Enhanced Auditors' Report

A review of first-year implementation experience in Malaysia

Suruhanjaya Sekuriti
Securities Commission
Malaysia

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The extensive changes introduced in the Enhanced Auditors' Report (EAR) are expected to make the auditors' report more transparent and informative. Implementation of these standards will drive the flow of useful and relevant information to the capital market, reduce speculation about companies' performance and promote understanding of financial statements.

Foreword

Trusted financial reporting is vital to sustaining confidence in Malaysia's business and investment environment. As a foundation of this trust, the auditors' report provides investors with an independent view of whether the financial statements are true and fair in accordance with the applicable accounting framework. Yet the auditors are but one link in the financial reporting chain and need to connect well with others in the chain – directors, management and especially investors – to engender good governance and accountability.

In 2015, in response to strong calls by investors and other users of financial statements for the auditors' report to provide more relevant and valuable information, the International Auditing and Assurance Standards Board (IAASB) issued its new and revised enhanced auditor reporting standards. These standards were adopted by the Malaysian Institute of Accountants (MIA) that same year and became effective for audits of financial statements with financial periods ending on or after 15 December 2016.

The extensive changes introduced in the Enhanced Auditors' Report (EAR) are expected to make the auditors' report more transparent and informative. Implementation of these standards will drive the flow of useful and relevant information to the capital market, reduce speculation about companies' performance and promote understanding of financial statements.

Over time, the EAR will further empower investors and help drive more relevant and meaningful discussions among stakeholders. From a governance perspective, the robust processes behind the EAR will guide companies' boards of directors and management to be more vigilant and communicative, especially in areas where shareholders show heightened interest.

As a game-changer, it is clear that the EAR affects not only auditors, but also the wider financial reporting ecosystem. Realising its full value will also require additional efforts from those charged with governance (i.e. the board of directors), management and investors. A spirit of collaboration and improvement is therefore important right from the start.

The Securities Commission Malaysia (SC)'s Audit Oversight Board (AOB), the MIA and the Association of Chartered Certified Accountants (ACCA) undertook this study to examine and share observations on the first year of the EAR's implementation in Malaysia. Looking beyond publicly available information, we conducted surveys and focus group discussions with audit committee members and investors to learn from their experience and perspectives.

We acknowledge Bursa Malaysia Securities Berhad (Bursa Malaysia) and the Minority Shareholders Watchdog Group for helping to promote the surveys and invite participants to the focus group discussions. We also extend our appreciation to the audit committee members and investors who have generously shared their views and experiences.

We hope this study will provide useful insights to all stakeholders in the financial reporting ecosystem. In this journey of continuous improvement, we are confident that the EAR will help to raise greater confidence in Malaysia's financial reporting and audit quality.

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25 January 2018

Executive Summary

About the study

This study explores the impact of the first generation of the Enhanced Auditors' Report (EAR) issued in Malaysia, focusing on auditors' communication with audit committees, and on the perceptions and behaviour of investors. It also identifies early trends and good practices, and suggests ways to support or improve the EAR process to increase audit quality.

In total, annual reports of 190 companies listed on Bursa Malaysia with December year-ends were reviewed. As well as examining the EARs issued, the study delves into the experiences and perceptions of the two parties who sit on either side of the EAR: on the inside, audit committees as 'guardians' of financial information of companies, and on the outside, the investors who receive, interpret and react to this information. Online surveys conducted as part of the study involved close to 170 audit committee members[1] and investors, and further insights were obtained from focus group discussions attended by close to 20 audit committee members and investors. A statistical comparison was also made against the EAR implementation experience in the UK, a forerunner in implementing more informative auditors' reports, as well as Singapore who has adopted the EAR at the same time as Malaysia.

1. Used throughout this report, this term includes individuals who are audit committee chairs.

Key findings: Enhancing behaviours in the financial reporting ecosystem

Sparking positive change

EARs have introduced positive changes in processes and perceptions throughout the financial reporting ecosystem, particularly as a result of the need to inform the public about the most significant issues tackled in the audit through the disclosure of Key Audit Matters (KAMs). The new insights resulting from this process have prompted constructive behavioural changes and better engagement between companies and investors.

- **Audit committee discussions about financial reporting risks with auditors and management are more focused and robust, putting audit committees in a stronger position to ensure accountability on behalf of investors.** A total of 85% of audit committee members who responded to the survey agreed that the need to discuss KAMs led to more robust discussions with management and auditors about these issues, strengthening the position of independent directors. This led to a better overall understanding of financial reporting risks with a significant 86% of audit committee members reporting that they had gained deeper insight into financial reporting risks of their companies as a result of considering KAMs and reviewing EARs. KAMs not only raised significant audit issues, but also enhanced audit committees' understanding of how the audit was performed to address these issues.
- **Investors are also gaining more insight into the financial reporting risks of the companies they invest in, as well as the audit process.** A total of 67% of surveyed investors agreed that the EARs had helped them to better understand the financial reporting risks of the companies they had invested in. A significant proportion of retail investors found KAMs particularly helpful in identifying financial reporting and audit matters to raise at Annual General Meetings (AGMs) to the auditors (80%), and to the board of directors and management (81%). Investors also reported greater confidence in Other Information (OI) contained in the annual report, now that auditors make an explicit statement about reviewing that information for inconsistencies with the financial statements.
- **The audit process has been strengthened through more visible audit partner involvement in discussions with audit committees, due to the need for in-depth deliberation and discussion of KAMs in particular.** The senior audit personnel's involvement is key to audit quality, and the development of clear and insightful KAMs for investors. A majority of audit committee members (68%) witnessed an increased involvement of the audit partner in the audit, and 84% of this group considered the increased effort to be sufficient. There were also those who did not observe increased involvement by the audit partner (26%), mainly because audit partners' involvement was already sufficient before the implementation of EAR.
- **Management are making efforts to improve disclosures in the annual report, following discussion about KAMs.** Nearly two-thirds of audit committee members indicated that, based on their experience, the process of considering KAMs and reviewing EAR had resulted in the directors and management making improvements to disclosures in the financial statements (64%) and other elements within the annual report (59%). Audit committees have also used EAR as an opportunity to put pressure on companies' management to drive greater transparency and improve competency of their financial reporting functions.
- **The EAR has improved the relevance and value of the auditors' report.** A total of 86% of investors reported that the inclusion of more information in the EAR made them more likely to read the auditors' report before the financial statements.

Translating insights into future action

Opportunities to further improve and increase the value derived from EAR were identified during the course of this study. In particular, improved communication of the KAMs can facilitate effective engagement with investors. Clearer and more tailored KAMs will allow for greater transparency, by driving trust and in turn allowing the capital market to better reflect each company's value. All parties in the financial reporting ecosystem have an important role in enhancing the quality of the financial statements audit, and in the longer term, towards further improving confidence in the Malaysian capital market. Further details on action points for the future are outlined in Section 4 of this report.

SECTION 1

The Study of Experience in the First Year

The EAR, by introducing a more transparent audit process and a clearer, more user-focused audit opinion, is uniquely poised to spur quality-based competition in the auditing market.

Development of EAR

The EAR, by introducing a more transparent audit process and a clearer, more user-focused audit opinion, is uniquely poised to spur quality-based competition in the auditing market. It forms part of the audit profession's response to calls from investors, regulators and others for more relevance and value from their audits.

The standards, which prescribe what auditors must set out in the EAR, were the result of eight years of development and consultations by the International Auditing and Assurance Standards Board (IAASB).

In Malaysia, following recommendation by the Malaysian Institute of Accountants' (MIA) Auditing and Assurance Standards Board (AASB), the MIA adopted the new and revised standards in 2015, to be applied for audits of financial statements for periods ending on or after 15 December 2016.

Overview of key changes

The most significant change in the EAR is that in addition to expressing a binary opinion on whether the financial statements are true and fair, auditors of listed companies must report the Key Audit Matters (KAMs) – the matters that were of most significance in the audit of the financial statements and how the audit addressed those issues.

Other changes include:
- Prominent placement of the auditors' opinion at the beginning of the auditors' report.
- A new required separate section to highlight when a material uncertainty related to going concern exists, and clarification on the auditors' work effort in 'close call' situations.
- An affirmative statement about the auditors' independence.

Beyond improving the value of the auditors' report, it was expected that the EAR would foster more robust and informed processes throughout the financial reporting ecosystem. The KAMs are intended to improve meaningful and specific communication between auditors, management and those charged with governance (TCWG). For the purpose of this report, TCWG refers to the board of directors of a company.

Extent of the survey

The study examined the first generation of EARs issued in Malaysia, the experience of audit committee members as they worked with the auditors who wrote the EARs, and the views of investors who received new insights into the companies in which they invested their savings.

The study comprises two parts:

(a) Analysis of EARs and annual reports

The observations are based on the review of annual reports of 190 public listed companies (PLCs) in Malaysia with financial year ended 31 December 2016, the first set of annual reports issued after the enhanced auditor reporting standards became effective. The samples were selected from 477 listed companies with December year-ends, taking into account the spread across different industry sectors and size of market capitalisation.

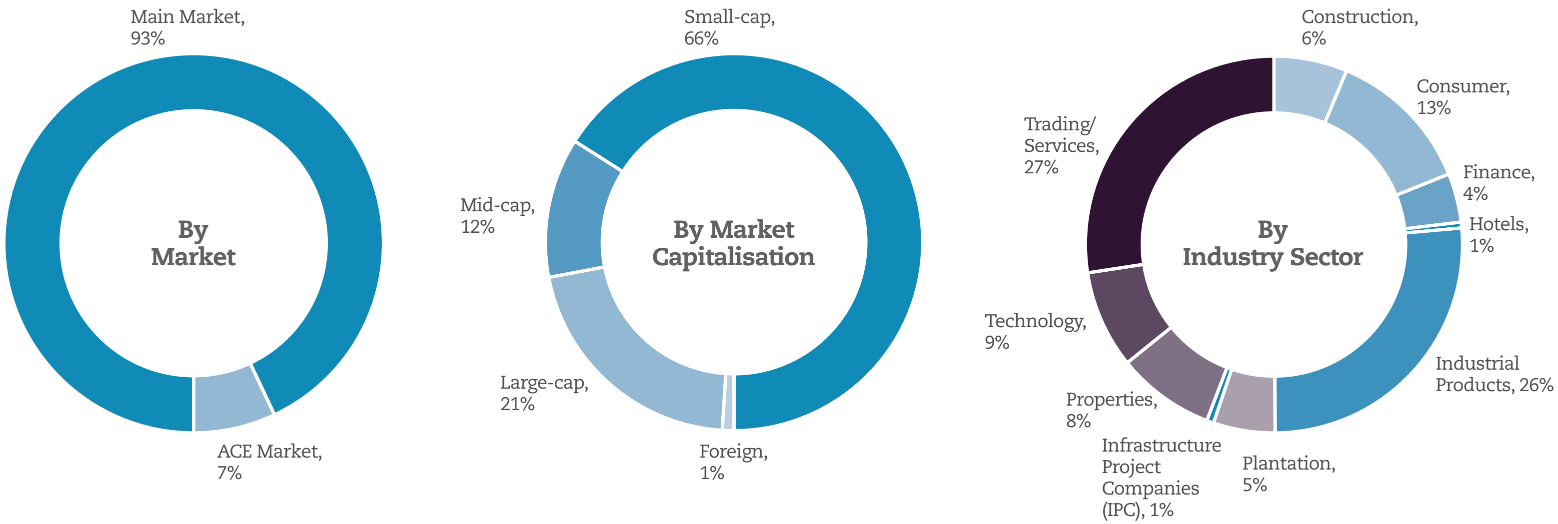
Auditors' reports with a disclaimer of opinion were excluded from the study, as the inclusion of a KAMs section or an Other Information (OI) section in the auditors' report is prohibited when the auditors disclaim their opinions on the financial statements.[2]

All annual reports are publicly available and were extracted from the Bursa Malaysia website during the month of June 2017.

