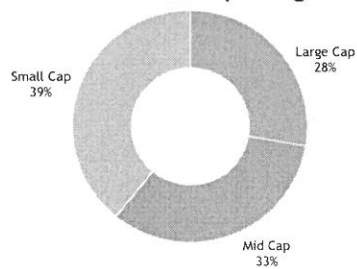
Breakout session 3b – Specific Topics Related to the 2017 IFIAR Survey

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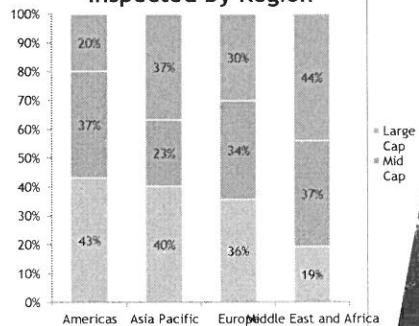
What Did the Survey Data Show? Listed PIE Audits

What was Inspected

Listed PIE Audits Inspected by All Members Reporting

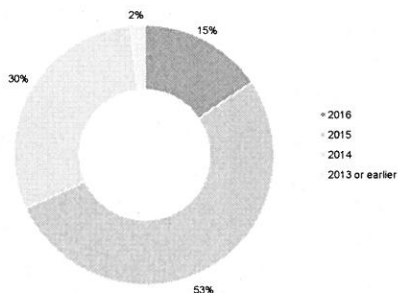


Size of Listed PIE Audits Inspected by Region

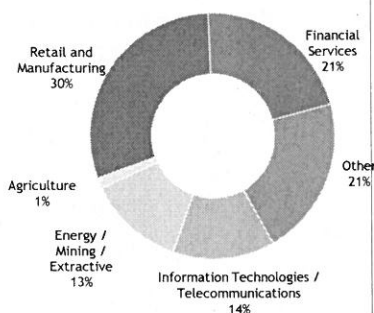


What was Inspected

FYE of Listed PIE Audits Inspected



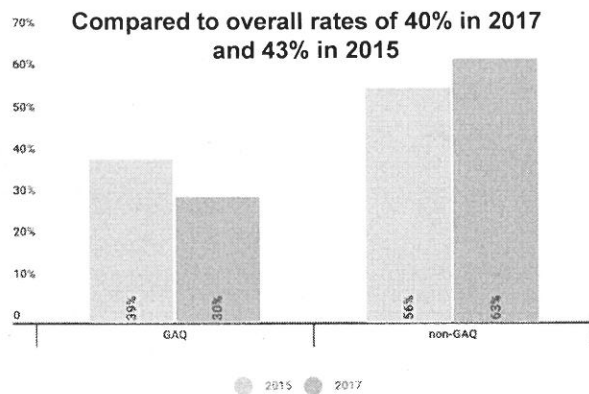
Listed PIE Audits Inspected by Industry



Survey Messages

- ▶ Deficiencies cited in a high but decreasing percentage of audit engagements.
- ▶ Of concern to IFIAR, the global audit firm networks' progress in reducing the rate of findings is not observed consistently across jurisdictions.

Inconsistency in Findings Rates: % of Listed PIE Audits Inspected with findings (GAQ WG vs. non-GAQ WG)

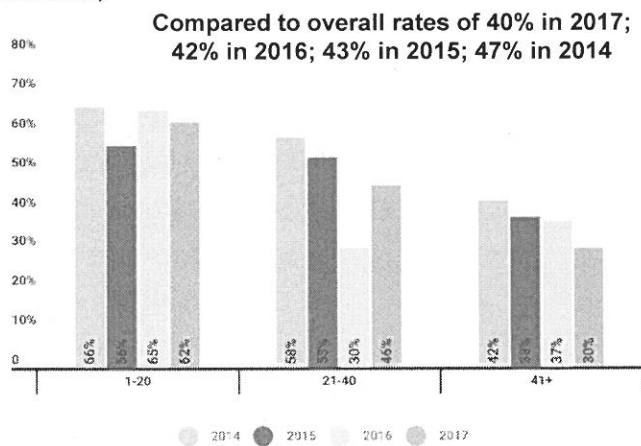


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Inconsistency in Findings Rates: % of Listed PIE Audits Inspected with findings (by inspection program size)



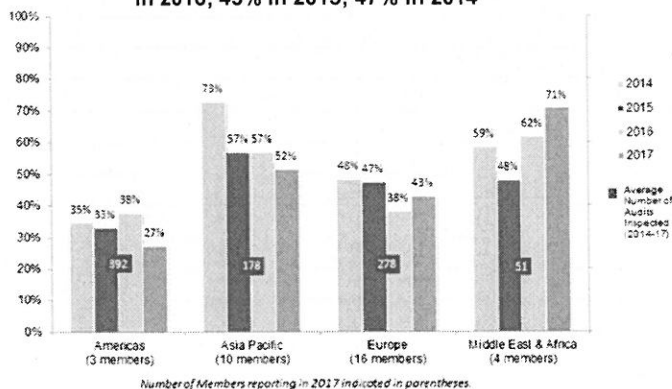
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Inconsistency in Findings Rates: % of Listed PIE Audits Inspected with findings (by region)

Compared to overall rates of 40% in 2017; 42% in 2016; 43% in 2015; 47% in 2014



Listed PIE Audit Inspections

Listed PIE Audits: Findings and Percentage of Audits with Findings

Inspection Theme	2017	2016	2015	2014
	%	%	%	%
Accounting Estimates, including Fair Value Measurement*	29%	32%	*	*
Fair Value Measurement*	*	*	18%	20%
Audit of Allowance for Loan Losses and Loan Impairments*	*	*	22%	13%
Internal Control Testing	17%	18%	23%	24%
Audit Sampling	13%	17%	**	**
Group Audits	15%	11%	14%	10%
Engagement Quality Control Review	11%	6%	8%	10%
Adequacy of Financial Statement Presentation and Disclosure	10%	9%	12%	12%
Substantive Analytical Procedures	10%	13%	11%	14%
Inventory Procedures	9%	12%	19%	16%
Revenue Recognition	7%	13%	15%	14%

Listed PIE Audit Inspections

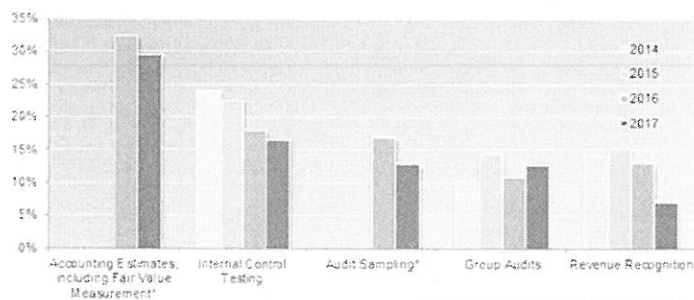
Listed PIE Audits: Findings and Percentage of Audits with Findings

Inspection Theme	2017	2016	2015	2014
	%	%	%	%
Fraud Procedures	7%	6%	7%	6%
Use of Experts and Specialists	7%	9%	9%	11%
Related Party Transactions	6%	6%	5%	8%
Adequacy of Review and Supervision	6%	5%	6%	10%
Risk Assessment	4%	6%	14%	7%
Going Concern	3%	4%	2%	6%
Audit Report	3%	3%	3%	**
Audit Committee Communications	2%	2%	2%	3%

* During 2012-2015, IFIAR collected data separately for findings related to "Audit of Allowance for Loan Losses and Loan Impairments" and "Fair Value Measurement". Data collected and reported in previous survey reports for these two themes is:

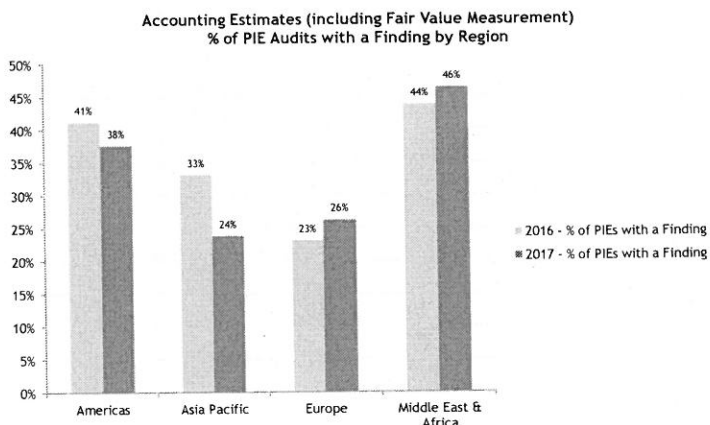
** Data for this theme was not collected during the survey year.

Listed PIE Audit Inspections



* Data for theme was not collected in 2014 or 2015

Listed PIE Audit Inspections

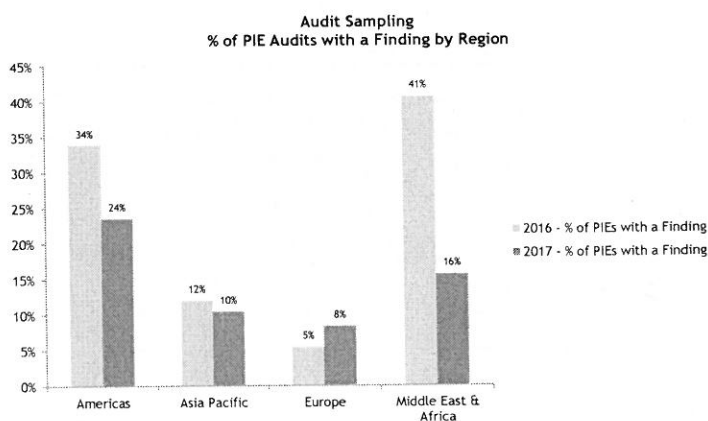


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Listed PIE Audit Inspections

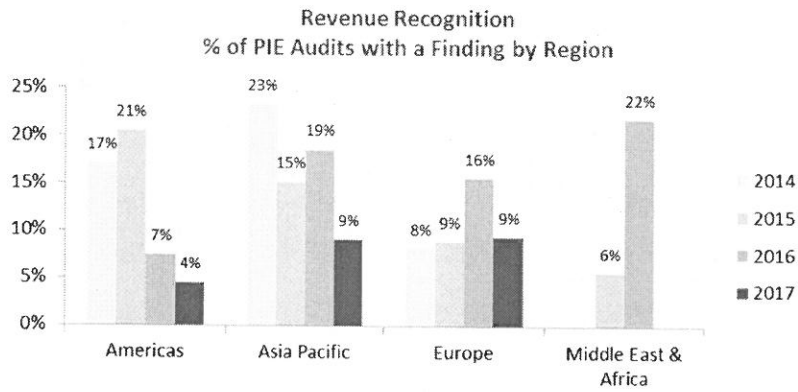


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Listed PIE Audit Inspections

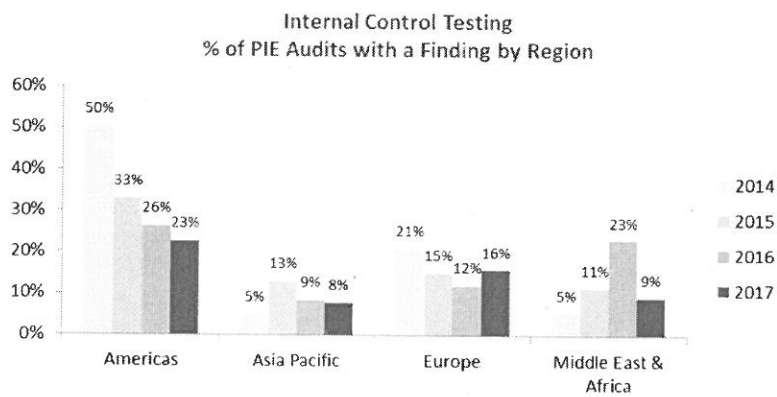


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Listed PIE Audit Inspections

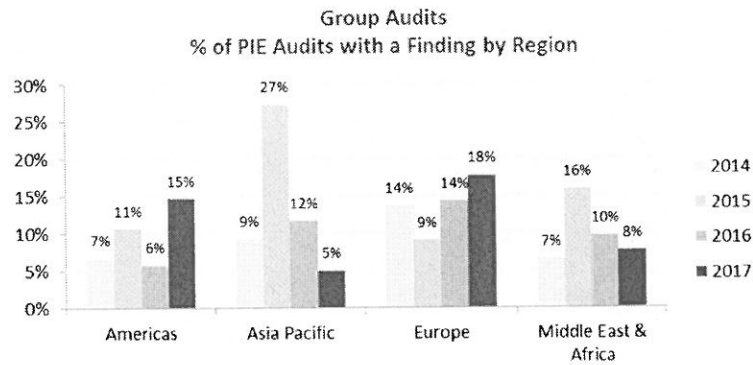


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Listed PIE Audit Inspections



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Open Discussion

- ▶ Other than the audit areas discussed so far, in your jurisdiction, what audit areas have notable numbers, frequency, or severity of findings?
- ▶ GAQ WG asks firms to compare survey results to internal inspection results. In your experience, how consistent are the firms' internal inspection findings to your findings?
- ▶ How does the Survey assist you in conducting audit oversight locally? (Do you refer to the Survey results in your interactions with the firms or other stakeholders?)
- ▶ How could the Survey be improved to provide information more useful to your local inspection program?

