

SPECIAL REPORT

AOB, although not perfect, is effective in improving audit quality

BY ESTHER LEE

The Enron, WorldCom, Parmalat and Tyco accounting scandals that broke in the early 2000s spawned a new wave of whistleblowers and unearthed deficiencies in the audits of public companies. Since then, many countries have established audit oversight mechanisms, including audit oversight boards to oversee auditors of public companies, periodic inspections and setting auditing standards.

On its part, Malaysia came up with the Audit Oversight Board (AOB) on April 1, 2010, in the wake of local accounting scandals at companies such as Transmile Group Bhd, which was labelled the "Malaysian mini Enron", and Megan Media Holdings Bhd in 2007, and loss of public confidence in the quality of audit reporting.

However, questions have been raised about whether it was necessary to set up the board in what seems to be an already highly regulated area.

While it is undeniable that regulations are necessary for a group of professionals that authenticates financial reports often used in decision-making, over-regulation can stifle its growth.

Unsurprisingly, views on the regulatory body are divided. Some lament that the AOB has been too punitive on audit firms, while others praise it for keeping them on their toes.

The Edge spoke with audit partners who believe that the AOB has been effective in meeting its objectives, bringing positive changes to the industry.

Datuk Rauf Rashid, managing partner and Asean Assurance leader of Ernst & Young Malaysia, shares that the AOB's existence has sent a clear message to auditors and also preparers of financial statements on the importance of professionalism.

Rebuilding confidence in the audit profession

BY LIEW JIA TENG AND CINDY YEAP

Of the many headlines surrounding 1Malaysia Development Bhd (1MDB), an accounting scandal was not among them. There are those who think it should have been, arguing that 1MDB ran into cash flow issues not too long after being cleared as a going concern.

Others disagree. While none of 1MDB's audited financial statements issued through March 31, 2014, had a qualified opinion, the Public Accounts Committee's investigations show that two of its external auditors were replaced over a span of five years for asking too many questions.

And 1MDB's accounts have thus far gone through three of the so-called "Big Four" audit firms — Ernst & Young, KPMG and Deloitte. (The fourth "Big Four" is PricewaterhouseCoopers, Tesco plc's auditor of 32 years, which came under the spotlight in 2014 after investigators said the UK supermarket chain had grossly overstated its profits.)

Globally, at least two of the "Big Four" firms have been sued for failing to highlight fraud.

Whether or not there is a mismatch between public expectation on the ability of auditors to detect and expose fraud, the credibility of the accounting profession has again been thrown into question — despite heightened scrutiny by accounting oversight bodies since the likes of Enron and WorldCom imploded over a decade ago. In 2007, Malaysia saw its own mega accounting scandal in Transmile Group Bhd, which counted reputed billionaire businessman Robert Kuok among its shareholders. (Tesco had Warren Buffett as shareholder.)

Nik Mohd Hasyudeen Yusoff, the Audit Oversight Board (AOB) founding board member, recalls the general "frustration of audit not being done properly" in Malaysia in the wake of accounting scandals. An independent audit regulator was sorely needed to establish a base standard for the audit profession and, over time, raise the bar.

The same frustration was felt globally. "If you look around the world, there are now at least 50 countries that have independent au-

dit regulators. Today, it is expected that a good economy must have good independent audit regulator because you need that independence," says Nik, who was AOB executive chairman until end-March.

Malaysia responded by setting up AOB on April 1, 2010, under the Securities Commission Malaysia Act 1993. This is to provide independent audit oversight over so-called public interest entities (PIEs) and ultimately, restore and strengthen investor confidence in the quality and reliability of audited financial statements.

1MDB, which falls under Minister of Finance Inc, is not among the 1,140 PIEs under the AOB's purview. Any institution can be added to come under its purview by order of the minister of finance.

Even so, Nik says rebuilding confidence in the system involves a lot more than the act of putting 1MDB or any other entity under AOB's supervision.

"1MDB is a little bit tricky because it falls under the category of government-owned companies, like Khazanah [Nasional Bhd]. It's not as simple as [widening coverage, because you will need to have more people to cover other government-linked companies]. We have to be careful. We cannot extend the scope just because of one incident. There will be other unintended consequences," adds Nik, who was also president of Malaysian Institute of Accountants (MIA) from 2007 to 2009 and a member of the Malaysian Anti-Corruption Commission's operational review panel for six years through 2015.