Figure 1 provides an analysis of annual reports reviewed by market, market capitalisation category and industry sector.

Figure 2 provides an analysis of auditors' reports reviewed by audit firm type, market capitalisation and market.

Figure 1: Analysis of reports reviewed by market, market capitalisation category and industry sector



2. Malaysian Approved Standard on Auditing ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

The most significant change in the EAR is that in addition to expressing a binary opinion on whether the financial statements are true and fair, auditors of listed companies must report the Key Audit Matters.

Figure 2: Analysis of auditors' reports reviewed by audit firm type, market capitalisation and market

Audited by	Market capitalisation				Market		
	Large (>RM1bn)	Mid (RM500m – RM1bn)	Small (<RM500m)	Total	Main	ACE	Total
Major Audit Fims[(a)]	38	18	63	119	117	2	119
Other Audit Firms[(b)]	2	5	62	69	57	12	69
Foreign auditors	-	-	2	2	2	-	2
Total	**40**	**23**	**127**	**190**	**176**	**14**	**190**

(a) Major Audit Firms are audit firms with more than 10 partners and audit more than 50 public-interest entities (PIEs) with a total market capitalisation of above RM25 bn.
(b) Other Audit Firms are audit firms other than Major Audit Firms.

(b) Gathering views of audit committees and investors

In June and July 2017 we surveyed audit committee members and investors about their experiences with the first EARs, the value they received from the EARs and the additional audit processes they entailed, and their thoughts on the future of EARs. The survey findings, together with the findings of the review of financial statements and EARs, were discussed in two focus groups – one with audit committee members and another with investors.

Issues covered by the survey and focus groups included:

- How stakeholders valued the EAR and its additional insights.
- The quality of communication within EARs, including how tailored and informative KAMs were.
- How EARs affected engagement between the companies and investors.
- How EARs affected investors' reading of OI contained in the annual report.
- How EARs could be improved to further enhance the value of the auditors' report and audit process.

Gathering views of audit committees

We further surveyed 98 audit committee members on:

- the value of the new EARs, particularly the KAMs;
- their experience of working with the auditors and management to finalise the report; and
- their views on areas for improvements.

The profile of the survey's respondents can be found below (Figures 3–5).

Figure 3: Number of audit committees of which the survey respondents are members

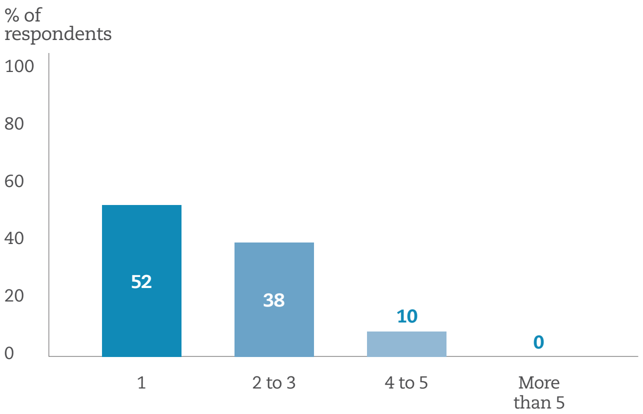


Figure 4: Career background

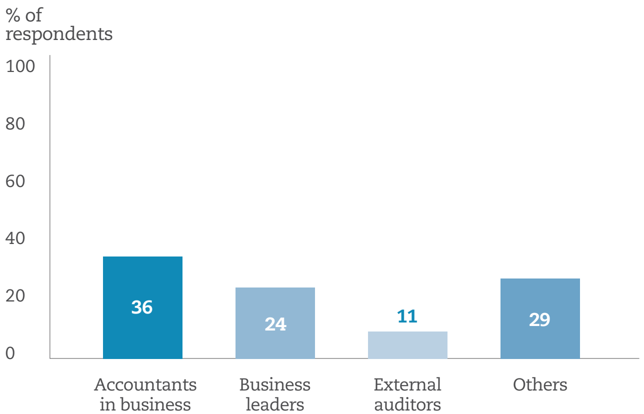
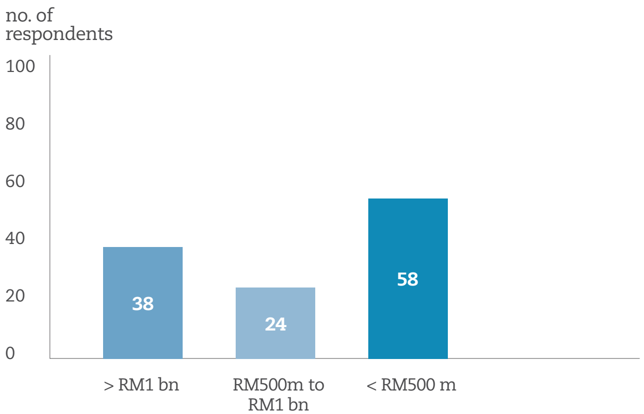


Figure 5: Market capitalisation of the companies of which the survey respondents are audit committee members

Cumulatively the survey respondents held 120 audit committee positions, and the breakdown by the companies' market capitalisation are as follows:



Gathering views of investors

We surveyed 72 institutional and retail investors (Figures 6–9). This was further supplemented by one focus group discussion in which 11 institutional and retail investors participated.

Beyond improving value from the auditors' report, it was expected that the EAR would foster more robust and informed processes throughout the financial reporting system. The KAMs are intended to improve meaningful and specific communication between auditors, management and TCWG.

Figure 6: Breakdown of institutional and retail investors

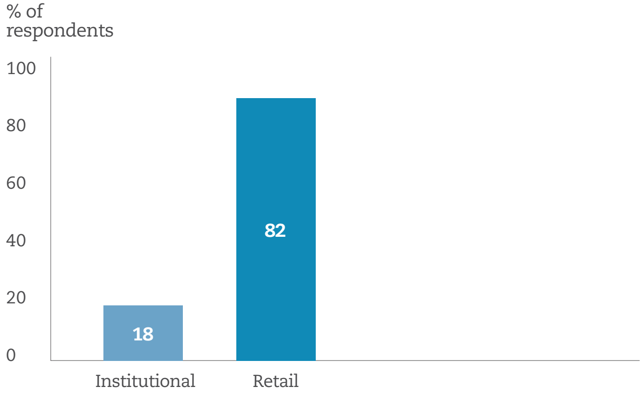


Figure 7: Retail investors – Number of listed companies invested in

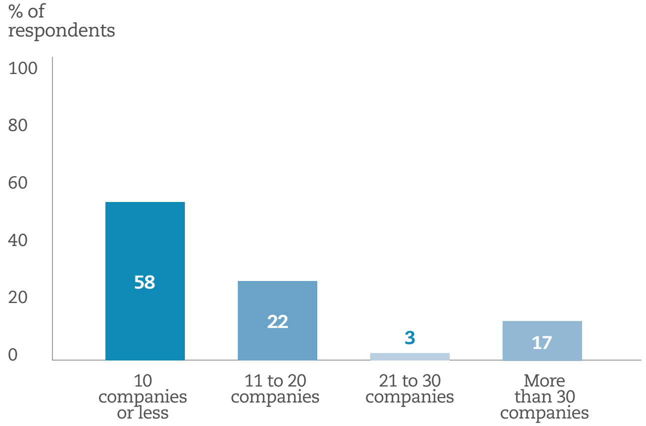


Figure 8: Retail investors – Profession

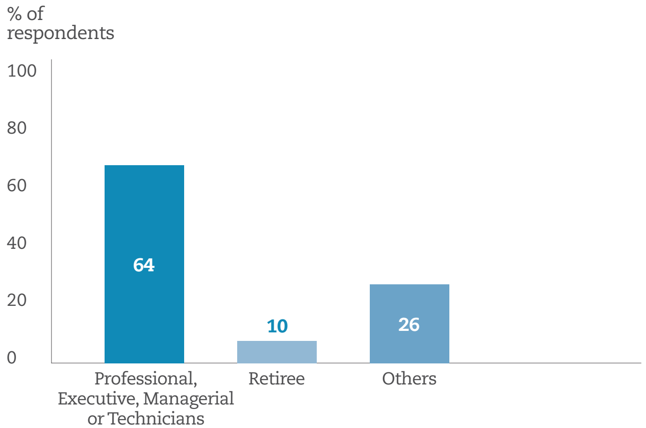
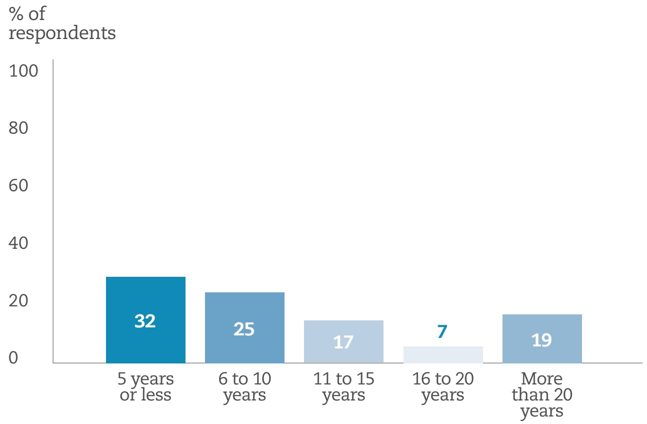


Figure 9: Retail investors – Years of investment experience



SECTION 2

Key Audit Matters: The First Year

To effectively unlock the value of this change, KAMs need to be clear, informative and specific enough to enable readers to understand why the audit matters were 'key' and to understand the matters in their proper context.

