Oversight of external auditors by the audit committee

MCCG Intended Outcome 8.0
There is an effective and independent Audit Committee.

The board is able to objectively review the Audit Committee’s findings and recommendations. The company’s financial statement is a reliable source of information.

MCCG Practice 8.2
The Audit Committee has a policy that requires a former key audit partner to observe a cooling-off period of at least two years before being appointed as a member of the Audit Committee.

MCCG Practice 8.3
The Audit Committee has policies and procedures to assess the suitability, objectivity and independence of the external auditor.

The internalisation and application of the content “Why” and “How” should be read in tandem with the line of sight outlined by the Intended Outcome.

Why
The case for change

An audit has value to financial statement users because it is performed by a competent third party who is viewed as having no interest in the financial success of the company. Investors take comfort in the fact that independent professionals have performed the required procedures and have a reasonable basis for the opinion that they render in the financial statements.

Given that audit quality is integral to the informed decision-making of investors, safeguards should be put in place to preserve the integrity and credibility of the audit process. A high level of scrutiny is also increasingly being placed by stakeholders on the work of external auditors. Independent audit regulators across the globe are now increasingly focusing on the drivers of audit quality via their inspection efforts. The Global Annual Survey of Audit Inspection 2016 by the International Forum of Independent Audit Regulators revealed that whilst there is a general decline in the inspection findings, a lack of consistency in the execution of audits and systems of quality control, including in the critical area of external auditors’ independence, continue to remain as causes for concern.

1 Concept release on auditor independence and audit firm rotation 2011, Public Company Accounting Oversight Board of United States
Recognising that promoting audit quality is not within the sole purview of external oversight bodies, regulators have also placed audit governance responsibilities on the audit committee, including in the selection and evaluation of the external auditor. For example, Bursa Securities Listing Requirements call upon audit committees to be proactive in overseeing the external audit process.

### Point for reflection

The insights from the inspection efforts carried out by the Audit Oversight Board (“AOB”) revealed that the quality of auditing in Malaysia has improved over the recent years. Notwithstanding that, the AOB continues to find instances in which it appeared that external auditors did not approach some aspect of the audit with the required objectivity, diligence and professional scepticism.

For example, audit procedures which required a high degree of unpredictability such as those relating to revenue recognition, inventory and related party transactions showed significant deficiencies in the inspection findings by AOB during the year 2016. Some of the common root causes which led to these deficiencies included inadequate quality control procedures and the lack of cognisance to the changing circumstances of the company’s business, especially for continuing audit engagements.

### Common significant deficiencies in audit engagements

<table>
<thead>
<tr>
<th>Category</th>
<th>Major audit firms</th>
<th>Other audit firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition</td>
<td>15%</td>
<td>21%</td>
</tr>
<tr>
<td>Inventory</td>
<td>18%</td>
<td>41%</td>
</tr>
<tr>
<td>Group audits</td>
<td>7%</td>
<td>29%</td>
</tr>
<tr>
<td>Sampling</td>
<td>9%</td>
<td>27%</td>
</tr>
<tr>
<td>Related-party transactions and balances</td>
<td>38%</td>
<td>25%</td>
</tr>
</tbody>
</table>

**Note:** Major audit firms refer to audit firms with more than 10 partners and audit more than 50 public interest entities (“PIE”) clients with a total market capitalisation of above RM20 billion.

### What could go wrong:

- Compromised objectivity of the external auditor.
- Lack of expertise and experience by the external auditor to conduct the audit process.
- Lack of robust focus on the critical areas of risk concerning financial reporting.
- Lack of value obtained from the external auditor beyond the scope of statutory external audit (e.g. audit findings are not contextualised to the industry and business).