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The graphic features three square cards hanging from thin white strings. The first card is dark with a white letter 'Q'. The second card is light with a dark ampersand '&'. The third card is dark with a white letter 'A'. The cards are arranged horizontally and slightly overlap.

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A partial view of a building at night, showing a window with a light on and some foliage in the foreground. The building is reflected in a body of water below.



Extended auditor reports

Elective session 9

Ed Cadby (UK)

Al Sze Yin (Singapore)

Muhd Hairth A. Bakar (Malaysia)

Niels Biemond (Switzerland)

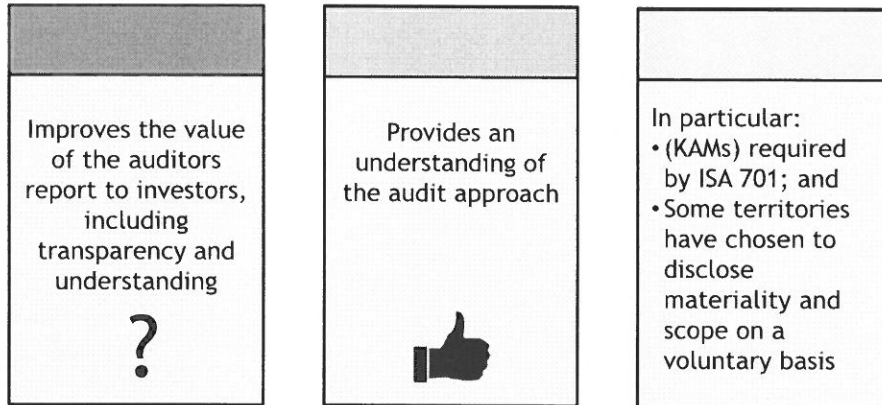
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Extended auditor reports Overview of session

- ▶ Background to extended auditor reports
- ▶ Singapore and Malaysia survey
- ▶ Switzerland experience
- ▶ UK experience

Background

Why have an extended audit report?



Background

ISA 701

- ▶ Auditing standards: ISA 701 (communicating key audit matters in the independent auditors report)
- ▶ Applicable to audits of the financial statements of listed entities for periods ending on or after December 2016:
 - ▶ Implemented by a number of countries by this date (including Australia, Dubai, Malaysia, New Zealand, Singapore, South Africa, Switzerland)
 - ▶ Most European (EU) countries implemented it for June 2017 year ends
 - ▶ The UK implemented similar requirements at an earlier stage
- ▶ Introduced the concept of Key Audit Matters (KAM)
- ▶ Observations today are based on the first year experience of ISA701 and the earlier introduction of extended auditor reports in the UK

Background ISA 701 - KAMs

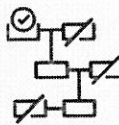
What is a KAM?

- An area of higher assessed risk of material misstatement (or significant risk)
- Significant audit judgements - areas involving management judgement subject to estimation uncertainty
- Significant events or transactions

?


The auditor is required to:

- Provide an understanding of the audit approach
- Determine the KAMs that were of most significance; and
- Include those KAMs in the audit report



What to report?

- Description of each KAM and why it is important
- How the matter was addressed in the audit
- EU legislation for PIE June 2017 y/e required the auditor to describe (where relevant) key observations



Enhanced Auditor's Report: Malaysia and Singapore Experience

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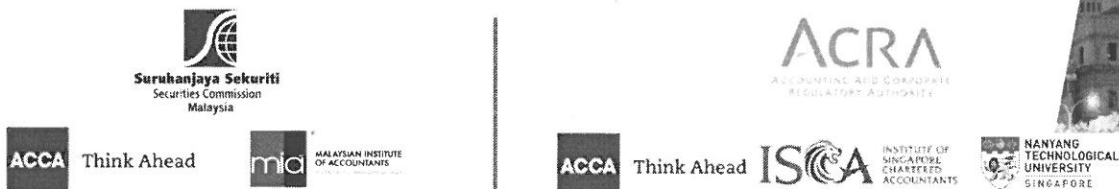
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About the Study

Objectives

- Identify EAR reporting trends and highlight good practices
- Gather views of other stakeholders (audit committee and investors) on what they value from EAR

Study Partners



Study Approaches

- Analyse KAMs reported for FY ended Dec 2016
- Conduct surveys and focus groups with ACs and investors



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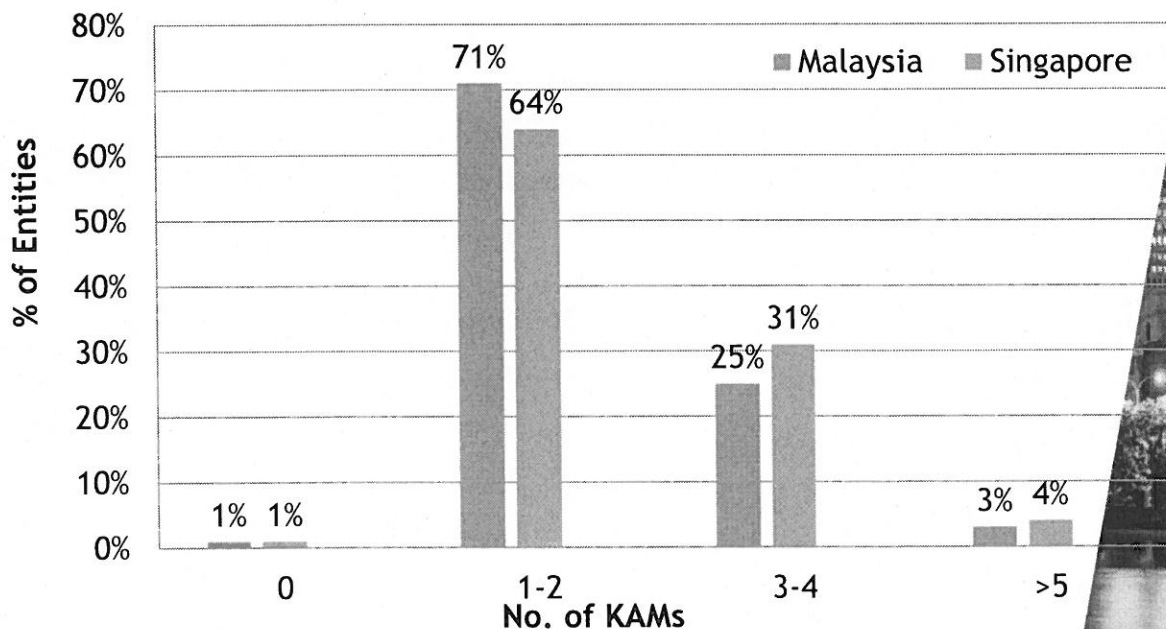
EARs Analysed

Selection basis:

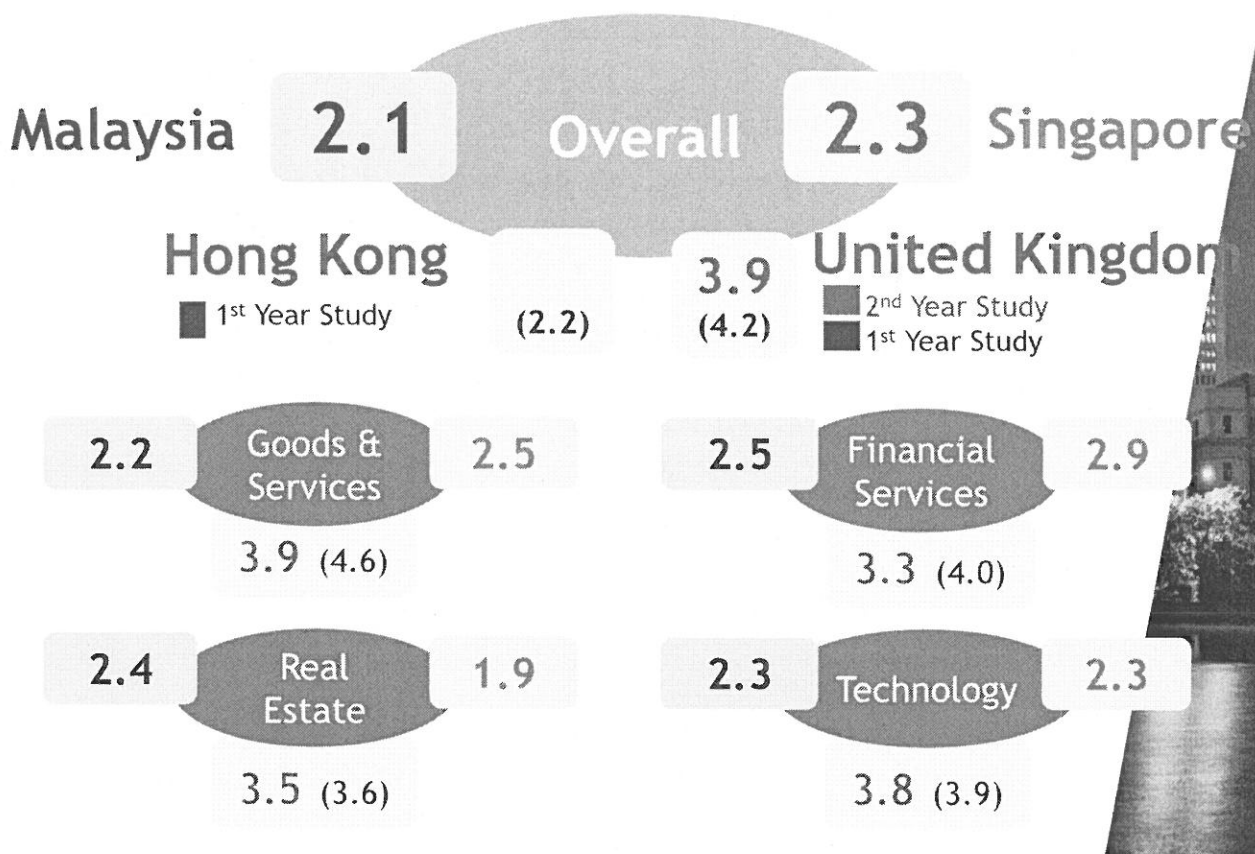
- Listed entities (including REITs) with 31 Dec 2016 year-end.
- Spread across industries, market cap size and auditors

	Malaysia			Singapore		
	Large (>RM1b)	Mid (RM500m - 1b)	Small (<RM500m)	Large (>\$1b)	Mid (\$300k - \$1b)	Small (<\$300k)
Big-4	35	15	39	27	20	70
Non-Big4	5	8	86	2	5	45
Foreign auditors	-	-	2	3	1	7
Sub Total	40	23	127	32	26	122
Total	190 (40% of 477 listed entities with Dec year-ends)			180 (41% of 443 listed entities with Dec year-ends)		

No. of KAMs Reported



Average Number of KAMs



Top 5 KAMs

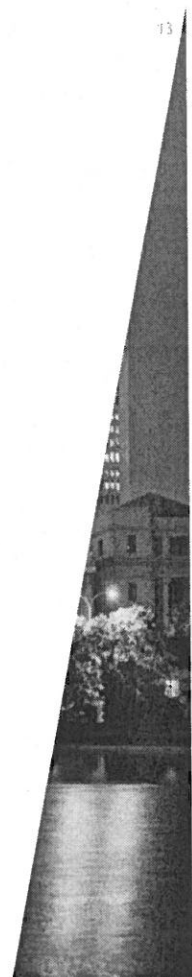
Malaysia

	KAM
1	Revenue recognition (not fraud presumption)
2	Impairment of receivables
3	Impairment of goodwill and intangible assets
4	Valuation of inventories
5	Impairment of investments

Singapore

	KAM
1	Impairment of receivables
2	Valuation of inventories
3	Revenue recognition (not fraud presumption)
4	Impairment of goodwill and intangible assets
5	Valuation of properties under fair value

Communicative Values of EAR



Findings from Retail Investors Survey

Malaysia

Singapore

69%

EAR helped me identify financial reporting risks¹

66%

80%

EAR helped me identify issues to raise with management

89%

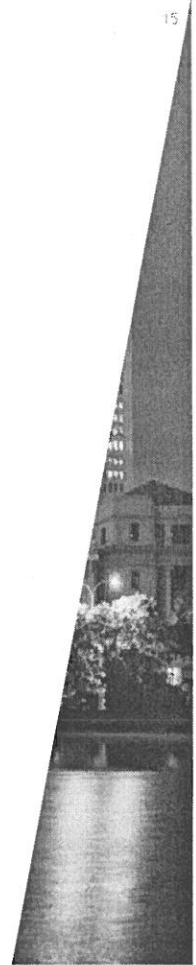
69%

EAR helped me better understand the audit process¹

58%

¹ From moderate to significant extent

Enhancing Corporate Disclosures Following EAR Implementation



Audit Committees' Reporting

Malaysia

Audit Committees are obliged to report on:

- a) **significant matters** including financial reporting issues, significant judgments made by management, significant and unusual events or transactions, and
- b) how these matters are addressed.