The inclusion of KAMs in the auditors' report for listed companies was the most significant change in the EAR. KAMs describe the issues that auditors judged to be of most significance in the audit of the financial statements and how the audit addressed these issues.[3]

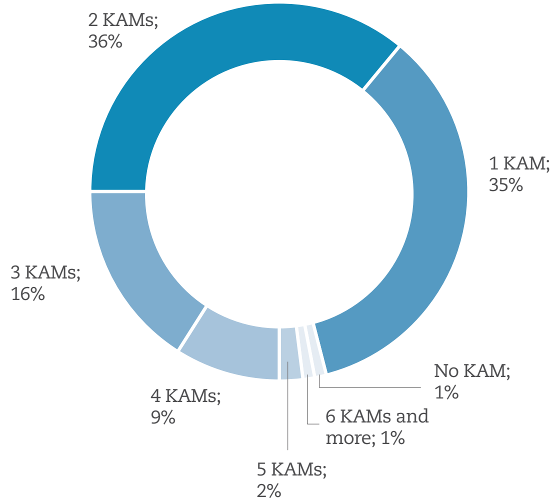
This section examines how auditors implemented the requirement to report KAMs, in the first year, including the number of KAMs, what issues they covered, and how well they conveyed the audit issues and processes to users.

The quality of communication and information in the KAMs is critical. The survey of investors showed that investors are most interested in knowing not only what the KAMs were, but also why the auditors identified those matters as KAMs. To effectively unlock the value of this change, KAMs need to be clear, informative and specific enough to enable readers to understand why the audit matters were 'key' and to understand the matters in their proper context. The description must go beyond stating the size of the matter or the extent of audit efforts involved.

Number of KAMs reported

Figure 10 shows the number of KAMs reported in companies' EARs, which ranges from disclosing no KAM[4] to a maximum of six KAMs.

Figure 10: Analysis of number of KAMs reported in companies' EARs



3. Malaysian Approved Standard on Auditing ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report.*
4. The two auditors' reports that reported no KAMs at all were both in a small market capitalisation group. In one, the auditor explained that there were no KAMs to be communicated – which the standards do allow for. The other KAM-less EAR was a qualified opinion, and the auditor explained that there were no other KAMs to communicate beyond the matter addressed in the Basis for Qualified Opinion section.

Figure 11 presents an analysis of KAMs disclosure by industry sector. The results do not suggest a relationship between the nature of the industries and the average number of KAMs. This is consistent with the fact that the number of KAMs is dependent on the complexity and circumstances of the company, as well as the auditors' judgement.

Figure 12 shows the distribution of the number of KAMs included in EARs in Malaysia sampled for this study and, for comparison, in Singapore[5].

Figure 11: Companies reviewed and average number of KAMs reported by sector

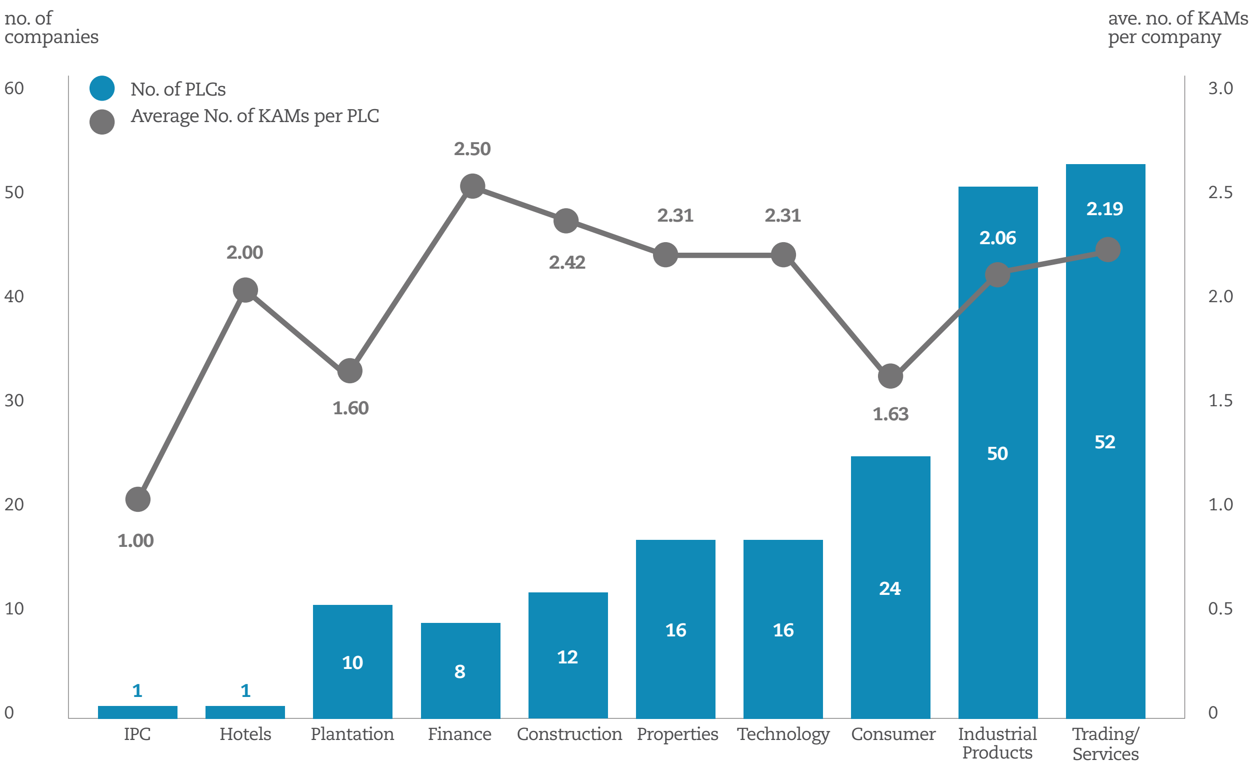
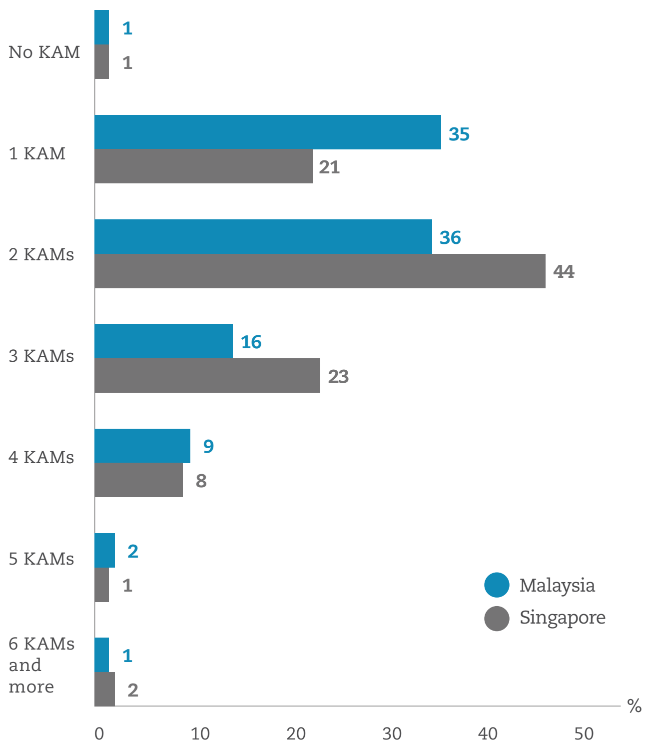


Figure 12: Distribution of KAMs included in EARs reviewed



5. Source: *Embracing Transparency, Enhancing Value: A first year review of the enhanced auditor's report in Singapore*, October 2017

Malaysia's average number of KAMs per EAR of 2.09 is close to Singapore's average of 2.3. Both markets experienced a lower number of KAMs in their first year of implementation than the UK, where an average of 4.2[6] KAMs per EAR was disclosed in the first year. This average fell slightly to 3.9[7] KAMs in the UK's second year of implementation. A number of reasons may account for the UK's higher average, which may be due to the greater size and complexity of reporting entities in UK.

Also during the focus group discussion, audit committee members acknowledged the tension auditors face when determining KAMs for inclusion. On the one hand, auditors might have wanted to raise more KAMs to ensure that they fully discharged their reporting duty. On the other, they had to manage management's concerns about the potential negative perceptions on the higher number of KAMs disclosed. One audit committee observed that due to years of reading boilerplate auditors' reports, companies and their stakeholders are 'hardwired' into thinking that any additional disclosures in the auditors' reports are negative.

'I think… we are hardwired to say that whatever is in the audit report is not good… and [so] if you have two companies… one has three KAMs and one has five [the perception is that] the other one must not be doing as good.'

'Beyond [KAMs, auditors and audit committees] do discuss a lot more things… The auditors may go along with the idea [to] drop… a KAM and [there is] nothing wrong with it because they have robustly discussed and they will be able to defend… how they dispensed with it. They have looked at the big picture [on] whether that should be… a KAM… I think they have many considerations which are very qualitative [and] judgemental, and I think we have to [be] very careful. It's not… one size fits all…'

Focus group, audit committees

6. Source: Extended Auditor's Report: A review of first year experience, UK FRC, March 2015
7. Source: Extended Auditor's Report: A further review of experience, UK FRC, January 2016