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2Annual Report 2016, Audit Oversight Board (Malaysia)
Functions of the audit committee

A listed issuer must ensure an audit committee, amongst others, discharges the following functions:

(1) review the following and report the same to the board of directors of the listed issuer:
   (a) with the external auditor, the audit plan;
   (b) with the external auditor, his evaluation of the system of internal controls;
   (c) with the external auditor, his audit report;
   (d) the assistance given by the employees of the listed issuer to the external auditor;
   (i) any letter of resignation from the external auditors of the listed issuer;
   (j) whether there is reason (supported by grounds) to believe that the listed issuer’s external auditor is not suitable for re-appointment; and

(2) recommend the nomination of a person or persons as external auditors.

Rights of the audit committee

A listed issuer must ensure that wherever necessary and reasonable for the performance of its duties, an audit committee must, in accordance with a procedure to be determined by the board of directors and at the cost of the listed issuer –

(d) have direct communication channels with the external auditors and person(s) carrying out the internal audit function or activity; and

(f) be able to convene meetings with the external auditors, the person(s) carrying out the internal audit function or activity or both, excluding the attendance of other directors and employees of the listed issuer, whenever deemed necessary.

Note: Only requirements pertaining to the external auditor are extracted from paragraphs 15.12 and 15.17 of Bursa Securities Listing Requirements.

External auditor

In appointing an external auditor, a listed issuer must consider, among others –

(a) the adequacy of the experience and resources of the accounting firm;
(b) the persons assigned to the audit;
(c) the accounting firm’s audit engagements;
(d) the size and complexity of the listed issuer’s group being audited; and
(e) the number and experience of supervisory and professional staff assigned to the particular audit.
Similar provisions are also encapsulated for financial institutions in Bank Negara Malaysia’s Policy Document on Corporate Governance. For example, Appendix 1 of the said document requires the audit committee to foster a quality audit of the financial institution by exercising oversight over the external auditor, in accordance with the expectations set out in the Bank Negara Malaysia’s Policy Document on External Auditor³.

**The practice in substance**

In assessing the suitability, objectivity and independence of the external auditor, the audit committee should establish policies and procedures which cover all aspects of the audit service provided by the audit firm.

The audit committee’s recommendation on the appointment of an external auditor should be based on an assessment of the independence and capabilities of the external auditor as well as the effectiveness of the audit process.

Key considerations relating to the application of these Practices (Practices 8.2 and 8.3 of MCCG) are discussed on the following page.

³ The Policy Document on External Auditor by Bank Negara Malaysia outlines the qualifications of an external auditor to be appointed by a financial institution.
What are policies and procedures that can be put in place by an audit committee to assess the suitability (in terms of capabilities, objectivity and independence) of the external auditor?

Examples of policies and procedures (non-exhaustive) that can be established by the audit committee in this regard are outlined below:

Examples of policies:

- Having in place a policy on the appointment, re-appointment and removal of external auditor (including selection and qualification criteria).

- Establishing a policy on the types of non-audit services that are prohibited and limits to the level of fees for non-audit services rendered by the external auditor.

- Having in place a policy to govern the appointment of a former key audit partner as a member of the audit committee and/or employee.

Examples of procedures:

- Obtaining written assurance from the external auditors confirming that they are, and have been, independent throughout the conduct of the audit engagement in accordance with the terms of all relevant professional and regulatory requirements.

- Developing a list of audit quality indicators by the audit committee to monitor effectiveness of the external audit process. Examples of such indicators may include:
  - adequacy of audit scope;
  - ability of the external audit firm to meet audit deadlines;
  - timeliness in escalating audit issues to the audit committee;
  - allocation of resources to significant audit risk areas; and
  - effectiveness of the external audit firm’s recommendations in addressing weaknesses observed during previous audits, particularly on internal controls relevant to financial reporting process.

- Performing an annual evaluation on the performance of the external auditor and undertaking follow-up measures thereafter (note: a sample exhibit on the evaluation of external auditor is provided in Appendix II of this Pull-out).

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4 Paragraph 15.21 of Bursa Securities Listing Requirements outlines the considerations in appointing an external auditor.
What are the salient areas that should be considered in evaluating an external audit firm’s capabilities to conduct the audit?