Singapore

53%

ACs reported additional work performed / more details on issues

33%
reported
AC views

47%

ACs reported similar to what auditors reported

An example of AC Reporting

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i. Allowance for impaired financing and advances and others

ii. Collective Impairment Allowances

The Group's provision for impairment is more than adequate, supported by intensified vigilance on the financing assets, including early warning signals and triggers.

The Group's collective impairment provision was at 1.4% against BNM requirement of 1.2%. The Group also has sufficient financing loss buffers with financing loss reserves at 175.4% against industry average of 90.2% as at end December 2016, reflecting its prudent provisioning practices. In addition, the Group's impaired financing ratio as at end of 2016 held firm at 0.98% against the banking industry's gross impaired ratio of 1.61%.

BHB Group has in place a process to appropriately group lending exposures based on similar risk characteristics. The basis of grouping lending exposures into portfolios with similar credit risk characteristics include asset type, industry, geographical location, collateral type, past-due status and other relevant factors. A multi-dimensional vintage analysis is done on each of the asset portfolios and the historical loss experience is adjusted based on current observable data to reflect the effects of current conditions. Also removed are the effects of conditions in the historical period that do not currently exist. Impairment allowances are provided based on the revised loss experience.

Also, the Credit Management team identifies portfolios that are susceptible to emerging events in the external environment and focuses in effort to manage the risk. The Credit Management team continuously monitored the Group's exposure to the Oil & Gas, Plantation, Property (Bridging Financing) and Manufacturing sectors; and the impact of depreciating Ringgit on the Bank's portfolio since September 2015. The Group's exposure to the oil and gas sector constituted 9% of the Group's financing portfolio as at end December 2016. Exposures to the volatilities of the USD/ RM exchange rate were not significant.

The AEC is regularly updated on the status of the financing portfolios, adequacy of impairment allowances as well as emerging events in the external environment, the potential risks and their impact and also the measures taken to manage the risks. This ensures impairment allowance estimates incorporate timely recognition of potential risk. The AEC also requests and receives information on specific industries based on emerging events in the external environment.

The Group also performs regular stress testing on the financing portfolios to assess the impact on the capital and profitability under the various stress scenarios.

Similar description as KAM reported

Additional consideration by Audit Committee

Additional work by Audit Committee

Findings from Audit Committees' Survey

18

These statistics are subject to change

Malaysia

68%

EAR resulted in increased involvement of audit partners

78%

EAR helped me better understand the audit process¹

(0.2) days

(From KAM analysis) Audit sign-off date was (earlier) / extended by

Singapore

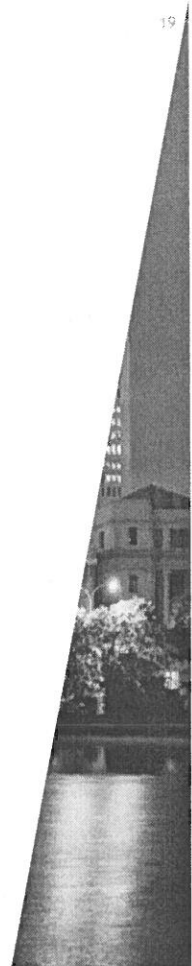
65%

63%

1.2 days

¹ From moderate to significant extent

Possible Enhancements



Auditors - To provide deeper insights into KAMs

1 To tailor description of KAMs

Malaysia



Investors felt that KAMs were not sufficiently tailored
50%

43% of top 3 KAMs reported *generic descriptions* (did not provide deep insights)

Singapore



Investors felt that KAMs were not sufficiently tailored
62%

43% of top 3 KAMs reported *generic descriptions* (did not provide deep insights)

Auditors - To provide deeper insights into KAMs

2 To disclose 'bolder' outcomes



76% Investors **70%** Audit Committees

wanted 'bolder' outcomes from conducting audit procedures in KAMs

11% of KAMs had outcomes generically disclosed (e.g. "appropriate" / "reasonable")



82% Investors **62%** Audit Committees

wanted 'bolder' outcomes from conducting audit procedures in KAMs

50% of KAMs had outcomes generically disclosed (e.g. "appropriate" / "reasonable")

Audit Committees - To enhance AC commentary and engage more with management and auditors

1 To explain how Audit Committees (ACs) have addressed areas covered by KAMs



1%

of AC commentary found to be similar to KAM descriptions

- Matters that could be included:
- Management of risks
 - Internal control lapses
 - Implementing internal control and risk
 - Assessment of accounting policy



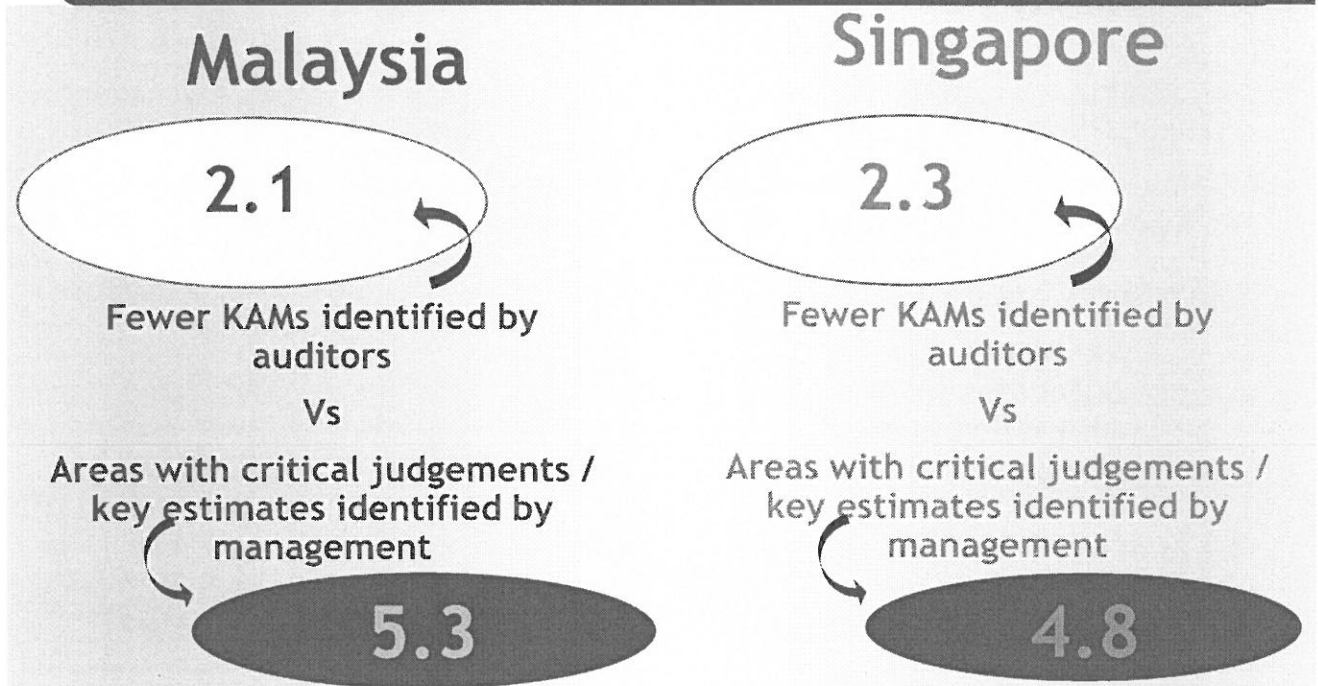
47%

of AC commentary found to be similar to KAM descriptions

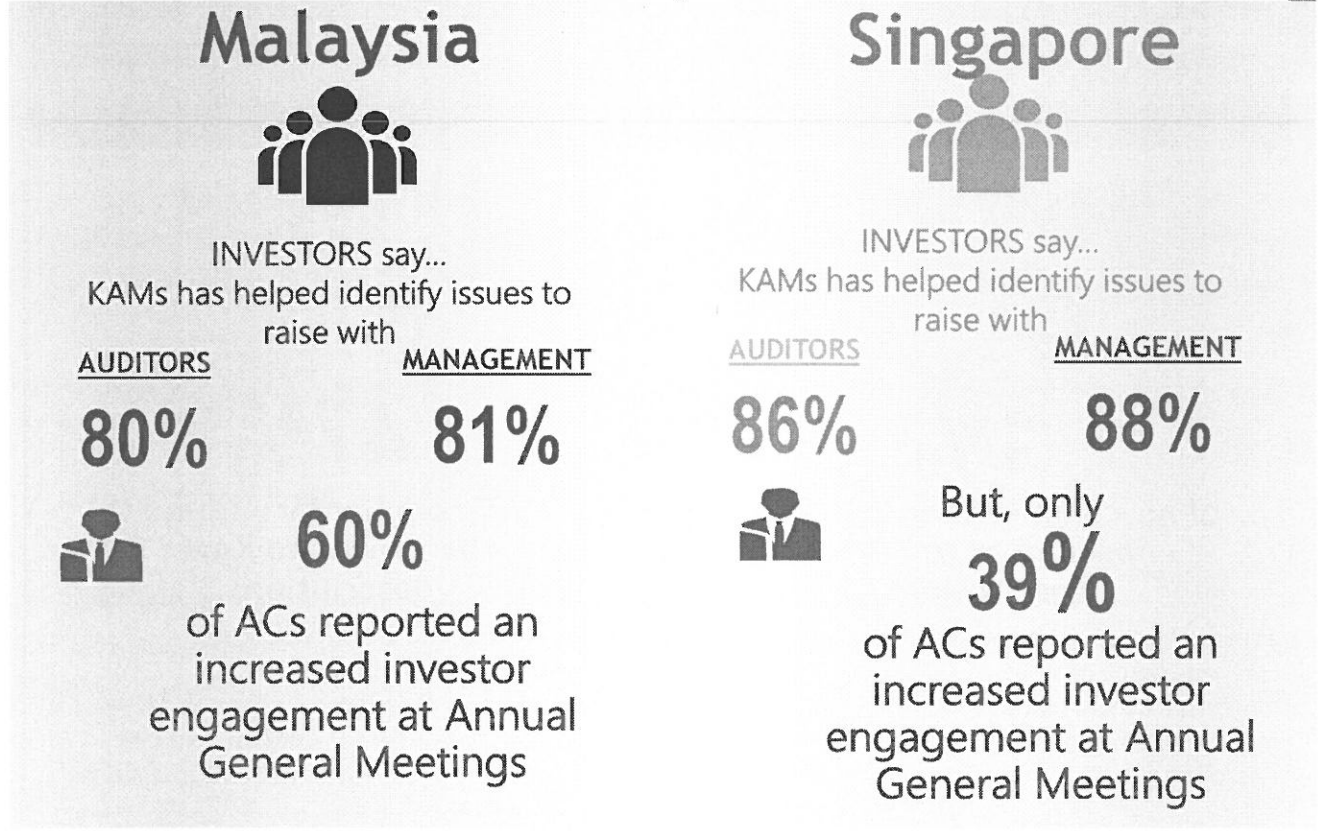
- Matters that could be included:
- Management of risks
 - Internal control lapses
 - Implementing internal control and risk management system for new acquisitions

Audit Committees - To enhance AC commentary and engage more with management and auditors

2 To ensure areas of critical judgements / estimates not covered by KAMs are



Investors - To engage more with auditors when KAMs are not drafted clearly



Encouraging first year results

Investors

- EAR helped investors identify financial reporting issues
 - If KAMs are unclear, seek clarification from auditors and management