Nik acknowledges limitations on AOB's scope as it "cannot be regulating everybody". "We were looking at the sectors that need to be regulated. That would be the capital markets, banking and insurance sectors as well as fund management companies and stock brokers. That's how the mandate of AOB was drafted. It was purely for these sectors," he says.

According to him, anything outside AOB's purview automatically falls under MIA, a professional body with regulatory powers that allow it to investigate and punish members for falling short in carrying out their professional duties. (It is worth noting that the Ministry of Finance oversees the Accountant General's



Nik: It makes good business sense for audit firms to maintain quality work

Department, which nominates appointees to MIA's council, including some audit firm heads.)

Rather than discussing the potential conflict of interest, Nik says AOB and the Securities Commission of Malaysia (SC) have sent a strong signal to the profession on the severity of non-compliance when it comes to upholding audit and professional standards.

Last year, for the very first time, AOB revoked the registration of audit firm Wong Weng Foo & Co and two of its partners for failure to remain fit and proper to audit PIEs. The appeals were pending as at end-2015, according to data on the SC's website.

At the AOB level, the financial penalty is up to RM500,000 and the board can also prohibit an auditor or audit firm from accepting any PIE or schedule fund as a client for a period of 12 months or permanently.

The SC is also sending out a strong message to auditors when it comes to companies (their clients) making misleading statements by pursuing criminal prosecution. Yue Chi Kin, audit partner of Messrs Roger Yue, Tan & Associates,

was fined RM400,000 and sentenced to a year's imprisonment by the Kuala Lumpur Sessions Court on Oct 21 last year after he was found guilty of abetting United U-Li Corp Bhd in making a misleading statement to Bursa Malaysia in its annual report and financial statements for the year ended Dec 31, 2004.

The added regulatory oversight received a mixed response from auditors (see accompanying story). AOB and Nik himself (at the time of writing, a new AOB executive chairman had yet to be appointed since Nik left in end-March) had come under fire for arguably being "too punitive". Some auditors argue that AOB reprimands could tarnish their image and reputation.

Nik is unfazed, though. "I don't think this is a problem of us taking action, but more of a problem of auditors not doing their job. In fact, we didn't start taking any action until a few years ago. If the facts suggest that the breach is beyond our tolerance and makes us worry, we have to take action," he says.

While it is a company's responsibility to prepare a good financial statement, he says it is the auditors' job to audit it properly.

"We don't have a view on whether there are too many or too few [reprimands] ... [but] we have to be objective. If the standard is not there, the standard is not there. It's not fair for the market to be supplied with work [that is not up to par with auditing standards]," Nik says, adding that AOB is always "objective and fair", with firms given a chance to explain their case before action is taken.

"[They're given] three chances to be heard ... it's a fair process. In fact, if they want to appeal to the SC, they have another chance, but most of them don't challenge.

"We just do our work and stick to the facts. It's not about us winning or the firm winning, but standards have to go up. Of course, there are people who have different ideas about how we should be doing our work ... they are welcome to challenge us," he says, adding that AOB never takes challenges personally.

But beyond wielding the stick, Nik is convinced good audit is good for business and hopes the industry will share this view instead

CONTINUES ON PAGE 68

"Auditors are now regularly reminded of the need to align their function with the AOB's mission, which is to foster high-quality independent auditing. It is important to understand that the AOB is not just an enforcement agency.

"It also helps provide support and guidance to audit firms in improving their quality-control policies, procedures and systems. As a result, we have seen a significant improvement in audit practices and compliance since the AOB was established," explains Rauf.

PwC Malaysia Assurance leader Pauline Ho concurs. She says this can be seen in the changes in audit opinions, audit team composition and audit procedures as well as restatement of financial statements, which was directly or indirectly caused by the AOB's inspection of 12 audit firms and 35 individual auditors in 2015.

"Through the PwC global network's interactions with regulators, we have found that the AOB appears to be one of the more progressive regulators globally, one which listens closely to the concerns of the profession," adds Ho.

Besides that, she says, the AOB has kept audit firms vigilant. In 2015, for the first time, the AOB took action, deregistering an audit firm and its managing partner.