In evaluating the external auditor’s capabilities in relation to its expertise, experience, network and reputation, the audit committee should give consideration to a range of factors as set out below.

Relevant considerations in evaluating an external audit firm’s capabilities (non-exhaustive):

- the audit firm’s reputation and its presence in the industry;
- qualifications of its professionals, including the breadth and depth of resources and experience of the team members;
- networking ability and competency to address overseas subsidiaries not audited by the firm (i.e. its liaison capability with the secondary auditors);
- audit methodology employed by the firm such as the underlying methodology and materiality used to determine the nature, extent and timing of testing required;
- the internal quality control processes in place (e.g. independent quality control review and approach to audit judgments); and
- how the audit firm delivers value other than through the provision of the statutory audit report.

How can the audit committee avert potential threats to an external auditor’s independence?

Two key issues that commonly bear on the external auditor’s independence are the provision of non-audit services as well as the appointment of former key audit partners as director or an employee of the company who is in a position to exert significant influence over the preparation of financial statements.

As mentioned above, the audit committee should put in place policies and procedures to aid in the safeguarding of the external auditor’s independence and objectivity, taking into consideration relevant professional and regulatory requirements.

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Provision of non-audit services

Provision of non-audit services by the external auditor to a company may result in misaligned incentives. In such instances, external auditors may be exposed to the possibility of reviewing part of their own work or have their objectivity challenged by over-reliance on the fee generated and the familiarity developed with the company.

Appointment of former key audit partners

There may be serious concerns to objectivity when a member of an audit engagement team joins the company (the audit client) and is in a position to exert significant influence over the preparation of the company’s financial statements.

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6 The engagement partners, the individuals responsible for the engagement of quality control review, and other audit partners, if any, on the engagement team who make key decisions or judgments on significant matters with respect to the audit of the financial statements on which the auditor will express an opinion.
Provision of non-audit services

Prior to the provision of any non-audit services by the external auditor, the audit committee should review and approve the acceptance of such engagements, drawing guidance from the By-Laws (on Professional Ethics, Conduct and Practice) by the Malaysian Institute of Accountants (“MIA”). If the non-audit service results in concerns on independence to an extent that they cannot be reduced to an acceptable level by the application of safeguards, the non-audit service shall not be accepted.

Examples of non-audit services that shall not be provided by the external auditors of a PIE pursuant to the By-Laws (on Professional Ethics, Conduct and Practice) by the MIA are outlined below.

Prohibited non-audit services (non-exhaustive)*:

- accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information;
- valuation services if the valuations would have a material effect on the financial statements;
- preparation of tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements;
- internal audit services that relate to a significant part of the internal controls over financial reporting, financial accounting systems or amount or disclosures that are material to the financial statements;
- design or implementation of information systems that form a significant part of the internal control or information on financial reporting, accounting records or financial statements;
- acting in an advocacy role on behalf of the company to resolve a dispute or litigation when the amounts involved are material to the financial statements;
- recruiting services with respect to a director, officer or senior management personnel who would be in a position to exert significant influence over the preparation of accounting records or the financial statements; and
- corporate finance services which involve promoting, dealing in, or underwriting shares.

In accordance with Bursa Securities Listing Requirements, disclosure should also be made on the nature and extent of non-audit services if the fees on such services are “significant”.

* Provisions 290.172 to 290.219 of By-Laws (on Professional Ethics, Conduct and Practice) by the MIA
Paragraph 18, Part A, Appendix 9C of Bursa Securities Listing Requirements

The content of an annual report must contain the following particulars in relation to the audit and non-audit services rendered to the listed issuer or its subsidiaries for the financial year:

(a) amount of audit fees paid or payable to the listed issuer’s auditors, stating the amount incurred by the listed issuer and the amount incurred on a group basis respectively; and

(b) amount of non-audit fees paid or payable to the listed issuer’s auditors, or a firm or corporation affiliated to the auditors’ firm, stating the amount incurred by the listed issuer and the amount incurred on a group basis respectively. If the non-audit fees incurred were significant, details on the nature of the services rendered. If no non-audit fees were incurred, a statement to that effect.