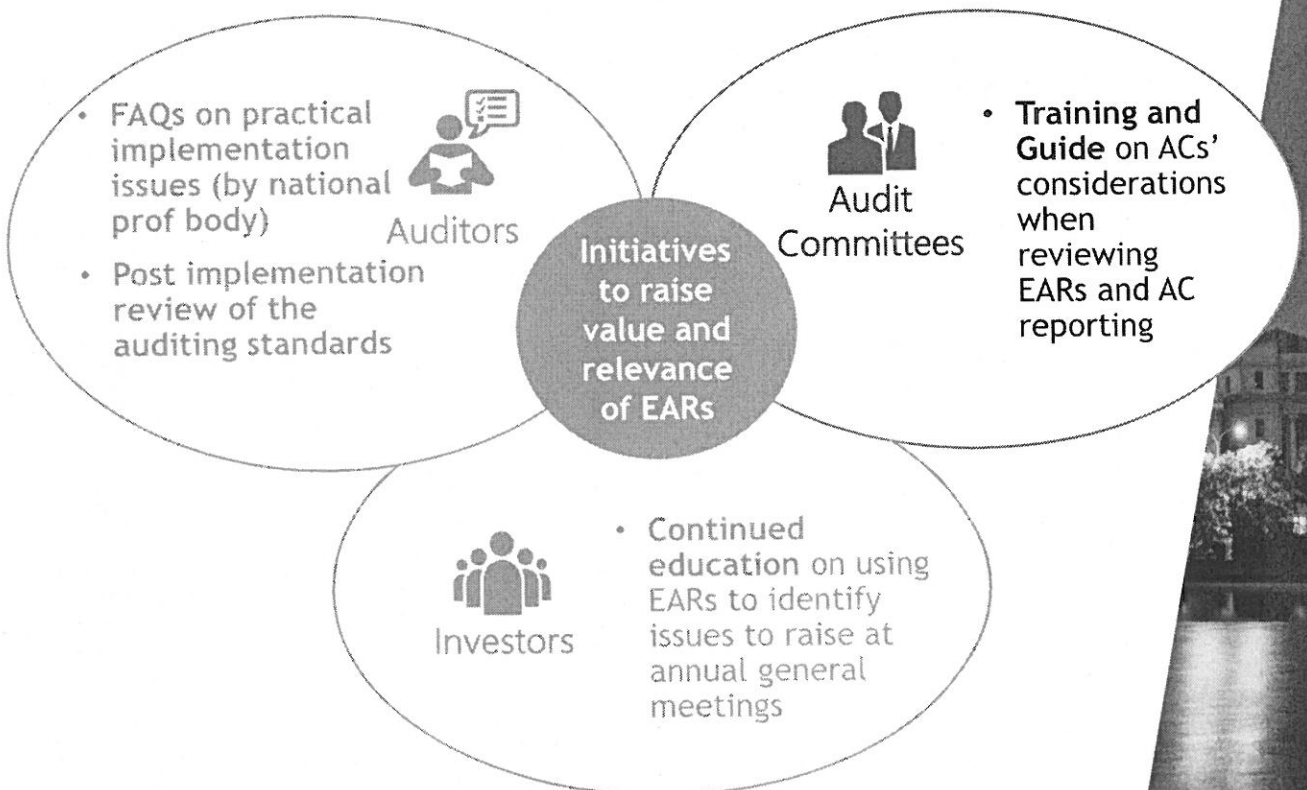
Management

- Enhanced KAM-related disclosures in FS
 - Be aware of the risk of failing behind good governance practices

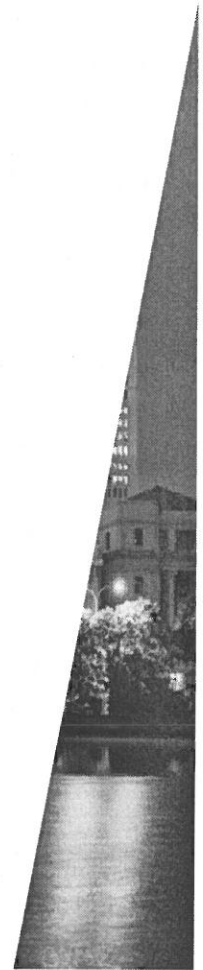
Audit committee

- Affirmed auditors' efforts in EAR
 - Seize opportunity to educate other directors and drive improved financial reporting
 - Play a mediating role between the auditors and management to ensure that the KAMs provided are truly valuable to the investor

Next Steps



Switzerland



FAOA Approach

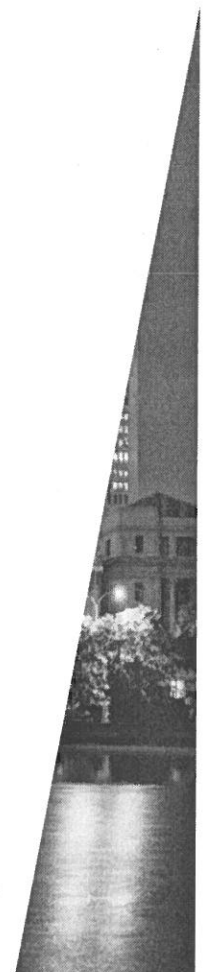
Thematic Review

► Purpose

- Evaluation and comparison of quality of audit reports
- Identification of best practices
- Risk based file selection

► Scope

- Companies listed at SIX Swiss Exchange*
- Audited by Big 5 audit firms



FAOA Approach

File Review

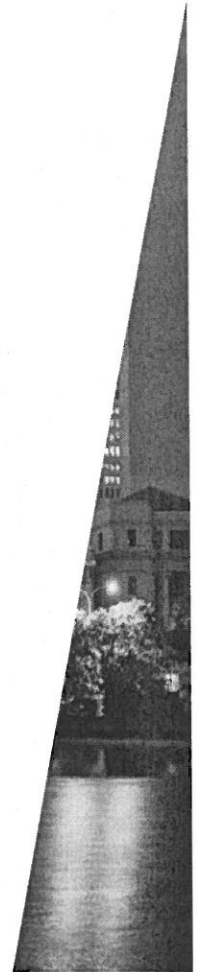
► General

- KAM = Focus area 2017 file reviews
- Additional files selected (“KAM files”)*

► Inspection procedures

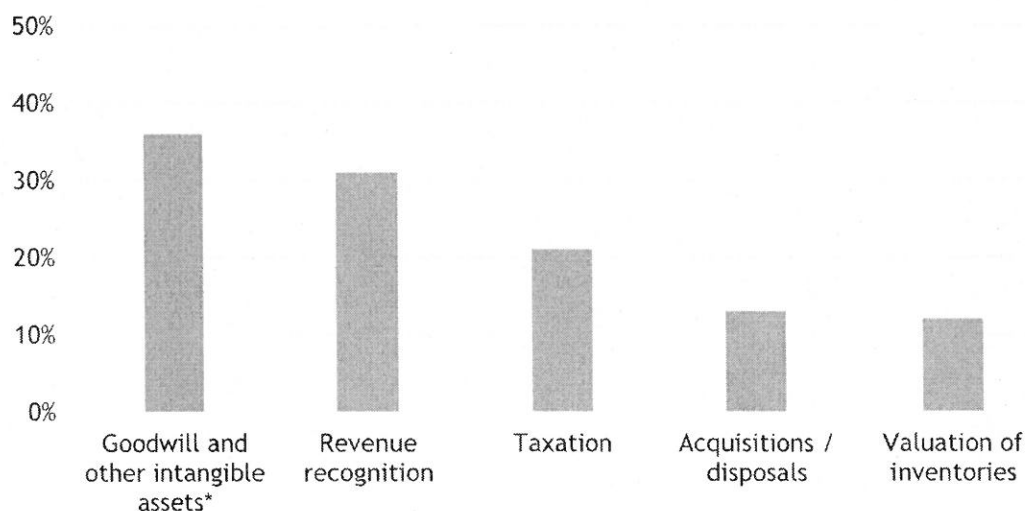
- Guidelines, policies etc. of the audit firm
- Communications with TCWG
- Determination and documentation of KAM
- Description of KAM in the auditor’s report
- Audit work performed related to KAM

* Selection based on thematic review

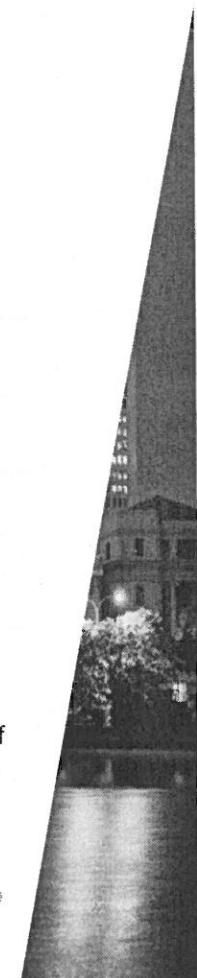


Results of thematic review

% of audit reports containing each risk type (SIX)

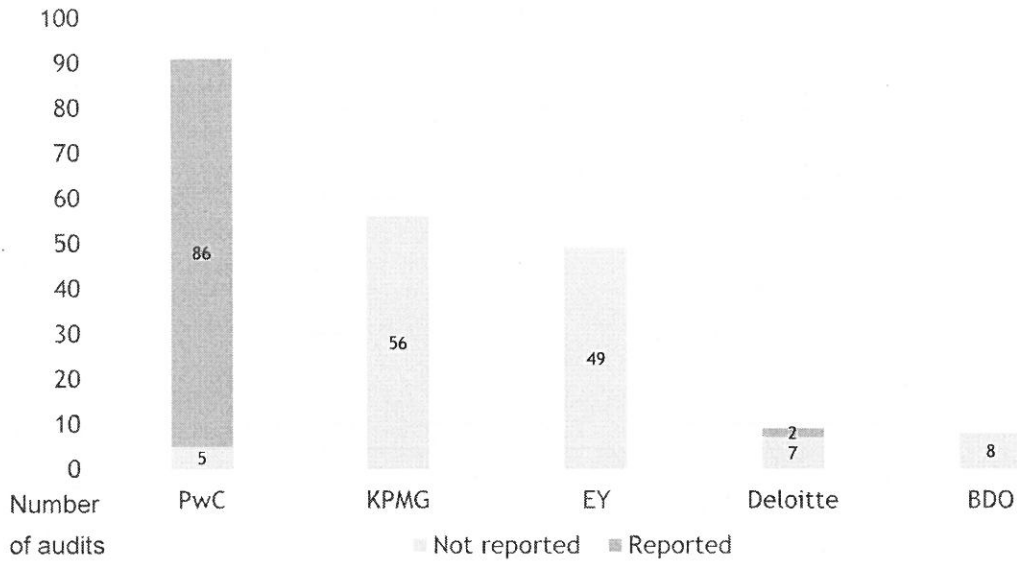


* Indefinite useful life



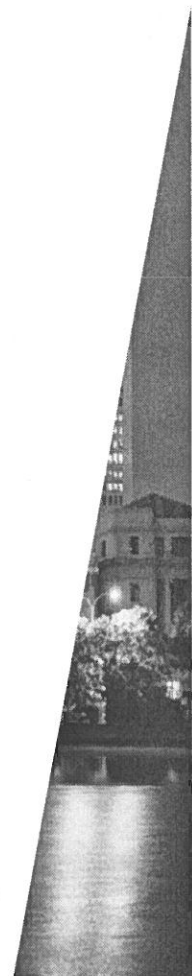
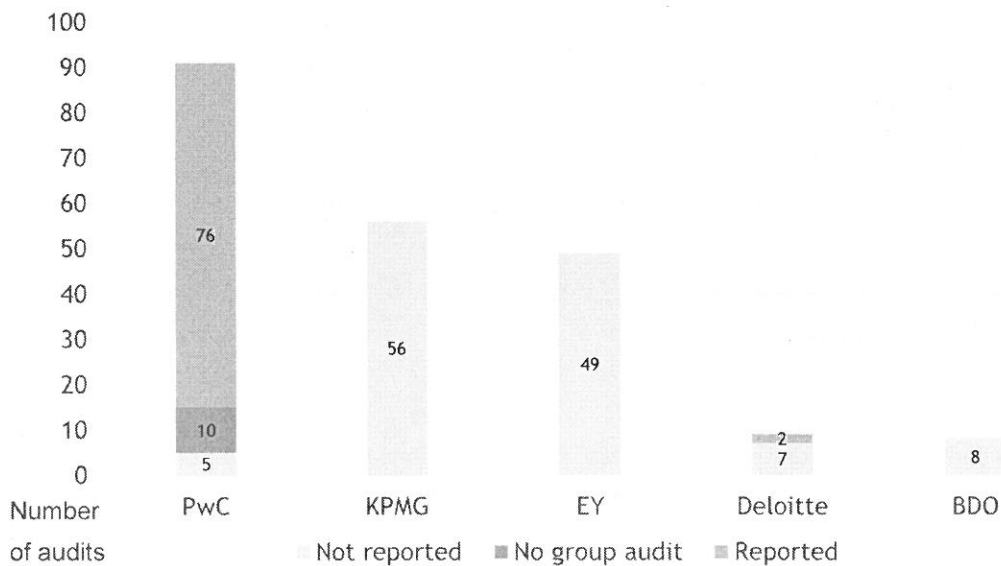
Results of thematic review

Voluntary disclosure of materiality (SIX)