However, some auditors think that some companies that intentionally understated or overstated their accounts have got off scot-free, while the auditors are the ones who suffer for not following certain audit procedures.

"Does reprimanding the audit firms really help? I think the AOB may be sending the wrong message to the public. Whenever something goes wrong with a company, the auditor gets the blame first. With AOB publicly reprimanding audit

firms, it kind of confirms the public perception that fraud is caused by the auditors, which is definitely not the case," says a visibly upset audit partner who declines to be named.

PwC's Ho thinks that reprimands and punitive actions do play a role. However, internal culture shaped by a strong tone at the top that focuses on audit quality is more important. "I believe that there should be recognition for audit quality where demonstrated, so that there is a more balanced view of the profession. It is important to note that audit quality is not the sole responsibility of AOB and the auditors. All parties in the financial reporting ecosystem and regulators need to play their roles effectively to ensure that the quality of financial reporting and auditing is enhanced," she says.

Rauf opines that the AOB has been proactive in reaching out to various parties in the financial

reporting ecosystem for feedback and hopes to see continuous engagement with all stakeholders in order to better understand the challenges faced by the industry.

"The AOB is in a privileged position to have an overview of the various issues and challenges faced by the industry and profession, from the large international auditing firms to the smaller and medium-sized ones. Perhaps it could extend its role further by providing benchmarking or guidance on addressing common issues faced by the auditing firms; and by creating a forum for the sharing of best practices," he suggests.

He adds that the AOB could also consider issuing periodic alerts to the auditing profession and highlighting emerging or notable circumstances that may affect how auditors conduct their audit under the existing requirements and relevant laws.

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CRIMINAL PROSECUTION

Nature of offence/misconduct	Parties involved	Case description	Sentence/action taken
Abetting in making a misleading statement to Bursa Malaysia	Yue Chi Kin, who was at the material time the audit partner of Messrs Roger Yue, Tan & Associates, which audited United U-Li Corp Bhd's financial results for FY ended Dec 31, 2004	On Oct 21, 2015, the Kuala Lumpur Sessions Court found Yue Chi Kin guilty of abetting United U-Li Corp Bhd in making a misleading statement to Bursa Malaysia in its annual report and financial statements for FY ended Dec 31, 2004, an offence under Section 122B(b)(bb) read together with Section 122C(c) of the Securities Industry Act 1983. Yue was charged on April 28, 2009.	1 year's imprisonment and RM400,000 fine

AOB SANCTION

Nature of offence/misconduct	Parties involved	Case description	Sentence/action taken
Breach of AOB's registration condition imposed under Section 310(3) of the Securities Commission Act 1993 (SCMA)	Lee Kok Wai, partner of Crowe Horwath who was the engagement partner in the audit of Silver Bird Group Bhd's financial statement for the year ended Oct 31, 2010	Failure to comply with certain requirements of the International Standards on Auditing in the discharging of his professional duties in auditing the public-interest entity (PIE)	Reprimand and RM50,000 penalty on Jan 16, 2015. Lee appealed but the Securities Commission rejected it on Feb 25, 2016. (Application for judicial review was filed twice against the SC in respect of the AOB's inquiry against Lee in January and February 2014 but the High Court dismissed the application with costs.)
Breach of AOB's registration condition imposed under Section 310(3) of the SCMA read together with paragraph 5.04(b,c,e) of the AOB's Handbook on Registration relating to compliance with auditing and ethical standards, honest and competent practice	Wong Weng Foo & Co (audit firm)	Wong Weng Foo & Co failed to ensure that the auditor who audits the financial statements of PIEs is properly qualified, sufficiently trained and competent. As a result, there was recurring and numerous significant deficiencies in the audit of two public-listed entities for the financial years ended Dec 31, 2013 and June 30, 2014	Revocation of registration with AOB pursuant to Section 31Q(1)(a)(B) of the SCMA on Dec 2, 2015. The appeals are pending.
	Wong Weng Foo, managing partner Wong Weng Foo & Co; and Abdul Halim Husin, partner, Wong Weng Foo & Co, engagement partner in the audit of two public-listed entities for the financial years ended Dec 31, 2013 and June 30, 2014		Revocation of the managing partner and partner's registration with AOB pursuant to Section 31Q(1)(a) (B) of the SCMA on Dec 2, 2015. As at Dec 31, 2015, the auditors had appealed to the SC against the AOB's decision. Pending the decision on the appeal, the AOB's decision to revoke their registration shall not take effect.
Breach of AOB's registration condition imposed under Section 310(4) of the SCMA	Wong Weng Foo & Co (audit firm)	Failure to comply with Section 31N (1) of the SCMA which requires audit firms to be registered with AOB when acting as auditor; and failure to comply with the By-Laws (On Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants requirement, which relates to the independence of an auditor	On May 30, 2014, the audit firm was fined RM30,000 and is prohibited from accepting any PIE as a client for a period of 12 months, effective June 30, 2014. The audit firm appealed against the AOB's decision but the Securities Commission rejected the appeal on June 26, 2014.
Breach of AOB's registration condition imposed under Section 310(4) of the SCMA	Chan Kee Hwa, partner of Khoo Wong & Chan, who was the engagement partner in the audit of a PIE for the financial year ended March 31, 2011	Failure to comply with certain requirements of the International Standards on Auditing in the discharging of his professional duties in auditing the public-interest entity (PIE)	Reprimanded on Feb 18, 2014
Breach of AOB's registration condition imposed under Section 310(4) of the SCMA	Lim Kok Beng, partner of Ong Boon Bah & Co, who was the engagement partner in the audit of a PIE for the financial year ended June 30, 2011	Failure to comply with certain requirements of the International Standards on Auditing in the discharging of his professional duties in auditing the public-interest entity (PIE)	Reprimand and RM10,000 penalty on Feb 18, 2014. AOB also requested the audit firm (which continued to audit the PIE) to furnish evidence from the audit working papers to prove that all significant deficiencies were rectified in the subsequent year's audit.