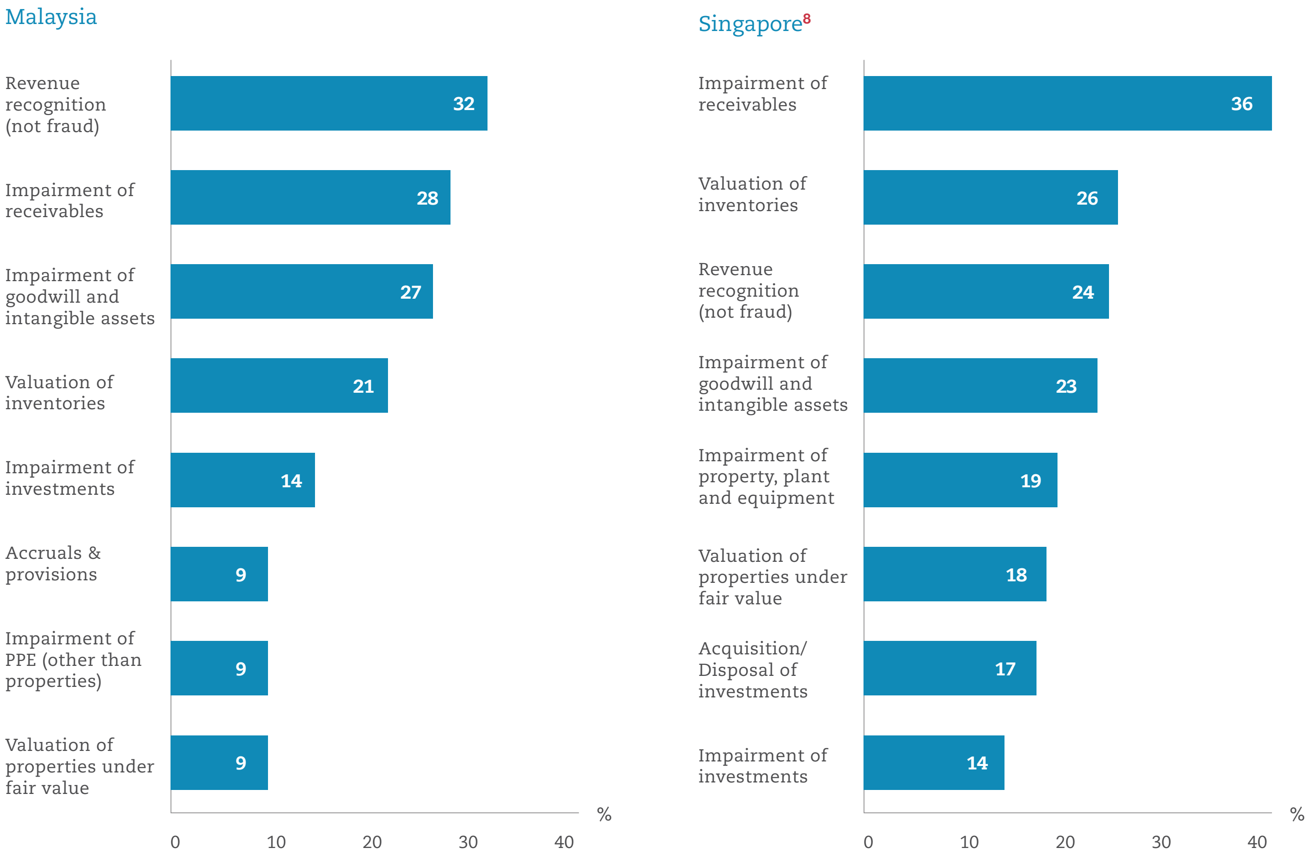
Other factors auditors need to consider include how to meaningfully discuss assumptions and how to discuss the KAMs in a tone that commensurates with the risks and significance of the KAMs. Auditors and audit committees should strive to educate investors and management that the number of KAMs included in an auditors' report is not a good measure of the quality of a company's governance and financial reporting. To develop a healthy and objective approach to identifying and selecting KAMs, auditors will need to guide companies about the implications of including KAMs and promote an understanding between companies and investors. As one audit committee member pointed out: 'Even though [a key audit matter represents]… a risk… the way it is resolved can show that the organisation has taken great strides in doing the right thing and it can be seen very positively on the investor's side as well.'

The important overarching point is that, even if an auditor proposes a KAM but decides not to include it after discussion with the audit committee, the robust discussion required to arrive at such conclusion is very valuable. The KAM selection process is an important opportunity for audit committees to fully explore issues to ensure that the risks are well managed, even if not all the KAMs are eventually included in the EAR. The KAM selection process is an important opportunity for audit committees to fully explore issues to ensure that the risks are well managed, even if not all the issues are eventually included as KAMs in the EAR.

Topics reported in KAMs

Figure 13 shows the top eight areas covered by the KAMs reported in the first year in Malaysia. The most commonly reported KAM topics in Malaysia related to revenue recognition (excluding fraud risk), impairment of receivables and impairment of goodwill and intangible assets.

Figure 13: Top eight KAM types reported as a proportion of all samples



8. Source: *Embracing Transparency, Enhancing Value: A first year review of the enhanced auditor's report in Singapore*, October 2017

It is worth noting that the topics covered by the KAMs reported in Malaysia are also commonly reported in Singapore. These topics encompass matters involving management's judgement, such as valuation and impairment assessments, and revenue recognition (other than fraud).

Figure 14 shows the top three KAMs reported by companies in each of the industries that appear to reflect the nature of the industry.

Figure 14: Top three KAMs reported by industry segment

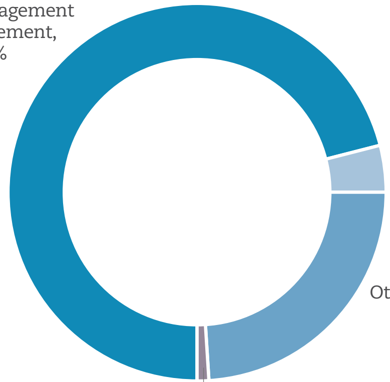
Sector	Top three KAM types reported		
	First	Second	Third
Overall	Revenue recognition (not fraud)	Impairment of receivables	Impairment of goodwill and intangible assets
Construction	Revenue recognition (not fraud)	Impairment of receivables	Impairment of goodwill and intangible assets
Consumer	Impairment of goodwill and intangible assets	Impairment of receivables	Valuation of receivables
Finance	Impairment of loan, advances and financing (for financial institutions only)	Impairment of goodwill and intangible assets	Impairment of investments
Hotels	Valuation of assets (others)	Going concern	Acquisition/disposal of investments
Industrial products	Valuation of inventories	Impairment of receivables	Revenue recognition (not fraud)
Infrastructure project companies (IPC)	Revenue recognition (not fraud)	Acquisition/disposal of investments	Valuation of financial instruments (equity and debt)
Plantation	Valuation of properties under fair value	Impairment of goodwill and intangible assets	Impairment of assets (others)
Properties	Revenue recognition (not fraud)	Impairment of goodwill and intangible assets	Valuation of properties under fair value
Technology	Impairment of goodwill and intangible assets	Impairment of receivables	Revenue recognition (not fraud)
Trading/services	Impairment of goodwill and intangible assets	Revenue recognition (not fraud)	Impairment of investments
Real estate investment trusts (REITS)	Acquisition/disposal of investments	Valuation of financial instruments (equity and debt)	Valuation of properties under fair value

The KAM selection process is an important opportunity for audit committees to fully explore issues to ensure that the risks are well managed, even if not all the issues are eventually included as KAMs in the EAR.

Reasons why matters were KAMs

Figure 15 shows the reasons for the selection of the 398 KAMs reported by the sampled companies, with the vast majority involving significant management[9] judgements.

Figure 15: Reasons for identification as KAMs



From the review, it was noted that many KAMs used generic descriptions which may not be able to clearly articulate the reasons auditors had judged the matters to be KAMs. Although this is the first year of implementation, it is important to ensure that all parties work towards better articulation on identification of KAMs to improve the ease of understanding of EAR.

Quality of KAMs and key observations

The quality of communication in the KAMs is vital to their mission of enhancing the value and relevance of the auditors' reports. KAMs are expected to be entity-specific or 'tailored' rather than general or 'boilerplate', and offer relevant and useful insights. They should be clear and jargon free.

Audit committee members were in strong agreement that boilerplate reporting of KAMs with unclear language would defeat the EAR's purpose and return auditors' reports to binary information and jargon that exclude the public.

The audit committee members acknowledged the need to counter several pressures that work against the production of clear and specific KAMs. The pressures against clarity, reported by audit committee members, included management's desire not to reveal insights to competitors. Such fears worked against efforts to make information specific to the company. A further difficulty was the inherently technical nature of the issues, which were therefore difficult to make relevant to everyday investors. To overcome this challenge, an audit committee member suggested that while a KAM description may align with language in the financial statements notes, the auditors can make a difference by explaining the audit work in readable and tailored terms.

9. For a company incorporated under the Companies Act 2016 in Malaysia, the directors have a statutory responsibility for the preparation of the financial statements, including the oversight of the financial reporting process.

'[In a] smaller [PLC] ... because it was a competitive situation... [management] do[es] not want the competitors to be completely [aware]... of what they are trying to get to. So there was a lot of discussion, but I think at the end it was a compromise and, of course, tailored a little bit... I am just thinking how much [the auditors will need to] compromise... but it should be clear enough for the shareholder... to clearly [understand]... exactly [what]... is being said.'

'When you talk about simplicity for the user... in terms of the audit report, [I would ask whether] the users really understand the difference between the three types of modified reports? I don't think so... If the user can't [even] understand [the difference] between disclaimer versus an adverse [opinion]... and how the wording should be, it doesn't matter what you put in the seven pages or eight pages [of EARs]. How simplified can you be? This is not selling a commodity for example a bottled drink. It is their professional opinion; I think we have to respect that.'

Focus group, audit committees

Good examples of KAMs

The review of EARs examined how well KAMs and other elements of the EAR fulfilled the expectations placed upon them by examining the language auditors used in their first year of issuing KAMs. This was complemented by surveying investors and audit committee members for their views on the quality of communication in the KAMs.

Generally, these positive examples:

- described comprehensively the issues in the KAMs and the reason the auditor considered them to be KAMs;
- included details of audit procedures performed and references to notes to the financial statements, as required by the standards;
- sufficiently elaborated how the auditors responded to the risks;
- used suitable and simple language that promoted a better understanding of the subject matter; and
- provided (voluntarily) a conclusion on the audit procedures performed on each KAM.

Among the reviewed EARs, several KAMs enabled users to thoroughly understand the issues in KAMs. A commendable example is set out below.

Key audit matters	How our audit addressed the key audit matters
Impairment of vessels Refer to Note 2.4 – Significant accounting policies, Note 3.2 – Critical accounting estimates and judgements, Note 16 – Property, plant and equipment	
Given the lack of recovery in the market, management had performed an impairment assessment of its vessels, which were affected by the downturn. This was predominantly the Offshore Marine Services (OMS) segment where certain vessels do not have long-term charter contracts, but spot or short charter contracts. The carrying amounts of the vessels were written down to the respective recoverable amounts, which is the higher of the fair value less costs of disposal and the value in use. Management engaged external independent valuers to determine the fair value of vessels with impairment indicators. The existence of significant estimation and judgement to arrive at fair value and value in use is why we have given specific audit focus and attention to this area. The details of the significant estimates and judgement used by management have been disclosed in Note 3.2 to the financial statements.	In relation to the fair value of the vessels estimated by the valuers, we held discussions with both the valuers and management to understand the methods and assumptions used in arriving at the fair value of the vessels. From our discussions with management and the valuers, we noted considerations were made to each vessel's individual specifications when estimating the fair value. We considered the valuers' objectivity and expertise based on their experience and reputation. We found no evidence to suggest that the objectivity of the valuers in their performance of the valuations was compromised. In relation to the value in use for certain vessels, we evaluated the reasonableness of key assumptions used by the management in arriving at the projected cash flows, i.e. future vessel utilisation and charter rates. We held discussions with management on future prospects of the OMS business and industry outlook on the OMS segment, in particular the anticipated period for oil and gas market to recover. We also corroborated the industry outlook on the OMS segment with external industry reports. Based on our procedures, the key assumptions were materially in line with our expectations.