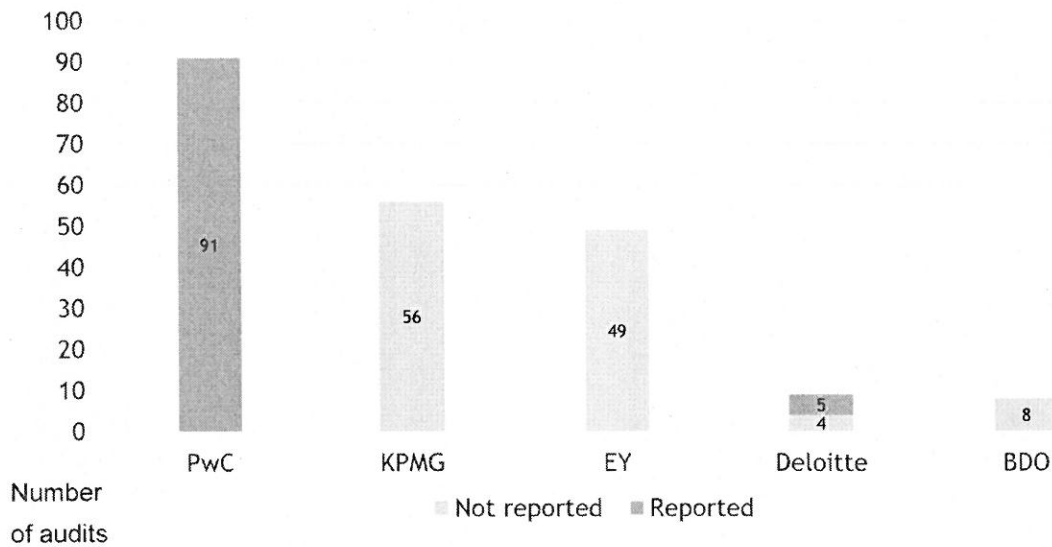
Results of thematic review

Voluntary disclosure of scoping (SIX)



Results of thematic review

Voluntary disclosure of observations / findings (SIX)



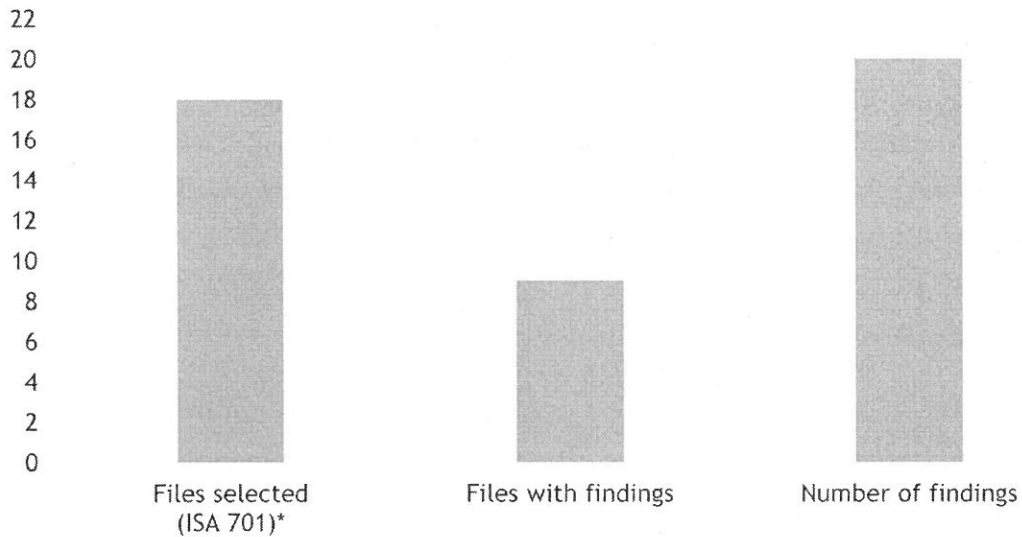
Results of File Reviews

Overall Assessment

- + Early communication of auditor with TCWG
- + Additional review of audit reports by technical departments
- + Additional training sessions
- + Additional work papers / templates developed
- Number of findings in the area of KAM

Results of File Reviews

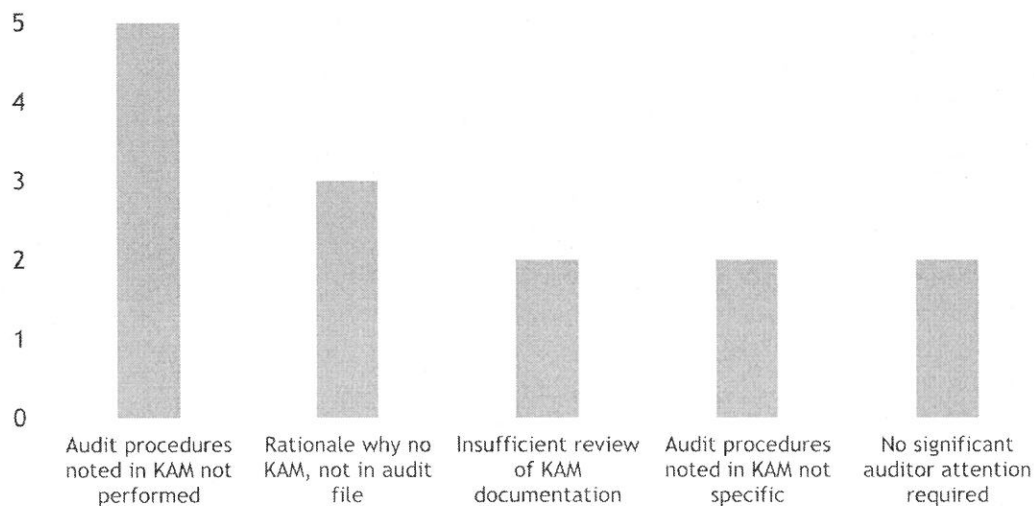
Summary of Findings



* File reviews

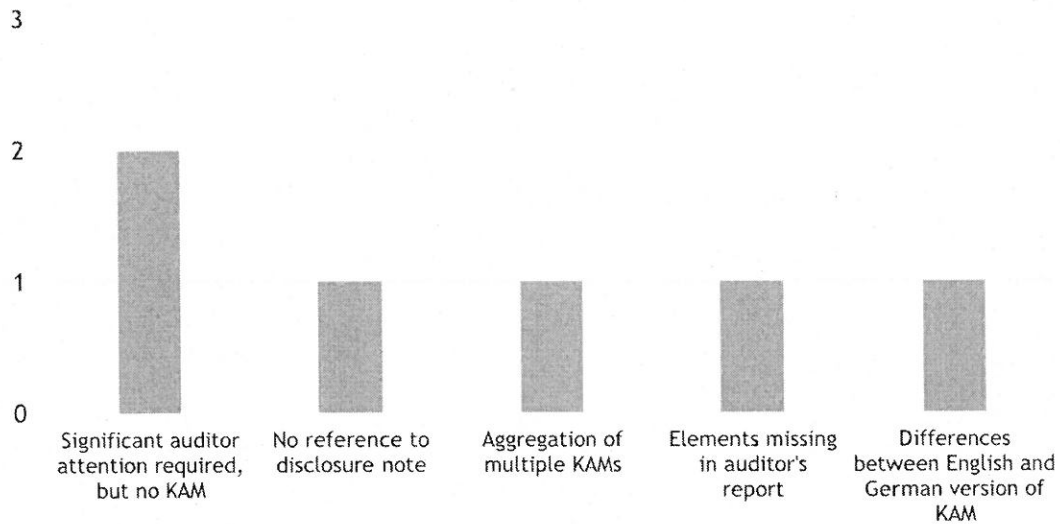
Results of File Reviews

Inspection Findings (1/2)



Results of File Reviews

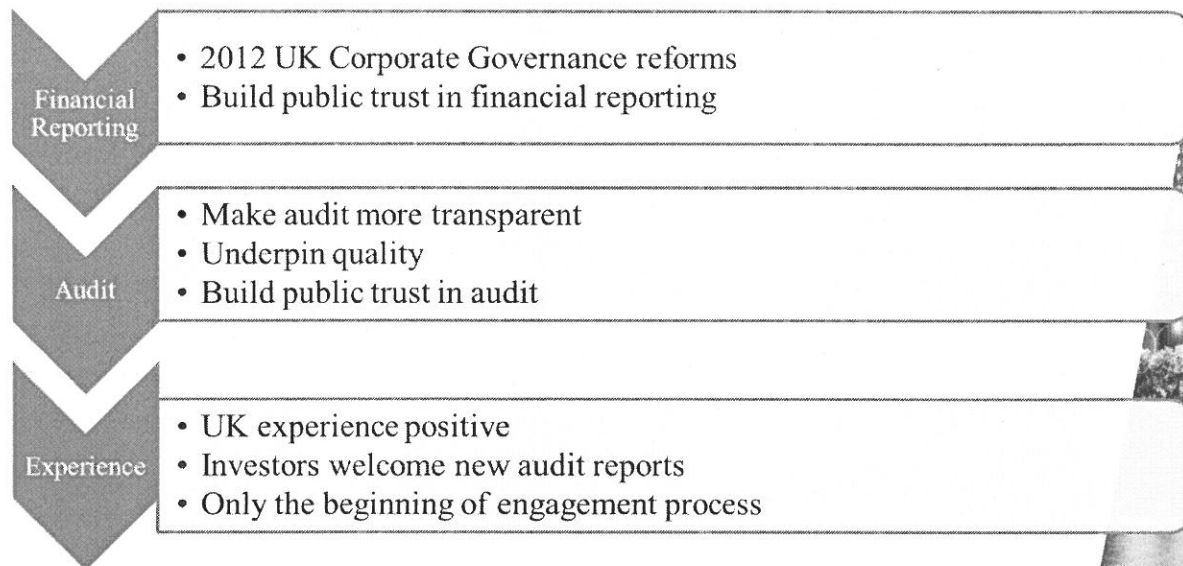
Inspection Findings (2/2)



UK

UK experience

Background



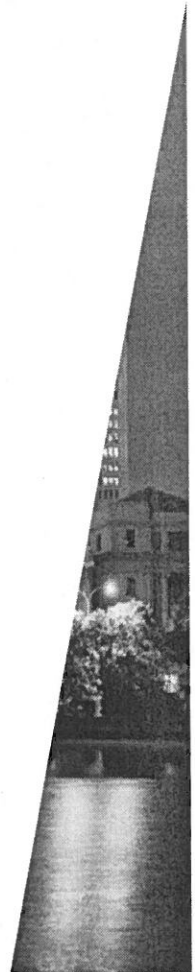
UK experience

Comparison with ISA 701 (prior to 2016)

- ▶ **Similar:** Auditors reports included KAMs
- ▶ **Different:** Reporting also required:
 - ▶ Materiality; and
 - ▶ Scope

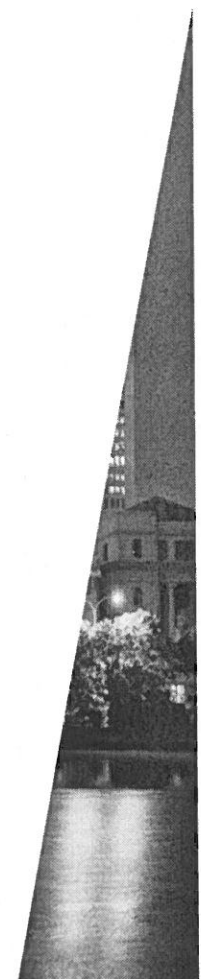
UK experience Highlights

- ▶ FRC reports on first three years of new auditor reporting in the UK
- ▶ Engaged with investors, auditors and others
- ▶ Auditors have innovated significantly
- ▶ Auditor reports now provide significantly more and better information
- ▶ Response from investors enthusiastic, including annual 'awards' for the best reports