SPECIAL REPORT

No easy task for transition to accrual accounting in public sector

BY ESTHER LEE

Malaysia's move to accrual accounting for the public sector has been on the wish list of many since the government embarked on this journey four years ago. However, the transition from cash accounting to accruals is still in the works and has fallen behind the government's targeted implementation date of early 2016.

"We need more time. It will be done on a staggered basis. We will try to do it as soon as everyone is ready. We need perfection of systems at the ministry, agency and department levels," Deputy Finance Minister Datuk Johari Abdul Ghani tells *The Edge*.

Perhaps the government was a little too ambitious on the transition timeframe. According to Ross Campbell, the director of public sector at the Institute of Chartered Accountants for England and Wales, most countries that have made the transition from cash to accrual accounting took five to eight years for full implementation to take place.

Campbell is the former accounting policy lead and financial reporting standard setter for the UK central government at HM Treasury. He also served as the group chief accountant at the Ministry of Defence and the director at the National Audit Office in the UK.

"Malaysia benefits at least from having quite a strong accountancy profession compared with many countries. It is a relatively sophisticated country with a relatively good understanding of information systems. So, it would be, in theory, possible to do it in five to six years. Very few countries can do it much faster, it is just the scale of what is required," Campbell tells *The Edge* in an interview.

The accrual method of accounting is known to give a more accurate picture of public finances, especially when it comes to the government's balance sheet. In recent years, there has been increasing awareness for governments to shift to the accrual method as people demand more accountability in the way public funds are utilised during tough economic times.

"Everybody is feeling the squeeze and that is throwing the spotlight on how we could manage public money better, and with that, generally comes positive feedback. It is improving the information, making it more transparent, more usable to policymakers. But you also need to create that feedback loop of public accountability because it is only really through accountability that you have the pressure to reform," says Campbell.

Malaysia is no different. The government has embarked on the switch to accrual accounting in order to strengthen fiscal discipline and improve financial management to ensure the stability and sustainability

of public funds, Treasury secretary-general Tan Sri Dr Mohd Irwan Serigar Abdullah said in his speech at the Public Sector Forum 2016 earlier this month.

"The transformational switch from cash to accrual accounting will provide a more comprehensive reporting of the government's financial position, its financial performance and cash flow for the periods under review. With this, decision-making will improve and eventually lead to more optimum usage of public resources," he said.

Irwan added that accrual accounting will meet the growing demand from the various stakeholders for more transparency and provide more meaningful benchmarking of financial performance and the position of Malaysian and foreign public-sector entities.