Note: Item 9.47A of the Questions and Answers in relation to Bursa Securities Listing Requirements clarifies that listed issuers should consider the amount of non-audit fees incurred compared to the amount of audit fees paid to determine if the non-audit fee is “significant”. Generally, if the non-audit fees constitute 50% of the total amount of audit fees paid to their external auditors, then such non-audit fees are regarded as significant.

Appointment of former key audit partners

The company should have in place a policy to govern the circumstances under which former key audit partners of the present and former external auditor(s) can be appointed to the board or be employed by the company. Such policies should include a procedure on a cooling-off period to govern the independence of such appointments.

Applicable provisions for cooling-off periods found in professional requirements are outlined below.

Provision 290.139 of the By-Laws (on Professional Ethics, Conduct and Practice) by the Malaysian Institute of Accountants

Familiarity or intimidation threats are created when a key audit partner joins the audit client that is a public interest entity as:

(a) A director or officer of the entity; or

(b) An employee in a position to exert significant influence over the preparation of the client’s accounting records or the financial statements on which the firm will express an opinion.

Independence would be deemed to be compromised unless, subsequent to the partner ceasing to be a key audit partner, the public interest entity had issued audited financial statements covering a period of not less than two years and the partner was not a member of the audit team with respect to the audit of those financial statements.
An illustrative disclosure highlighting the policy on appointing former employees of the external auditor (including former key audit partners of the external audit firm) as members of the company’s audit committee or the company’s employees is shown below with the following elements outlined:

- responsibility of the audit committee to oversee the policy;
- coverage of policy (i.e. applicable to former key audit partners and other audit team members); and
- length of cooling-off period established.

**Illustrative disclosure**

As part of its remit, the audit committee keeps under review the objectivity, independence and effectiveness of the external auditor. The committee has approved a policy on appointment of former key audit partners and former employees of the external auditor firm, to the company. Under this policy:

- On an ongoing basis, the audit committee agrees with the external auditors which members of the audit team are categorised as “key audit partners” and “other key team members”.
- Key audit partners will not be offered employment or be appointed as a member of the audit committee by the company or any of its related corporations within **two years** of undertaking any role on the audit.
- Other key team members will not be offered employment or be appointed as a member of the audit committee by the company or any of its related corporations within **six months** of undertaking any role on the audit.
- Other audit team members (excluding key audit partners or key audit team members) who accept employment or are appointed as a member of audit committee by the company or any of its related corporations must cease the audit activity immediately and tender their resignation to the audit firm.

Any offer of employment to a former employee of the audit firm in respect of a senior management position or appointment of the former employee as a member of the audit committee must be pre-approved by the audit committee. Between meetings, the audit committee chairman has the delegated authority to deal with such appointments at his or her discretion. Any such interim approval must be ratified at the next meeting of the committee.

*Adapted from KPMG’s Audit Committee Institute Handbook 2017*
Regional/international perspectives

As with Malaysia, audit committees in many jurisdictions including United Kingdom and Singapore are tasked to exercise robust oversight of the external audit process, including in evaluating the suitability and independence of the external auditor.

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<tr>
<th>Country</th>
<th>Provision(s)</th>
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<tr>
<td>United Kingdom</td>
<td>A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:</td>
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<td>• the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;</td>
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<td>• an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans; and</td>
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<td></td>
<td>• if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence are safeguarded. (Provision C.3.8)</td>
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<td>Singapore</td>
<td>The duties of the audit committee should include:</td>
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<td></td>
<td>d) reviewing the scope and results of the external audit, and the independence and objectivity of the external auditors; and</td>
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<td></td>
<td>e) making recommendations to the Board on the proposals to the shareholders on the appointment, re-appointment and removal of the external auditors, and approving the remuneration and terms of engagement of the external auditors. [Guideline 12.4(d) and (e)]</td>
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