UK experience Highlights

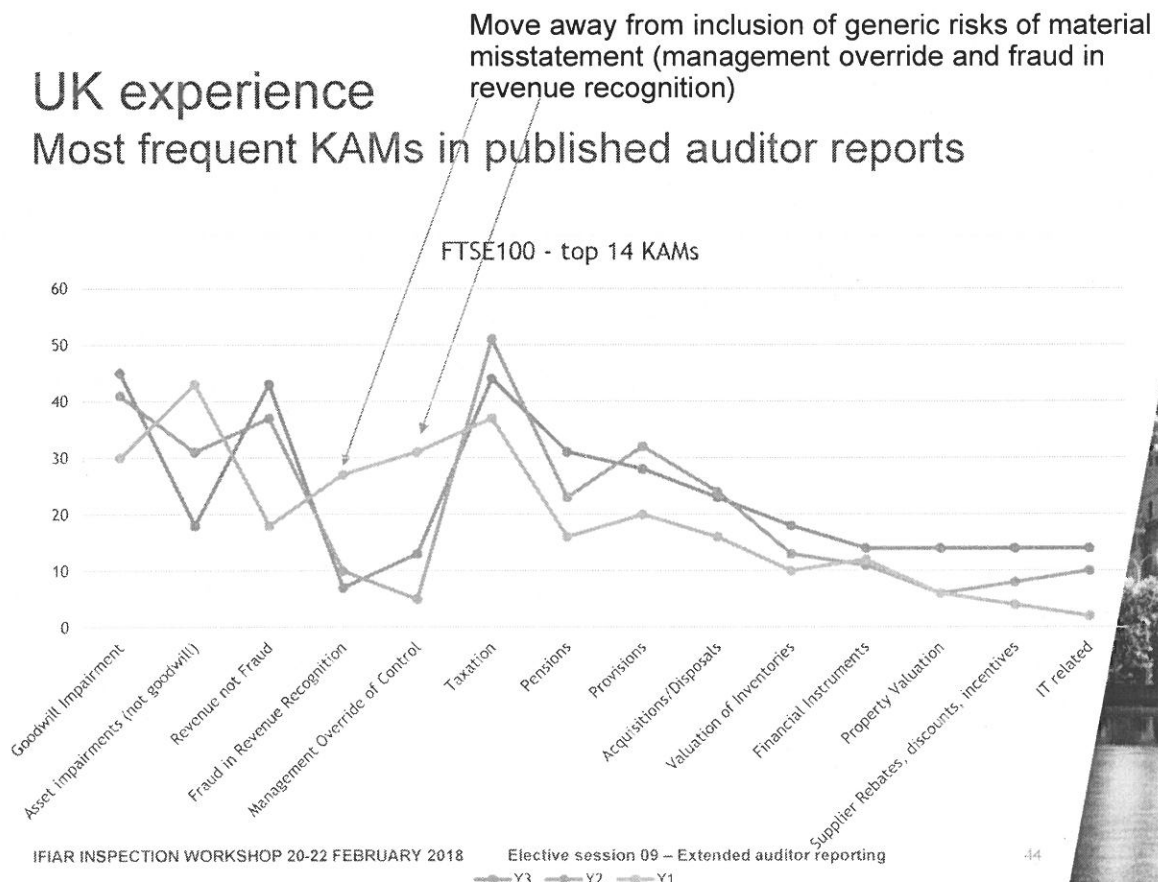
- ▶ Investors, firms and audited entities broadly in favour of extended auditor reporting
- ▶ Language continues to move away from generic to specific
- ▶ The 'best' reports are well structured and consider needs of user
- ▶ Some reports include 'findings'
- ▶ Investors want more granularity about ranges in management estimates and results of audit testing
- ▶ However little analysis of change in issues between first and second years



UK experience KAMs

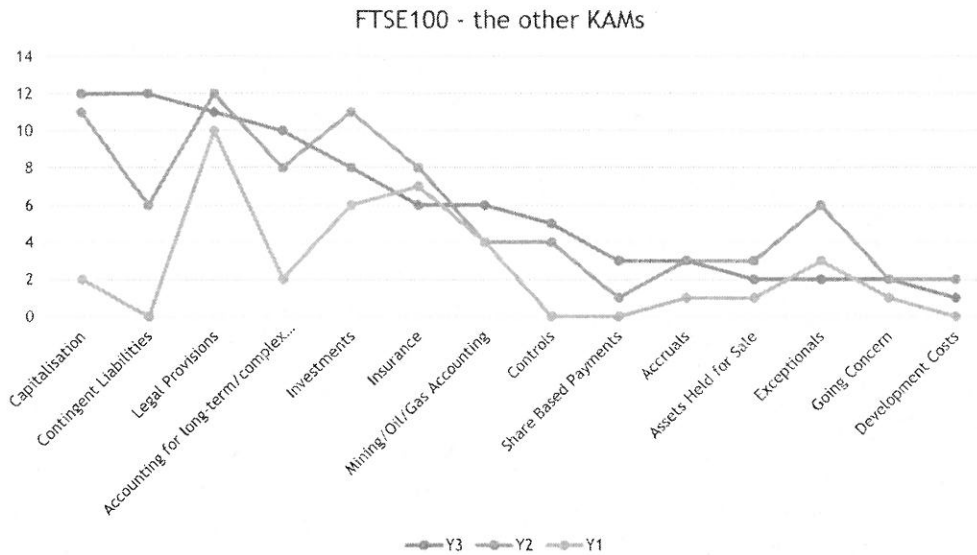
- ▶ Up to 2016, the FRC required auditors to:
 - ▶ Describe risks of material misstatement with greatest effect on the audit
 - ▶ Greatest effect on the audit strategy, allocation of resources and directing efforts of the team
 - ▶ Complement the description of significant issues by the Audit Committee/Those Charged With Governance
- ▶ In the second year of reporting there was a move away from inclusion of generic risks of material misstatement (management override and fraud in revenue recognition)

UK experience Most frequent KAMs in published auditor reports



UK experience

The other KAMs in published auditor reports



UK experience

KAMs

- ▶ Language used to describe risks has become less generic
- ▶ Challenge to be even more precise – avoid “significant downward adjustments”, “mildly cautious” etc
- ▶ Only 20% of auditor reports included findings (vs. 2% in year 1)

UK experience KAMs

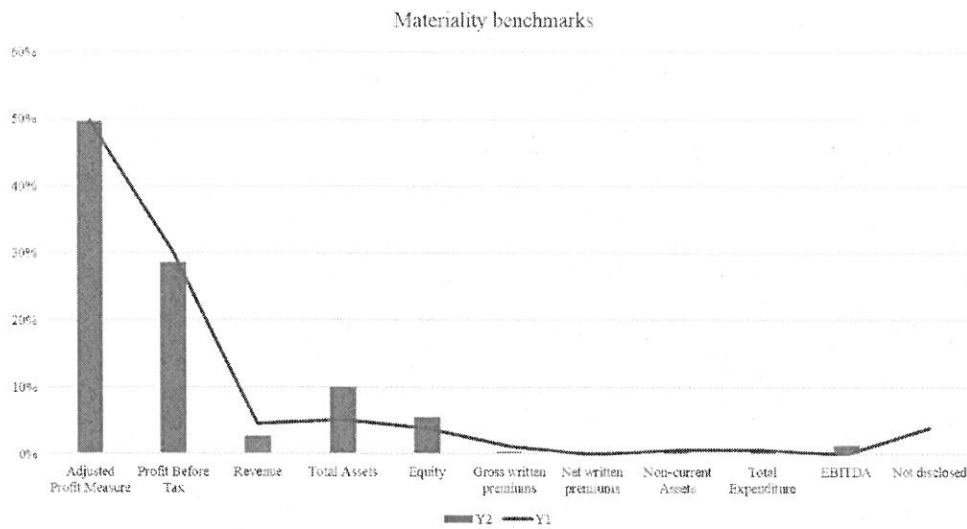
- ▶ Auditors generally did not explain changes year-on-year

Content of Reports	No. including the content	% of sampled reports
Audits with an overview of changes section	2	2%
Audits which explain changed materiality or benchmark	16	15%
Audits which provide commentary on changes to scope since prior year	2	2%
Audits which explain changes to areas of audit focus since prior year	24	22%

UK experience Materiality

- ▶ The FRC standards go beyond the requirements of the IAASB
- ▶ FRC requires auditors to:
 - ▶ Explain how they applied the concept of materiality in both planning and performing the audit
 - ▶ Disclose the materiality threshold for the audit of the financial statements as a whole
- ▶ Investors would like more explanation about the reasons for the benchmark chosen, and the % applied
- ▶ Investors are sceptical about a methodology which “nearly always ends up at 5% of profit”
- ▶ Only one firm discloses performance materiality

UK experience Materiality



UK experience Scope

- ▶ The FRC required:
 - ▶ Broad description of how the audit covered measures such as proportion of profit, total assets and revenue
 - ▶ How the significant issues and risks impacted what was done
 - ▶ The relationship between scope, risk and materiality to be explained
- ▶ Investors told us more could still be done:
 - ▶ more information on the differentiation between full scope and other procedures
 - ▶ commentary on quality control over international group audits

UK experience

Lessons learned

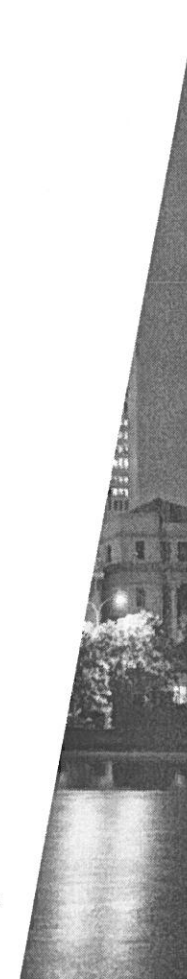
- ▶ Auditor's reports are becoming more interesting to read
- ▶ Reports are increasingly well structured, user friendly and fluent representations of the audit process
- ▶ No evidence that the reporting timetable has been disrupted
- ▶ No evidence of related increase in audit fees
- ▶ Audit reports can stimulate engagement but are the beginning of the process
- ▶ Transparency helps drive up audit quality which builds confidence
- ▶ Confidence can easily be lost if the quality of the work does not reflect the quality of the audit report



UK experience

Inspection approach – individual audits

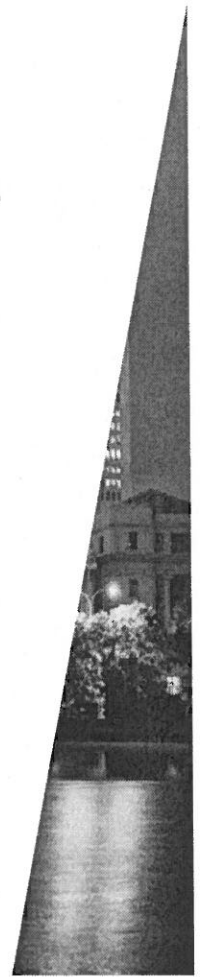
- ▶ The FRC has been reviewing the auditors report on every PIE audit inspected.
- ▶ Standard work program used which includes:
 - ▶ Ensuring the auditors report is in line with the firm's template and guidance
 - ▶ Comparing the KAMs to the prior year for changes
 - ▶ Reviewing consistency between KAMs and significant risks and other areas of audit focus
 - ▶ Review of consistency between responses to KAMs and the audit work set out in the audit files



UK experience

Inspection approach – firm wide procedures

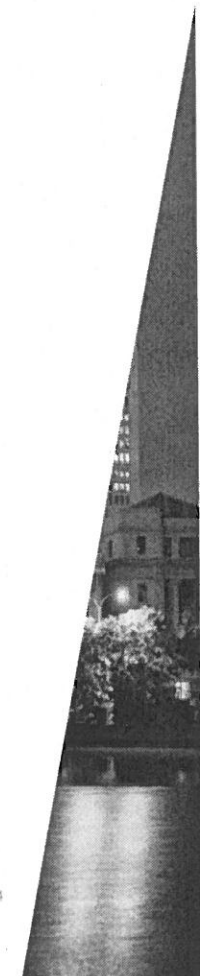
- ▶ UK implemented ISA701 in 2017 for PIEs
- ▶ Big six firm wide procedures reviewed
- ▶ The firms have focused on:
 - ▶ Guidance/ methodology updates
 - ▶ Training
 - ▶ Level of central support on an ongoing basis
 - ▶ Use of templates
 - ▶ Policies over central review of draft auditor reports prior to issue



UK experience

Most common inspection findings

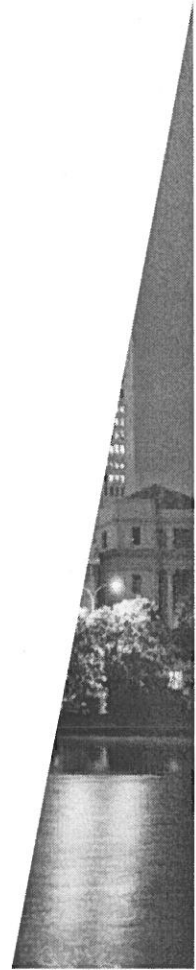
- ▶ Description of procedures to address the KAM not necessarily reflecting the actual work performed:
 - ▶ Difference between description of procedures in auditor reports and the audit files
 - ▶ More difficult for audit teams to evidence for group audits
- ▶ Sometime too few KAMs
- ▶ Sometimes too many KAMs



UK experience

Other thoughts

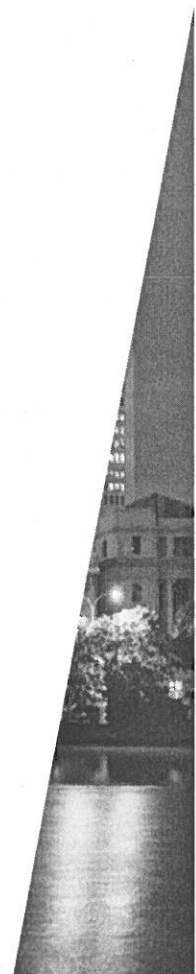
- ▶ One firm led innovation in the UK
- ▶ Other firms have sought to replicate this on the introduction of ISA701
- ▶ The insight, innovation and presentation of the extended auditor report may sometimes be seen as a promotional tool



Extended auditor reports

Key take away points

- ▶ ISA 701 applicable for 2016 December year ends
- ▶ Extended auditor reporting includes KAMs
- ▶ Some territories also volunteer to disclose materiality and scope
- ▶ Most frequent KAMs are similar in the different countries, including revenue recognition, impairment, taxation and pension accounting
- ▶ Recent study by New Zealand echoes the above observations
- ▶ Most frequent inspection findings:
 - ▶ Accuracy of description of audit responses to address the risk
 - ▶ Matters considered to be KAMs
 - ▶ Accuracy of materiality and scope
- ▶ Raising inspections findings in the first year where the requirements are in force to ensure firms take action
- ▶ Inspection experience may help focus future inspections, particularly for countries that haven't yet adopted ISA701.