Given the transparency and more reflective disclosure, the adoption of accrual accounting should, theoretically, reduce the number of accounting scandals. Campbell opines that the numbers displayed in the accounts would offer an added dimension in the way the balance sheet is managed — including its growth, assets and liabilities and the changes that take place.

"No major corporation would try to run its business without this sort of information. The government is not really any different in that sense. It has income and expenses, it employs people and it incurs liability associated with that. It owns things and it borrows money. There is not that much difference in the nuts and bolts of financial management. The difference is in the purpose.

"Invariably, when you start to shine a light on places that a light has never been shone before, you find things, and not all the things you find are pleasant surprises ... In the long run, what gets measured, gets managed. If the numbers are there and are visible, politicians will feel that they need to do something about them," Campbell says.

The switch to accrual accounting inevitably has its challenges. Besides tangible problems, like the changing of the entire information system and the painstaking process of accounting for government assets, the bigger challenge, according to Campbell, is embedding the culture and fostering a different way of thinking about the numbers.

"That is a journey and that does not happen overnight. People have to change their mindset. We have been doing this (accrual accounting) in the UK for 20 years, but only now do we have people who are coming up to the senior jobs in government to whom this has always been normal and it is the way things work," says Campbell.

'Good businesses want to be associated with credible audit firms'

FROM PAGE 66

of being afraid of losing clients for raising audit standards. Firms determined to maintain audit quality and professional standards "are not worse off economically compared with their peers and in certain market segments, are more competitive" because good businesses want to be associated with credible audit firms.

"There is a commercial element in what we do. We highlight something from an independent point of view, so many firms actually see that as a positive way of dealing," Nik says.

"It makes good business sense for audit firms to maintain quality work. It's not like 'Don't go to this firm, its standards are high'. It doesn't work like that. There are companies that want to be associated with such firms ... it is a positive thing. I'm quite happy with where we are today."

There is always room for improvement, even among the "Big Four + two (BDO Binder and Crowe Horwath)". They lead the pack of eight firms with "more than 10 partners", which collectively (with 191 auditors) audit 922 PIEs covering 95.64% of the market capitalisation of public-listed companies and 872 schedule funds covering 99.3% of the fund size in Malaysia.

"The workload means each partner, on average, viewed and signed 217 audit reports last year, which could range up to 24 PIEs, 288 entities related to PIEs, or 1,330 non-PIEs per partner," AOB says in its 2015 annual report, flagging that "unreasonable workload contributes towards inconsistency of engagement performance, which ultimately affects audit quality".

Nik also says the complexities that come with globalisation and a fast-changing business environment mean auditors have to understand a client's business in order to perform a good audit.

"Today, banks are driven by technology, so the auditors must have the ability to look at IT audit. Conglomerates are involved in different industries and they are everywhere in the world, so it's not as easy as last time," he says.

Nik also warns against having a false sense of security when auditing companies they are familiar with and to always obtain evidence to support their judgement, because circumstances and context can change over time. "One of the threats is when the auditors don't bother to check — 'I'm familiar with the company. I've seen it before, so it must be the same thing'. That's where they get caught."

He also reckons that an audit firm should not accept a client if its people are not confident in doing a good job.

Nik adds that audit firms have become more proactive in highlighting audit issues and audit quality in Malaysia in recent years following AOB's engagement with auditors.

"Things still happen, yes, but we have to look at what led to those incidents. Last time, there were companies that suddenly collapsed. So the company may fail first, only then do people realise that it was an audit issue.

"But today, these incidents are more driven by the audit firms. They refuse to sign [off the accounts], they alert the market, they issue a disclaimer. In that respect, they have done what they are supposed to do, although we still find some audit issues today. What is more important is, we expect the auditors to perform their duties honestly and diligently," he says.

AOB's 2015 annual report, released on May 10, also noted "instances of change in audit opinion subsequent to its regulatory activities", mainly in the area highlighted in AOB's inspection findings. AOB also observed instances of changes in audit composition and audit procedures to obtain more reliable audit evidence. It did not provide specific statistics on the number of cases or how substantial the changes were.

To be sure, there is no perfect system. What is certain, though, is that there is a need to safeguard investor confidence with regard to the reliability of financial statements because a breakdown of trust would mean a higher risk premium and higher costs for companies seeking funds from the market.