(Bumi Armada Berhad – PricewaterhouseCoopers, 2016, page 187)

Audit committee members' and investors' views on KAMs quality: A need to align expectations

On average, while the reviewed EARs generally used non-technical terms in their reporting of KAMs and audit procedures, the survey results suggest a need for improvement to facilitate investors not only to understand KAMs, but gain insights from them. There is also a need to align the expectations of audit committees with investors about the level of clarity and specificity.

While 92% of surveyed audit committee members said the KAMs were drafted in a way that investors could easily understand, a much lower proportion of investors (65%) thought the KAMs were in fact easy to understand. Of the surveyed investors, accounting jargon was identified as a key problem in their understanding of KAMs reported. Generally, the investors were of the view that KAMs need to be more concise and precise about the risks and audit procedures.

Examples of both are as follows, where different approaches are used to describe verification of inventory accuracy. While the example for Marco Holdings Berhad is commendable in voluntarily disclosing the outcome to audit procedures performed, the example for Press Metal Berhad has used simpler, more straightforward wording to describe the audit procedures performed which is easier for users' overall understanding.

Key audit matters - Inventories

Per the Group's accounting policy, inventories are valued at lower of costs and net realisable values. As explained in Note 1(d)(i), management's assessment of percentage of write down for inventories is based on the experience and judgement of the management. In addition the value of inventories as at 31 December 2016 is material to the financial statements.

Our audit procedures included among others are as follows:

Discussed with management to understand the methodology used for Group's inventories write down policy and the assumptions applied. We evaluated the methods of measurement and assumptions used with reference to product historical performance and current market price. We also assessed the potential risk for management bias. We tested the **mathematical integrity of the value of inventories written down based on the agreed methodology**. We also assessed whether the inventories are valued at lower of cost and net realisable value. We found no errors in the calculation and the methodology has no indication of management bias and is consistently applied with that adopted in prior years.

(Marco Holdings Berhad – PCCO PLT, 2016, page 36)

Valuation of inventories

Refer to Note 2(h) – Significant accounting policy: Inventories and Note 10 – Inventories

The key audit matter

Inventories represent the second largest category of assets on the statement of financial position of the Group, at RM1,011,299,000 as at 31 December 2016. There was a significant degree of judgement involved to ascertain that the cost of inventories accurately reflects the manufacturing costs incurred in bringing them to their physical location and condition. This particularly relates to the assessment of direct labour costs incurred, manufacturing overheads to be absorbed and other relevant production costs.

How the matter was addressed in our audit

We performed the following audit procedures, among others:

- We agreed the cost of raw materials to suppliers' invoices on a sampling basis. For work-in-progress and finished goods, we assessed whether the absorption of fixed production overheads was based on a normal capacity of the production facilities and variable production overheads were absorbed into each unit of production on the basis of the actual use of the production facilities.
- We also **assessed whether all costs included as inventories comprise costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.** In particular, we considered the nature of the overheads absorbed to ascertain whether only directly attributable costs were included. We also considered production levels to ensure inefficiencies were not absorbed.

(Press Metal Berhad – KPMG PLT, 2016, page 209)

Audit committee members and investors also diverged on their view of how tailored the KAMs were. About 91% of surveyed audit committee members considered the KAMs to be sufficiently tailored, while only half of the investors—the target audience—shared this view.

The divergent views of audit committee members and investors were mainly due to audit committees being familiar with the issues raised, while investors do not have the same level of knowledge or access to information and, therefore, will demand more information. This was confirmed during the focus group discussion, where an audit committee member explained:

'I think [this is] because we assume and we are involved [in] the discussion. So, to us it is very clear, but actually, if you take a look at it from the other party's [perspective], it may not be as clear because they don't have all the information.'

Focus group, audit committees

The wide gap between the perception of audit committees and the expectations of investors reveals a significant opportunity for improvement. Tailored descriptions will make the EARs more valuable to investors and therefore more engaged with the company. Audit committees and auditors should review KAMs from the perspective of what an investor is able to understand, as well as what they would be keen to know.

Another perspective about the drivers behind the quality of KAMs communication was whether auditors were able to withstand pressure from management, and the corresponding need for audit committees to play a more active role in ensuring that clarity in the KAMs is not compromised. This is important especially for the smaller companies with less well-developed governance and reporting structures. As one audit committee member put it:

'[Effectiveness of KAMs is] very dependent on how the auditors use the language… [if] the language is too [boilerplate], then it goes back to the same thing. Because previous reports were very much a binary pass/fail. So, if the language is again compromised, then… it's not really going to highlight the key audit matters.'

Focus group, audit committees

Indicating outcomes or results of KAMs procedures

While the standards do not require auditors to include the outcomes or results of their KAM procedures, they may include their conclusions voluntarily, without suggesting a standalone opinion on the associated financial statement items. The aim of including conclusions is to help readers understand how they addressed each KAM in the audit.

In practice, very few KAMs – 11% of the sampled KAMs – included outcomes or results of the audit work performed for KAMs, all of which were generic in nature. However, discussion about the merits and possible pitfalls of including KAM conclusions continues, as shown in the survey of audit committee members and investors.

A total of 70% of the surveyed audit committee members considered it critical or very critical for auditors to voluntarily include conclusions or include conclusions or findings on each KAM. The proportion of investors who considered such discrete conclusions as critical or very critical parts of the EAR is higher (76%). Significantly, the surveyed investors gave this similar importance as the identification of KAMs and even the overall true and fair opinion.

While conclusions are not required under the standard, auditors should be aware that sharing outcomes of their procedures is one of the ways to help drive clarity in how KAMs are addressed. We envisage that with more experience in issuing the EAR, auditors will have more confidence to provide greater insights into the audit and provide more granular descriptions when disclosing the outcomes resulting from their procedures. Some examples are included below.

We have observed that auditors have adopted similar approaches in describing the outcomes or results of their procedures, as can be seen from the following examples of statements included in some of the auditors' reports:

Based on the result of audit procedures, we are satisfied that impairment loss for trade receivables of the Group have been in line with the Group's policy and we did not identify any material exception.

Based on our assessment, there were no significant exceptions noted, except that the surveyor report prepared by the quantity surveyor should be reported on a category basis. We have highlighted this to the management through a management letter.

Commentary by audit committees

While auditors take full responsibility for determining and drafting KAMs, audit committees play a crucial role in supporting auditors in the KAMs selection process. In particular, audit committees are the guardians of the companies' internal controls and the integrity of financial reporting. As KAMs direct investors' attention to matters under the watch of audit committees, audit committees can leverage on the intensified attention to have a deeper engagement with investors on these matters.

In Malaysia, coordinated efforts by the regulators, industry and accounting profession led to regulatory changes; in particular, amendments to the Bursa Malaysia Listing Requirements.

The audit committee's role when reviewing financial statements has been strengthened to also focus on significant matters highlighted in the financial statements and significant judgements made by management.

The audit committee report is also required to disclose how the audit committee has met its responsibilities in discharging its functions and duties for the financial year. This provides audit committees with the opportunity to share their views on the reported KAMs.

Most investors, at 82%, felt that it is important for audit committees to comment on KAMs.

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Investors in the focus group observed that if audit committees do not proactively respond to the KAMs, they are left with only 'one side of the story'.

'If you looked at audit committee reports… pre-KAMs era and post-KAMs era, I think most of them are still saying the same thing… So there doesn't seem to be that dialogue between what the auditors have been highlighting as potential areas of focus, judgement areas (and) how management is then dealing with it… so… investors are perhaps not getting the complete value of KAMs because we are not hearing the two sides of the stories.'

Focus group, investor

Additionally, the survey revealed the information that investors are interested in seeing in the KAMs, which audit committees can proactively provide in their commentaries. For example, 75% of investors surveyed were interested in information that will help gauge the company's quality of reporting. A similar proportion (78%) was interested in receiving information on how a company's practices compared to industry benchmarks. Responding to such calls for more insight could represent an opportunity for audit committees to enhance their role as guardians of financial integrity and transparency.

The review of the EAR revealed some exemplary examples of the audit committees' commentary on KAMs. However, overall, few audit committees' commentaries in the sample reports discussed the KAMs in any depth. The majority only made generic statements. Examples of exemplary and generic statements are set out below.

An example of audit committee generic reference to the KAMs:

Reviewed with the management on any significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements and steps taken to address the matters.

Reviewed with the External Auditors at the meeting held on 23 November 2016, their audit plan in respect of the financial period ended 31 December 2016, outlining the auditors' responsibilities, materiality, audit risks assessment, significant risks and areas of audit focus, fraud consideration, internal control plan, involvement of internal auditors and component auditors, timing of audit, engagement quality control, independence policies and procedures, and also on financial reporting and other updates.

In some companies, there was only a brief mention of KAMs within their 'Audit Committee' section, with no subsequent elaboration on the KAMs. For example:

Other main issues discussed by the AC include key audit matter, in relation to the impairment of investment in subsidiaries and property, plant and equipment, addressed in the audited report for the financial year ended 31 December 2016.

In contrast, several companies went through extra efforts and exhibited exemplary practices regarding the extent to which the audit committee gave significant attention to KAMs. For example, BIMB Holdings Berhad not only specifically mentioned its audit committee's discussion on KAMs, but also provided a thorough discussion closely corresponding to the KAMs reported by auditors. Extracts of both types of disclosures are set out below:

Specific mention of audit committees' discussion on KAMs:

During the year under review, the GCFO and the External Auditors have highlighted on the new requirements on key audit matters. A special briefing for the Board and the Management of the Group on the new financial reporting standards, including the requirements on key audit matters was organised. The briefing was conducted to help the Management and the Board to understand the requirements of the new/revised standards and to facilitate actions to address and meet the new requirements within the stipulated deadline.