Extended auditor reports

Useful links

- ▶ FRC Extended auditor's reports – a further review of experience (2016): <https://frc.org.uk/getattachment/76641d68-c739-45ac-a251-cabbfd2397e0/Report-on-the-Second-Year-Experience-of-Extended-Auditors-Reports-Jan-2016.pdf>
- ▶ FMA – Key audit matters – a stocktake of the first year in New Zealand (November 2017): <https://fma.govt.nz/assets/Reports/171129-XRB-FMA-Key-audit-matters-a-stock-take-of-the-first-year-in-NZ.pdf>

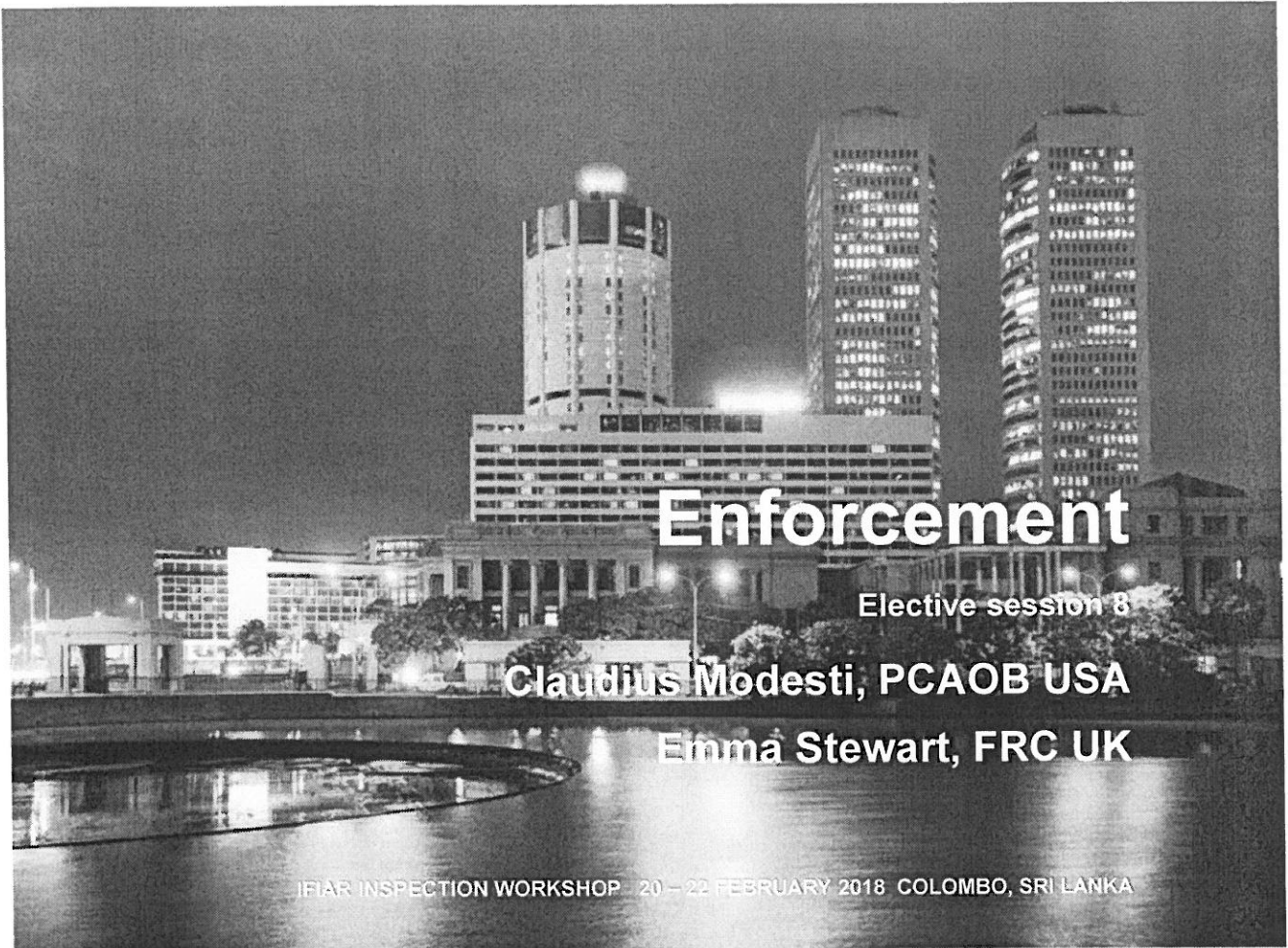


Extended auditor report

Questions and discussion

- ▶ What has been your own experience of ISA701 implementation?
- ▶ Have you found certain firms have taken a lead globally and within your territory?
- ▶ Have you been inspecting this at all firms/on all audit inspection reviews?
- ▶ Are the common KAMs familiar to you/are you seeing other KAMs not mentioned?





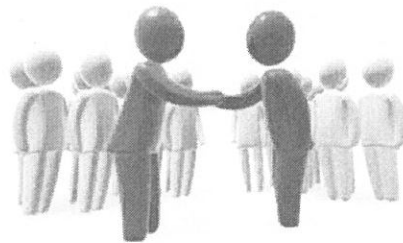
Overview of Session

- ▶ Referrals from inspections to enforcement
- ▶ Investigation techniques following referral
- ▶ Identifying improperly altered documents

Disclaimer

The views we express are our own and should not be attributed to the PCAOB or FRC, or their members or staffs.

Referrals from Inspections to Enforcement



Why Refer an Audit to Enforcement?

- ▶ Complementary functions in audit oversight regimes
- ▶ Reinforces the importance of inspections findings
- ▶ Ensures that, where appropriate, formal public sanctions are imposed on serious audit failings detected through routine inspections, to punish wrongdoing, promote public confidence, ensure remedial action, and deter future misconduct

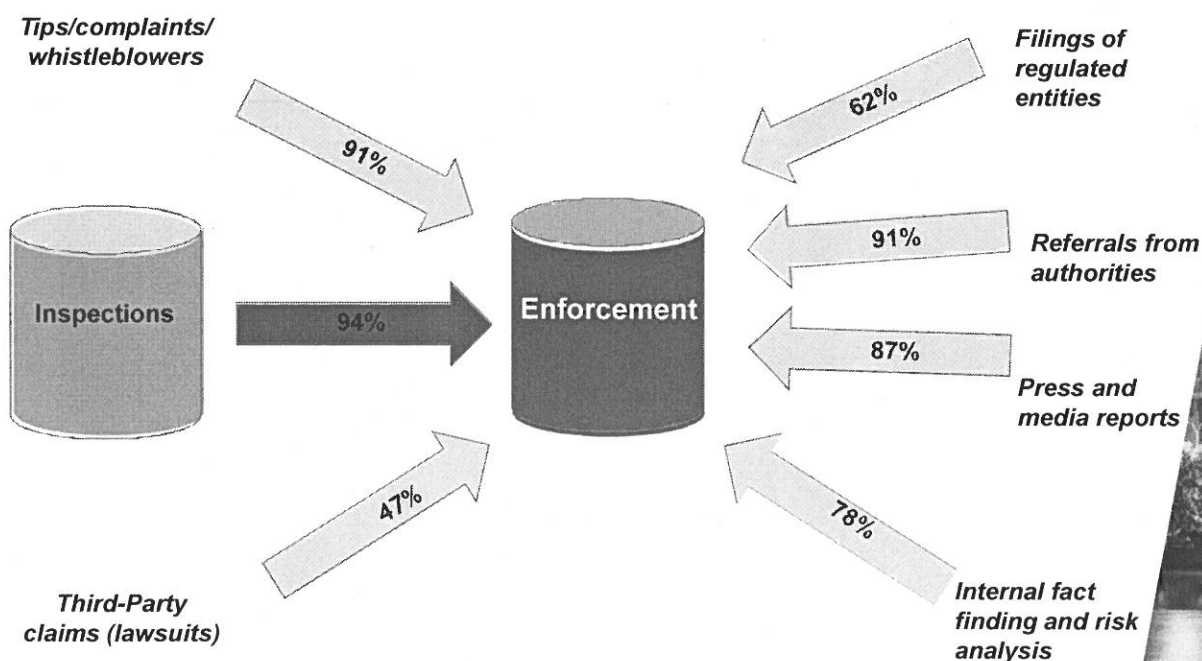
Key Difference Between Inspections and Enforcement

Enforcement	Inspections
Directed at addressing violations of audit laws, which may result in imposition of penalties, punishments, restrictions, or other disciplinary measures.	Aimed at identifying deficiencies in a firm's audits or quality controls and monitoring improvements in those audits and quality controls

What are the Criteria for an Enforcement Referral?

- ▶ Significance and impact of findings
- ▶ Failure to maintain independence from audit client
- ▶ Failure to co-operate in inspection process
- ▶ Withdrawal of audit report or restatement of financial statements
- ▶ Previous inspections findings (repetitive conduct)
- ▶ Failure to take appropriate action in relation to potential illegal acts
- ▶ Significant failure to maintain/comply with quality control system

Sources of Investigation

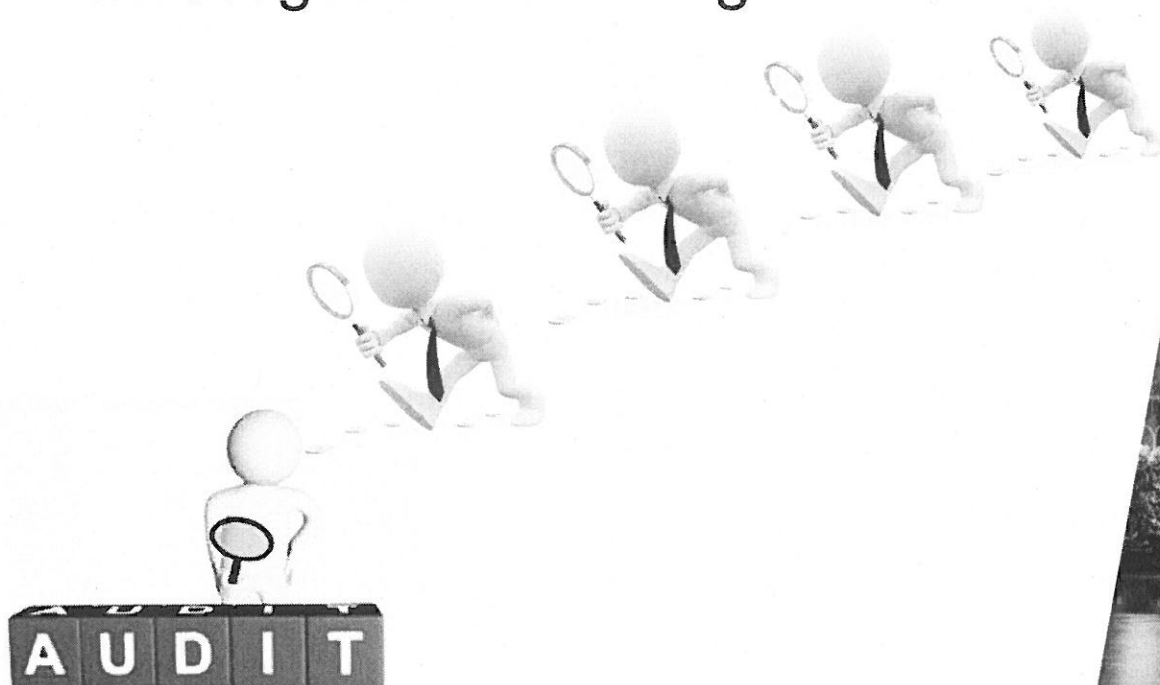


Criteria for Pursuing an Investigation

Criterion	Number of Respondents That Consider Criterion
Materiality	27 (84%)
Investor harm	25 (78%)
Nature of accounting and auditing issues involved	24 (75%)
Public interest considerations other than investor harm	23 (72%)
Resource constraints	11 (34%)
Other	8 (25%)

* Other: time passed since misconduct, reasonable grounds to assume misconduct, etc.

Next Steps Investigation Following Referral



To gather evidence

To assess whether legal test for enforcement sanction was met

Why are Investigations Necessary After Referrals?

To enter adjudication - leading to findings and sanction

To reach settlement or present evidence to decision maker

Investigation Following Referral

According to the 2014 EWG Survey—

- ▶ 91% have powers to compel the production of documents, answers to specified questions, and oral testimony
- ▶ 78% have the power to inspect physical premises
- ▶ Nearly all respondents indicated staff comprised legal counsel and former auditors as well as forensic accountants
- ▶ Forensic investigation; adjudication; sanctions

Improper Document Alteration

- ▶ Why are we discussing this?
- ▶ What is it?
- ▶ How can it be detected?
- ▶ What happens when alteration is detected?

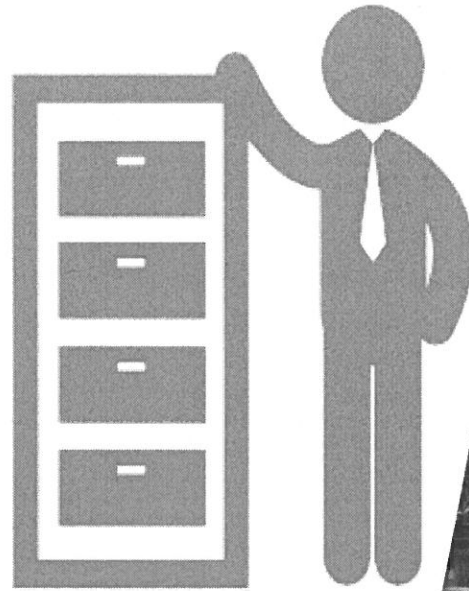


Objective

- ▶ Archived work papers are the best evidence of how the audit was originally conducted
- ▶ If improper alterations are made:
 - ▶ The goals of the inspection are thwarted
 - ▶ The integrity and ethics of the firm and its personnel are called into question
- ▶ Awareness of improper document alteration can help inspectors stay alert and be prepared to address it

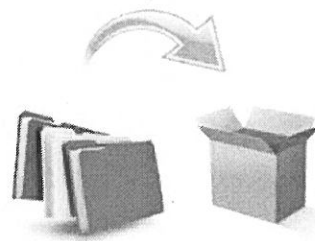
PCAOB and ISA Requirements

- ▶ The final audit file must be compiled shortly after the audit report is issued (PCAOB: 45 days; ISA/ISQC: “timely,” usually within 60 days)
- ▶ Once the final audit file is compiled, no deletions may be made
- ▶ Subsequent additions to the audit file must be documented
- ▶ See: AS 1215 (PCAOB), ISA 230/ISQC 1



Archiving Practices

- ▶ Most firms have systems to archive work papers at the end of the audit engagement for future use or inspection
- ▶ Large firm systems sometimes maintain a snapshot of the audit file as it existed when first archived



Examples of Modifying, Creating, Adding or Deleting Work Papers

- ▶ Changing the evidence obtained or conclusions reached during the audit
- ▶ Adding procedures performed during the audit but not documented at the time
- ▶ Portraying procedures performed after the audit as having occurred during the audit
- ▶ Describing procedures that were never performed
- ▶ Adding documents that were not obtained during the audit (confirmations, representation letters, etc.)

Types of Alteration Evidence

- ▶ Circumstantial: Auditor's behaviour or nature of work papers suggest the audit file was altered improperly
- ▶ Direct: Specific evidence from documents or people that the audit file has been improperly altered
- ▶ Circumstantial evidence may prompt search for direct evidence

Examples of Circumstantial Evidence Auditor Behaviour

- ▶ Long delays in providing documents or answering questions
- ▶ Evasive, complicated, inconsistent or hostile answers to questions from inspectors, especially about documents and archiving
- ▶ Reluctance to make certain engagement team members available to inspectors
- ▶ Reluctance to allow inspectors to visit certain office areas or locations

Examples of Circumstantial Evidence Documents

- ▶ Documents in hard-copy form, especially if critical to the audit or most documents are electronic
- ▶ Work papers not listed in the work paper index
- ▶ Documents that were not in the original audit file
- ▶ Documents that are inconsistent or contradict other work papers
- ▶ Work papers for significant or high-risk areas prepared after the audit report was issued

Real World Example

Inconsistent work papers

Management Representation Letter

Total misstatements:	\$30.0 million
Net income:	\$190 million
Misstatement %	15.8%

Work Paper

Total misstatements:	\$18.8 million
Net income:	\$190 million
Misstatement %	9.9%

Real World Example

Internally Inconsistent Document

IT Testing Work Paper

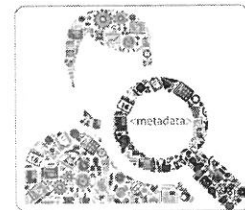
Test	Result	Conclusion
Password security	10 tests, 8 exceptions found	Control is operating effectively
Access security	5 tests, 4 exceptions found	Control is operating effectively
Super-user security	7 tests, 5 exceptions found	Control is operating effectively

Direct Evidence

Metadata and Audit Software Systems

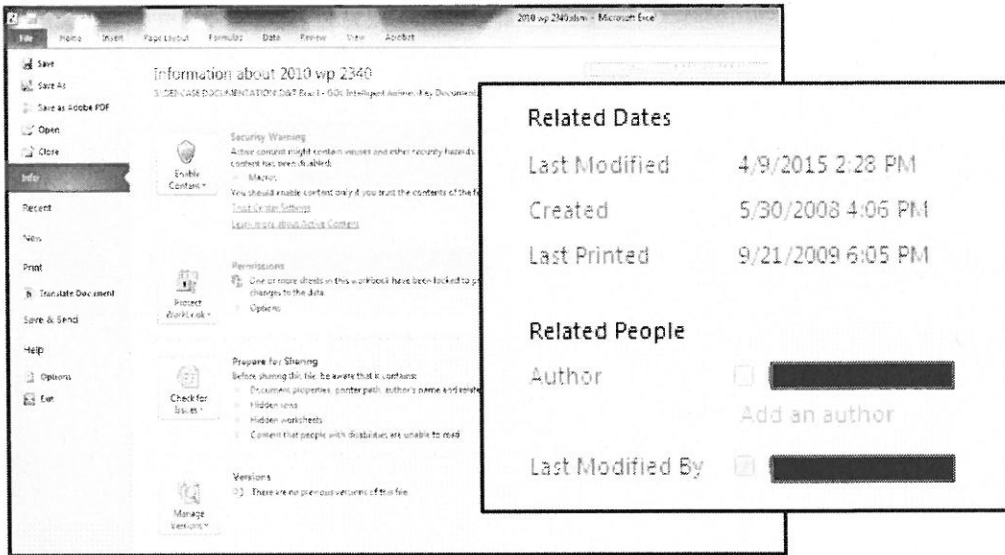
- ▶ Document metadata is information about electronic documents such as date and time the document was created and last modified
- ▶ Audit software systems, especially those used by large firms, may contain separate information concerning sign-off dates of work paper preparation and review

Metadata Types

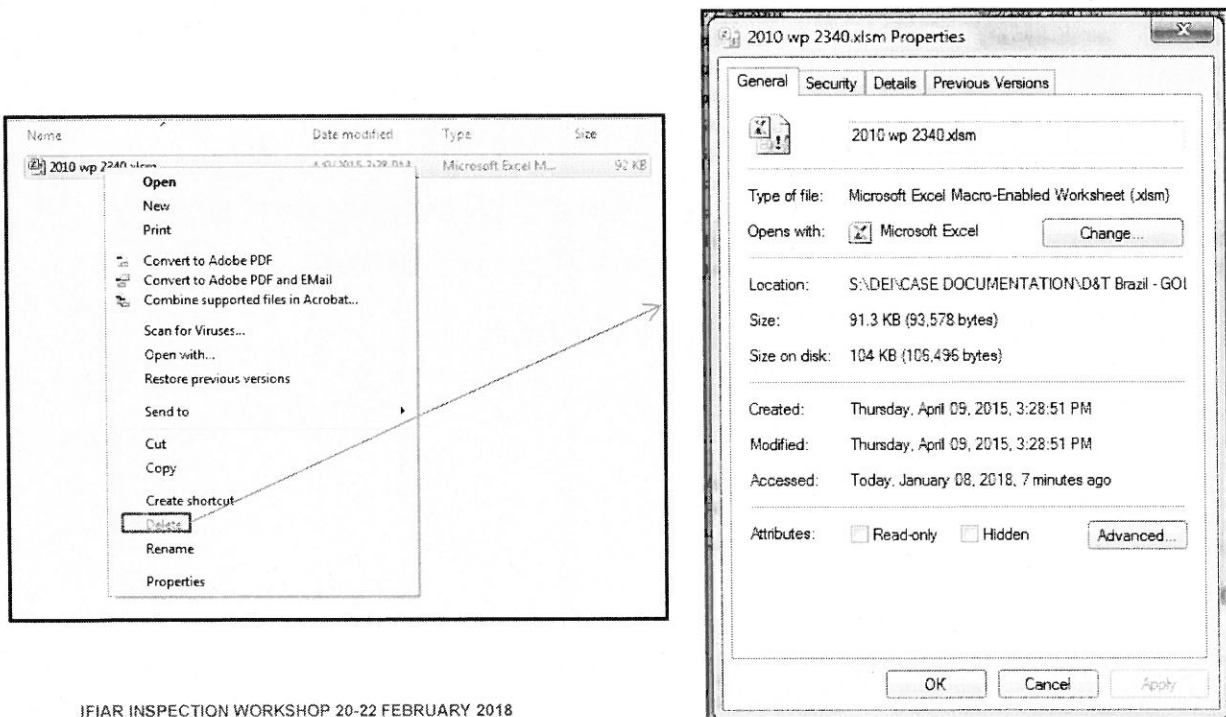


- ▶ Two kinds of document metadata:
 - ▶ File-level metadata: Generated by the software application (e.g., Microsoft Excel)
 - ▶ System-level metadata: Generated by the operating system (e.g., Microsoft Windows)
- ▶ Both types of metadata contain information on creation and modification of the document
- ▶ Inconsistency between two types of metadata is a red flag

Example of File-Level Metadata Microsoft Excel



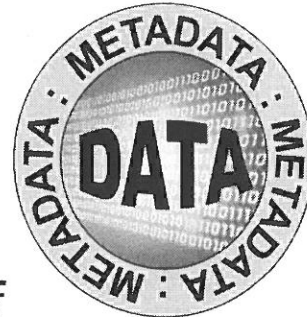
System-Level Metadata Microsoft Excel



How Metadata Can Be Used

Metadata can show work how papers were created or modified:

- ▶ After initial archiving
- ▶ In advance of inspection
- ▶ During the inspection itself



Audit Software Systems

Work paper sign-off dates in audit software system can show work papers:

- ▶ Reviewed after the date of the audit report
- ▶ Reviewed at a time different from the dates contained in the body of the document
- ▶ Modified after being reviewed
- ▶ Reviewed just before the audit report date

Metadata is Evidence, BUT...

- ▶ Opening and closing documents can cause them to show new “modified” date
- ▶ Creation dates may reflect the creation of a predecessor document or template
- ▶ Software exists to erase or manipulate metadata
- ▶ Computer clocks can be changed

How Else Does Enforcement Detect Work Paper Alteration?

- ▶ Emails, instant messages or texts by audit team
- ▶ Interviews of audit team members
- ▶ Documents from third parties (e.g. audit client)

Questions to Ask Archiving

- ▶ What is the firm's archiving policy?
- ▶ Is that policy documented?
- ▶ When were the work papers archived?
- ▶ Were the work papers accessed after archiving?
- ▶ What is the usual process for retrieving archived work papers?
- ▶ What actual process was followed this time?

Steps to Take if Alteration is Suspected

- ▶ Request electronic versions of hard-copy documents
- ▶ Request emails showing when work papers were drafted and reviewed
- ▶ Request draft versions of work papers on computers of audit team members
- ▶ Request snapshots from the work paper archiving system showing when work papers were archived and accessed

Key Takeaways

- ▶ Inspections and Enforcement are often distinct, but they can collaborate effectively
- ▶ Inspectors further their mission by understanding:
 - ▶ When to refer matters to Enforcement
 - ▶ What criteria Enforcement uses to open and pursue a matter
 - ▶ How the investigation and adjudication processes work
- ▶ Be alert to suspicious conduct or altered documents!



Useful Enforcement Links



- ▶ <https://www.ifiar.org/members/enforcement-working-group/>
- ▶ <https://pcaobus.org/Enforcement/Pages/default.aspx>
- ▶ <http://www.frc.org.uk/auditors/enforcement-division>