(BIMB Holdings Berhad, 2016, page 110)

Corresponding disclosures in the auditors' report and audit committee's report are as follows:

<table>
<tr><th colspan="2">Extract from auditors' report</th><th>Extract from audit committees' report</th></tr>
<tr><th>The key audit matter identified are:</th><th>How the matter was addressed in our audit</th><th></th></tr>
<tr><td>Allowance for impaired Financing and advances and others

The risk is that the carrying value of Financing and advances to customers held at amortised costs may be misstated.

Impairment is a subjective area due to the level of judgement and assumptions applied by management in determining both collective impairment and individual impairment allowances.

Refer to the significant accounting policy in Note 2.5 and 2.11, the disclosure of financing and advances in Note 9 and the disclosure of credit risk in Note 45.3.</td><td>The Group and Company's impairment assessment of financing and advances are collective impairment allowances and individual impairment allowances.

Our procedures in addressing this key audit matters are as follows:

<u>Collective Impairment Allowances</u>
Our procedures to assess management's provision for collective impairment allowances included, amongst others:
• assessed the design and operating effectiveness of controls implemented in identifying potentially impaired financing, classifying financing and adequacy of impairment allowances;
• checked the impairment allowance computation for consistency of methodology and compliance with MFRS 139, Financial Instruments: Recognition and Measurement and Bank Negara Malaysia Guidelines;
• reviewed management's reassessments of the appropriateness of key assumptions used in the collective impairment allowance methodology.

<u>Individual Impairment Allowances</u>
Our procedures to assess management's provision for individual assessment allowances, in response to the risks specific to the business units included, amongst others:</td><td>Allowance for impaired financing and advances and others

<u>(i) Collective Impairment Allowances</u>
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 [address the] group's 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.</td></tr>
</table>

Extract from auditors' report (con't)		**Extract from audit committees' report (con't)**
The key audit matter identified are:	**How the matter was addressed in our audit**	
	Consumer Banking We obtained an understanding of management's basis for determining whether a financing and advances is impaired and assessed the reasonableness of the impairment allowance using our understanding of the Group and Bank's financing portfolios and our broader industry knowledge. The impairment is calculated using a methodology. We therefore tested the completeness and accuracy of data from underlying systems that is used in the methodology. We obtained an understanding and critically assessed the impairment methodology used. The impairment is computed based on historical data. We discussed with senior management and challenged the appropriateness of the assumptions used to determine whether it was representative of current circumstances and the recent losses incurred in the portfolio. *Corporate and Commercial Banking* We obtained an understanding and tested the process for identifying impairment indicators within the financing portfolio and consequently, the grading of financing and advances. All customers in relation to financing and advances of the Group and the Bank are graded. Individual customers will be downgraded upon identification of events leading to impairment.	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. (ii) Individual Impairment Allowances Significant financing, that is, total financing outstanding of RM1 million or more are assessed individually. For individually assessed financing, objective evidence of impairment exists if there is a breach of contract, if the customer has significant financial difficulty, if it becomes probable that the customer will enter bankruptcy or other financial reorganisation or if there is consecutive downgrade of two notches for external ratings.

Extract from auditors' report (con't)		Extract from audit committees' report (con't)
The key audit matter identified are:	**How the matter was addressed in our audit**	
	We assessed the Group and the Bank's credit review process on the credit worthiness of selected customers. We selected a sample of financing customers, taking into consideration of industry trends/macroeconomic factors, e.g. commodity crisis, lackluster property market, etc. In particular, we focused on the plantation, real estate, and oil and gas portfolios which are higher risk due to the current economic conditions. For a sample of individually impaired customers we obtained an understanding of the latest developments and the basis of measuring the impairment allowances and considered whether key judgements were appropriate given the customer's circumstances. In addition, we also tested the key inputs to the impairment computation including the expected future cash flows, discount rates and valuation of collateral held. Additionally, we selected samples of performing financings and assessed that the borrowers did not exhibit any definable weaknesses that may jeopardise the repayment abilities.	The amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective profit rate. In estimating the future cash flows, judgements are made about the realisable value of the collateral pledged and the customer's financial position. The BHB Group also proactively monitors and identifies financing that show signs of stress and could potentially become impaired. The account management officers engage with such customers to advise, restructure and reschedule these accounts. The estimated future cash flows of these accounts are also reassessed and any shortfall in impairment allowances are immediately provided for. The Group's AEC is also updated on the status of these large individual financing accounts. The Credit Management team provides AEC the detailed listing of the individual accounts and the judgement exercised around the individual impairment provisions.

(BIMB Holdings Berhad – KPMG Desa Megat PLT, 2016, pages 280-281)

(BIMB Holdings Berhad, 2016, pages 111-112)

Two other examples of exemplary practices where audit committee reports displayed thorough discussions closely corresponding to KAMs reported by the auditors are shown below:

Extract from auditors' report		Extract from audit committee's report
Key audit matters	**How our audit addressed the key audit matters**	**Asset impairment testing**
Impairment review of plant and equipment in repair, servicing, maintenance and overhaul of motors business – Cash Generating Unit (CGU 1) (RM4.4mil) Due to historical losses, management had performed an impairment review of the plant and equipment in CGU 1 amounting to RM4.4 mil in accordance with the requirements of MFRS 136 'Impairment of Assets'. Refer to page 86 (Note E Summary of significant accounting policies), page 103 (Note 3 Critical accounting estimates and judgements). We focused on this area due to the quantum of plant and equipment of RM4.4 mil as at 31 December 2016, and because management's estimate of the entity's recoverable amount based on the 'Value in Use' method involved the use of key assumptions in deriving the future cash flows which are judgmental and therefore sensitive to estimate changes. The discounted cash flow projection of 5 years relied on the use of key assumptions as disclosed in Note 3 to the financial statements. The key assumptions used are revenue growth rate and EBITDA margins. During the financial year, a full impairment loss of RM4.4 mil was recorded in the statement of comprehensive income for the plant and equipment.	• Evaluated management's cash flow projections and the process by which they were developed to ensure key inputs are in line with cash flow projections approved by the Board of Directors; • Compared management key assumptions comprising revenue growth rate and EBITDA margins to historical trend and industry forecasts; • Checked the achievability of the budget used in the cash flow projections to prior actual and budgeted outcome. Based on the procedures performed, the results of our findings are consistent with management's assessment.	The judgements in relation to asset impairment largely relate to the assumptions underlying the calculation of the value in use of the business being tested for impairment, primarily the achievability of the long-term business plans and macroeconomic assumptions underlying the valuation process. This review was centred on two entities that were trading at a loss in the current and previous years giving rise to an impairment indicator that these assets might not be used profitably. Management had reviewed the usage of these assets consisting mainly plant and equipment against the related business plans for the coming year. The review indicated that assets with a carrying value of RM4.4 million were unlikely to be used for the generation of income. Accordingly, an impairment charge of the same amount was recognised in the financial statements of the current year. The AC has satisfied itself that the assessment and related actions taken by Management have been properly prepared and reviewed by the external auditors.

(Deleum Berhad – PricewaterhouseCoopers, 2016, page 161)

(Deleum Berhad, 2016, page 60)

Extract from auditors' report		Extract from audit committee's report	
Key audit matters	**How our audit addressed the key audit matters**	**Matter considered**	**Action**
Assessment on carrying value of goodwill		**Carrying value and recoverability of Goodwill**	
As at 31 December 2016, the Group's goodwill amounted to RM361.7 million, attributable to 2 significant cash-generating units (CGUs); VADS Berhad (RM308.4 million) and webe (RM52.1 million). We focused on these areas as the recoverable amount of these CGUs is subject to the use of significant accounting estimates and assumptions in the projected future cash flows. Refer to notes 2(f)(i), 3(c) and 24(b) to the financial statements.	Based on the recoverable amount calculations, we performed the following: • Agreed the cash flows to the budgets approved by the Board of Directors; • Discussed with management the key assumptions used in the recoverable amount calculations and compared the revenue and subscriber growth rates, and earnings before interest, tax, depreciation and amortisation (EBITDA) margin used in the cash flows to the historical performance of the CGUs and market comparable data; and • Checked the reasonableness of the discount rates and terminal growth rates with the assistance of our valuation experts by benchmarking to market comparable data. We also performed sensitivity analysis around the EBITDA margins, revenue and subscriber growth rates. Based on the procedures performed above, no impairment is required as the recoverable amounts for both CGUs exceed the carrying values.	The Group tests the carrying value of goodwills for impairment annually in accordance with its accounting policy or whenever events or changes in circumstances indicate that this is necessary. The assumptions used, results and conclusion of the impairment assessment are stated in note 24 to the financial statements.	Board Audit Committee (BAC) reviews and provides comments on the assumptions and parameters used in the annual review and test of carrying value of two significant goodwills carried by the Group, i.e. VADS Berhad and webe. Key parameters used, assumptions applied in projecting future cash flows and reasonableness of resulting uplift or otherwise in the resulting recoverable values are flexed and challenged through due sensitivity analysis, as well as appropriate benchmarking against the telecommunication industry and comparable peers. The necessary disclosures for inclusion in the Group's financial statements and Integrated Annual Report are also scrutinised in assessing the adequacy of the disclosures made for due understanding and relevance of key stakeholders in providing the necessary future outlook over the carrying value of the goodwills.

(Telekom Malaysia Berhad - PricewaterhouseCoopers, 2016, page 332)

(Telekom Malaysia Berhad, 2016, page 146)

KAMs and significant accounting estimations and judgement

As required under the Malaysian Financial Reporting Standards (MFRS)[10], companies disclose significant accounting estimates and judgement (SAEJ) used in the preparation of financial statements. SAEJ represents the estimates that require the 'most difficult, subjective or complex judgements' (MFRS 101.127/IAS 1.127[11]). It is reasonable to expect that many of the matters included in the SAEJ disclosures will be the most significant in the audit as well and, therefore, prime candidates for KAMs disclosures.

However, we observed in our review of annual reports that a large number of SAEJs disclosed in the financial statements were not identified as KAMs in the respective auditors' reports. In general, based on the annual reports reviewed, the number of SAEJ disclosures in the financial statements were much higher than the number of KAMs in the EARs. A total of 19 companies had more than 10 SAEJs disclosed, with one company having the largest number of 17 SAEJs. In comparison, the largest number of KAMs based on our sample was six (the auditors of three companies included six KAMs in each of their reports). And on average, a company disclosed 5.28 items under SAEJ, while only 2.09 were identified as KAMs.

It is a good practice for the auditor and company to compare the SAEJ disclosures in the financial statements with the KAMs disclosed in the auditors' report to ensure that any inconsistencies are reasonable, justified and based on considered judgement.

'Close Call' Situations and Material Uncertainty related to Going Concern

Following the global financial crisis and ongoing periods of economic volatility, investors and others have requested earlier warning of potential issues that may exist with respect to a company's ability to continue as a going concern. In response, new requirements were introduced to support the auditors' evaluation of disclosures on going concern.

Where a material uncertainty related to going concern (MUGC) exists, the auditor shall either include:
- if the disclosures are adequate, a separate section under the heading 'Material Uncertainty Related to Going Concern' drawing attention to those disclosures; or
- if the disclosures are inadequate, a modified opinion as the first section of the auditors' report.

However, the auditor may also conclude that no material uncertainty exists relating to events or conditions that may cast significant doubt on the company's ability to continue as a going concern, i.e. in a 'close call' situation[12]. Accordingly, one or more matters relating to this conclusion may be determined as KAMs.

Of the 190 auditors' reports reviewed, two companies reported a separate section on MUGC in the auditors' report. There were no examples of modified opinion expressed due to inadequate disclosure on MUGC.

10. The Malaysian Financial Reporting Standards (MFRS) framework was issued by the Malaysian Accounting Standards Board (MASB) in November 2011 in conjunction with its plan to converge with International Financial Reporting Standards (IFRS) in 2012. The MFRS framework is a fully IFRS-compliant framework.
11. MFRS 101/IAS 1, *Presentation of Financial Statements.*
12. *IAASB's Auditor Reporting Toolkit* on Going Concern clarifies that 'close call' situations refer to those where events or conditions were identified that may cast significant doubt on the entity's ability to continue as a going concern but, after considering management's plans to deal with these events or conditions, management and the auditor conclude that no material uncertainty exists.

Example where a 'close call' situation was reported as a KAM is as follows:

Key audit matters	How our audit addressed the key audit matters
Delay in the Kraken FPSO project in meeting the Backstop date Refer to Note 2.12 & 2.13 – Significant accounting policies, Note 3.1 & 3.7 – Critical accounting estimates and judgements, Note 4 – Financial risk management objectives and policies, Note 6 – Revenue, Note 45 – Significant and subsequent events	
An Amendment Agreement was signed during the year between Armada Kraken Pte. Ltd ("AKPL"), a subsidiary of Bumi Armada Berhad, with the charterers of the floating production, storage and offloading vessel ("FPSO") to be deployed at the Kraken Field at the United Kingdom Sector of the North Sea ("Field"). The key terms are as disclosed in Note 45 to the financial statements. As at the date of approval of the financial statements, the Kraken FPSO project is progressing (riser and umbilical hook up have been completed). The Group is negotiating with the charterers to revise the backstop date of 1 April 2017 for first production, failing which the charterers have the right to terminate the charter. As at the date of approval of the financial statements, the Group and the charterers have agreed in principle on a new backstop date of 15 July 2017. Please refer to Note 45 of the financial statements for further details. One of the consequences of a termination by the charterers is the repayment of the term loan to the lenders if lenders serve a notice of default.	Revenue recognition We read the terms of the Amendment Agreement and evaluated the financial impact to the change in milestone dates to the FPSO charter. Correspondingly, we considered management's accounting over liquidated damages and supplemental payments arising from any delays in fulfilling the terms of the Amendment Agreement based on management's assessment of the anticipated new Backstop Date. We also corroborated our understanding of contractual terms through discussions with the Legal Department on their assessment of AKPL's obligations. We discussed with management to understand progress of projects and its related cost estimates to assess whether there was any related impact to forecasted costs to complete and contractual obligations. We validated project budgetary controls and tested approval over changes in cost estimates. Based on the procedures performed above, we did not find any material exceptions in revenue recognition.

Key audit matters (con't)	How our audit addressed the key audit matters (con't)
With regards to the above, the Directors have considered the impact of various outcomes on the liquidity position of the Group, taking into account the Group's forecast cash requirements and the funding sources available to the Group to meet its debt service obligation over the next 12 months from the date of approval of the financial statements. Please refer to Note 4 of the financial statements for further details. Given the contractual right for termination by the charterers and the consequent potential for the lenders to serve a notice of default and seek repayment of the loan thereafter, we gave audit focus in considering the financial implications of the terms of the Amendment Agreement on the Group's conversion revenue recognition and the ability of the Group to meet its obligations as and when it arise.	<u>Liquidity position of the Group</u> We had discussions with the Chief Executive Officer, Chief Financial Officer, Head of Legal to understand: • Action plans in mitigating the delay and achievability of the new Backstop Date being negotiated; and • Status of negotiations with the charterers and lenders on the consequences of delay. We read minutes of discussions between the legal counsels of the charterers and lenders with management on the status of negotiations as at the date of approval of financial statements, assess whether management's present assessment that the outflow of resources based on the various outcomes anticipated, had a material impact to the liquidity position of the Group for the next 12 months from the date of approval of the financial statements. We have also tested Group's cash flow forecast for the next 12 months from the date of approval of the financial statements to assess the reasonableness of management's assessment that the Group is not likely to have any event of default declared on its debt service obligations arising from various outcomes of the ongoing negotiations, taking into consideration sources of funding available to the Group to meet its obligations as and when they arise. Based on the procedures performed, we found the assessment made by management in relation to the liquidity position of the Group to be reasonable.

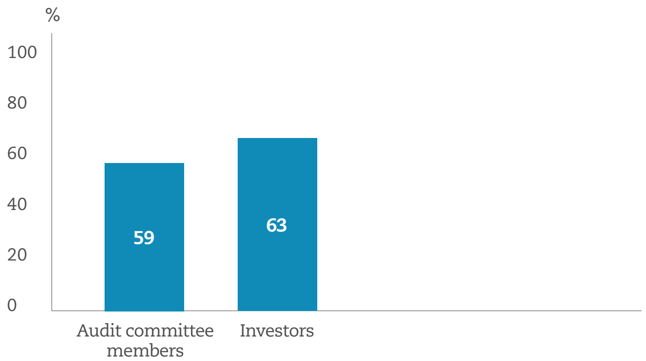
(Bumi Armada Berhad – PricewaterhouseCoopers, 2016, pages 188-189)

Voluntarily disclosing materiality level used in audit

The enhanced auditor reporting standards do not require auditors to disclose the materiality threshold that they have used in the audit, although auditors may disclose this voluntarily. However, the UK introduced an additional disclosure requirement for auditors to specify the threshold used as materiality for the financial statements as a whole in the auditors' report.[13] Such disclosure is currently not required in Malaysia and Singapore.

Based on feedback by respondents in the survey, the majority of audit committee members (59%) and investors (63%) felt that the auditors should voluntarily disclose the materiality used in the audit and for better understanding of the extent of work performed (Figure 16).

Figure 16: Preference for voluntary disclosure of materiality threshold in EAR



13. ISA (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statements.*

SECTION 3

Positive Impact: Enhanced Corporate Reporting and Auditing

Audit committees still considered the most critical aspect of the auditors' report to be the overall true and fair audit opinion, but ranked new features such as the identification of KAMs highly. Investors too were as interested in the KAMs as they were in the overall true and fair audit opinion.

The advent of EARs has driven positive change throughout the financial reporting ecosystem, in both process and perception, according to the survey results and focus group discussions. It is encouraging that the views expressed in the focus groups and surveys about the first year of implementation have been constructive, with a view to enhancing not just the audit reporting process but, ultimately, engagement between investors and those charged with governance.

The change also, as one audit committee member put it, 'kept people on their toes', especially as company management and directors had no precedent to follow or experience to learn from. Fortunately, the first year of experience indicates a more positive outlook than some might have worried about.

Most audit committee members (78%) and investors (73%) agreed that the EAR is an improvement over the old format of the auditors' report. Those who were indifferent to the change were a distinct minority: 17% of audit committee members and 18% of investors did not have a preference for either format. While the level of indifference seems low, the audit profession should monitor and reduce the level of indifference or ambivalence by continuing to improve the value and relevance of the auditors' report.

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Need to focus on confidence in audit quality

A total of 67% investors in Malaysia reported increased insight into the audit process as a result of the EAR as compared to 60% in Singapore. In both Malaysia and Singapore, the majority of surveyed investors (57%) reported increased confidence in the quality of audit as a result of the EARs and, in particular, the KAMs. This leaves some room for improvement.

In contrast, those who see the auditors 'in action' – the audit committee members – reported higher increased confidence, with 77% feeling better about audit quality in Malaysia as compared to 56% in Singapore.

The difference in perception between audit committees and investors suggests an opportunity for auditors to better describe their audit issues and procedures, and thereby gain higher investors' confidence in their work.

Acknowledged value of auditors' additional efforts

The audit profession can take heart that the survey results show acknowledgement of the additional efforts devoted by auditors in order to report the KAMs and other additional matters in the EAR.

A total of 76% of surveyed audit committee members recognised moderate or substantial additional efforts on the part of auditors. A significant 86% of investors recognised that auditors had made substantial or moderate incremental efforts to produce the EARs, while 67% felt that the additional time spent was worth the effort. As investors cannot 'see' the auditors' work, their perception is based on the 'output'. It therefore appears that the quality of KAMs by themselves (for example, if they contain specific and insightful information) is evidence to the investors that the auditors must be putting in more work.

More robust discussion throughout the audit process

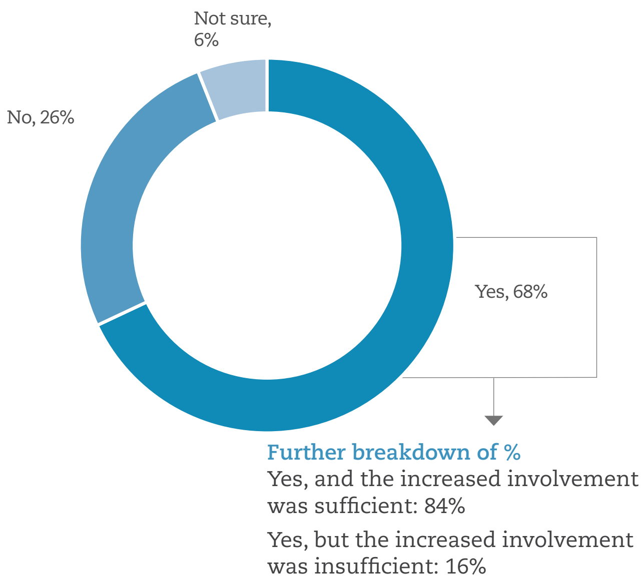
A measure of the EAR's improved role in the financial reporting ecosystem is the extent to which it changes behaviour, so that each stakeholder proactively and robustly improves financial reporting in their companies.

The behavioural change was evident in the discussions among audit committees, management and auditor, which in turn led to better outcomes in the form of better insights into a company's financial reporting risks. In simple terms of time spent on the EAR, audit committee members reported spending additional time reviewing and considering KAMs. Nearly a third of audit committee members spent half a day and nearly half spent one to three days on KAMs and the EAR. A small minority spent over four days and even fewer over a week.

Significantly, the same proportion of 85% of audit committee members agreed that the need to discuss issues that KAMs should cover have led to more robust discussion with management and auditors. This led to a better overall understanding of the financial reporting risks. As many as 86% of audit committee members reported that they had gained moderately or significantly deeper insight into financial reporting risks of their companies as a result of considering KAMs and reviewing the EAR.

Figure 17 below shows that the discussions between audit committees and auditors have improved. A majority of audit committee members (68%) witnessed an increased involvement of the audit partner in the audit, and 84% of this group considered the increased effort to be sufficient. The remaining 16% of this group felt that the increased involvement was insufficient. There were also those who did not observe increased involvement by the audit partner (26%), potentially because audit partners' involvement was already sufficient before the implementation of EAR. The senior audit personnel's involvement is key to audit quality and the development of clear and insightful EARs for investors.

Figure 17: Increased involvement of audit partner in the audit as a result of KAMs reporting



The focus group discussion among audit committee members further highlighted a real sense that the need to identify and articulate KAMs for public consumption makes the discussion more focused and thorough.

Singling out the most important issues in the eyes of the auditors not only improved the discussion between audit committees and auditors, it also strengthened the independent directors' role in challenging management to ensure objectivity and integrity in financial reporting on behalf of investors.

'For [board] members like myself who are not actually [executive]… not only does it raise significant issues, I feel that it also forces the auditors to tell us how they are going to resolve it, which is also critical for us to understand how the audit is being done. And… it also strengthens the position of independent directors. It brings the core topics, the core issues and risk to the table.'

'For audit committees… [EAR] gives us a lot confidence now in dealing with audit issues. I think we are being more transparent and we use that as an opportunity to put pressure on the management to come forth with all explanations.'

'[The EAR] gets the board and the auditors in a robust discussion… it was really very tense… And we didn't have this [tense conversation] before the EAR came about. …It puts a lot of pressure on everybody, including the auditors and the management.'

Focus group, audit committees

Improved corporate disclosure and investor engagement

Improved perceptions and changing behaviour were evident among investors, as well as those charged with governance. A substantial 86% of surveyed investors said that the inclusion of more information in the EAR made them more likely to read the auditors' report before the financial statements.

The EAR's role as a guide or primer for the financial statements appears to have had a flow-on effect into investors' understanding of the companies' financial reporting. A total of 67% of investors agreed that the EARs had helped them moderately or significantly better understand the financial reporting risks of the companies in which they had invested.

This understanding also applied to the audit itself, with 67% of investors feeling that the KAMs gave them deeper insights into how the auditors conducted the audits.

Translating insight into action

How did the more robust process and improved insights translate into action on the part of company management, audit committees and investors? The survey suggests the beginnings of behaviour change, as well as an opportunity for improvement.

Nearly two-thirds (64%) of surveyed audit committee members indicated that, based on their experience, the process of considering KAMs and reviewing EAR had resulted in the board and management making improvements to disclosures in the financial statements. To a similar extent, 59% of surveyed audit committee members also noted improvements to the other elements within the annual report – for example, management discussion and analysis, chairman's and CEO's statements – as a result of considering KAMs and EARs.

Investor action and engagement

The increased transparency brought about by the EAR appears to have created the potential for increased engagement with investors and other stakeholders, but has yet to spur investors into action. The survey results and focus group discussions suggest a need to encourage investors to use their new-found insights from the KAMs to engage management and auditors in conversation, and so enhance their knowledge and accountability.

A significant proportion of retail investors found KAMs particularly helpful in identifying financial reporting and audit matters to raise at annual general meetings (AGMs) to the auditors (80%) and to the board of directors and management (81%).

However, this does not appear to have translated into action. Only 60% of surveyed audit committee members reported their companies as having increased engagement with investors and other stakeholders. Most of this (69%) was at AGMs, while a significant proportion (44%) reported more engagement with analysts and a further 24% with banks.

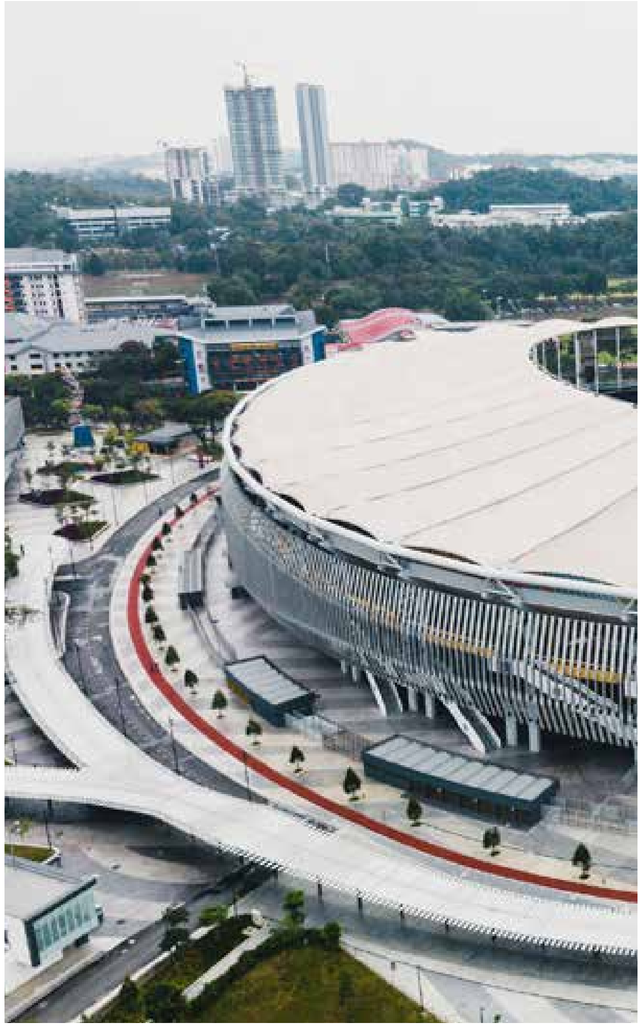
Over one-third of investors surveyed said that the availability of the KAMs had changed their approach towards analysing investment risks of companies. If investors want to fully reap the potential value of EARs, they will need to make active use of the new tool that auditors are providing them in the form of the EAR. On the other side of the equation, auditors should note the potential of the EAR is there, but not yet realised. Development of good EAR and KAMs practices will help investors make better use of the EAR.

When considering the value and usefulness of the EAR to investors, an important context acknowledged in the focus groups was that investors still pay insufficient attention to financial reporting and are not interested in engaging at AGMs – which the KAM by itself is not going to solve. More time would be needed for KAMs to have an impact on engagement. Some audit committee members, however, did witness investors asking questions for the first time, which they ascribe to the introduction of the KAMs.

While audit committees acknowledged that the EAR is an improvement, the auditors' report still has inherent limitations and should be evaluated in the context of other useful information, and other aspects of corporate governance that can go wrong, which the auditors' report does not cover.

‘If you are expecting the KAMs to cure everything, I think you’re being sadly mistaken. You’ll find that a lot of the wrongdoings in enforcements actions taken by Bursa [Malaysia]’s Listing Committee or Securities Commission [Malaysia] or even Bank Negara Malaysia… are [mostly] process-related or non-compliances with listing requirements or other things that can never be transcribed into KAMs. So an expectation gap definitely exists… You cannot cure [this]. It’s not the auditors’ fault… At the end of the day… we have to [be] mindful that it’s just one of the cogs in the wheel.’

Focus group, audit committees



Other Information[14]

Significant developments in corporate reporting, particularly in relation to the amount of detail included in a company's annual report, as well as the importance ascribed by users to the information in annual reports, beyond the audited financial statements and the auditors' report thereon, have led to changes to the auditors' responsibilities relating to OI.

The Malaysian Approved Standard on Auditing, ISA 720 (Revised), *The Auditors' Responsibilities Relating to Other Information*, requires the auditor to read the OI and to conclude whether there is a material inconsistency between:

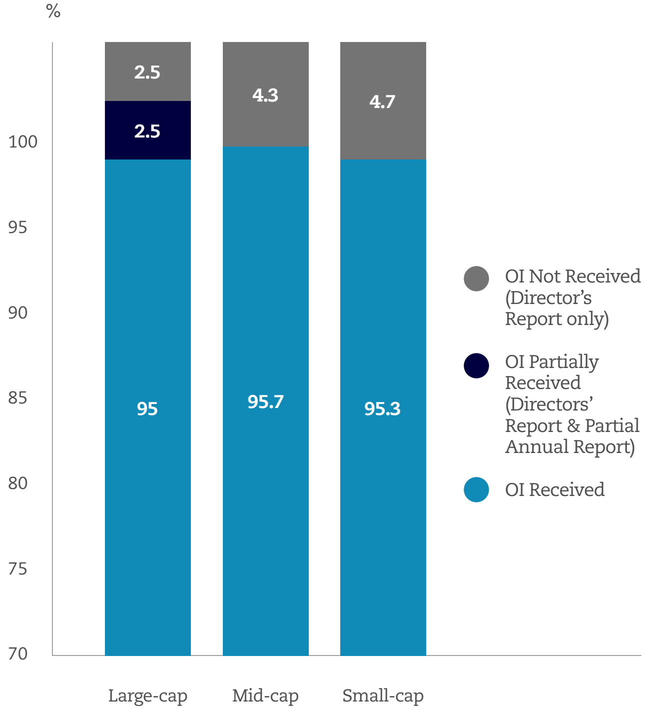
- the OI and the financial statements; and
- the OI and the auditors' knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit.

The auditors' report will always include a separate OI section when the auditors have obtained some or all of the OI as of the date of the auditors' report. For audits of financial statements of listed companies, an OI section will also be included if the auditors expect to obtain OI after the date of the auditors' report (i.e. when none of the OI has been obtained as of the date of the auditors' report.

More than 180 of the auditors' reports reflected that all of the OI was obtained by the date of the report on the financial statements. A total of seven of the auditors' reports reflected that only the Directors' Report was obtained by the date of the report on the financial statements. One auditors' report reported that the Directors' Report and partial annual report was obtained by the date of the report on the financial statements.

Figure 18 shows that most of the companies reviewed provided all OI as of the date of the auditors' report, regardless of the size of their market capitalisation.

Figure 18: Proportion of companies across their respective market capitalisation category that provided OI



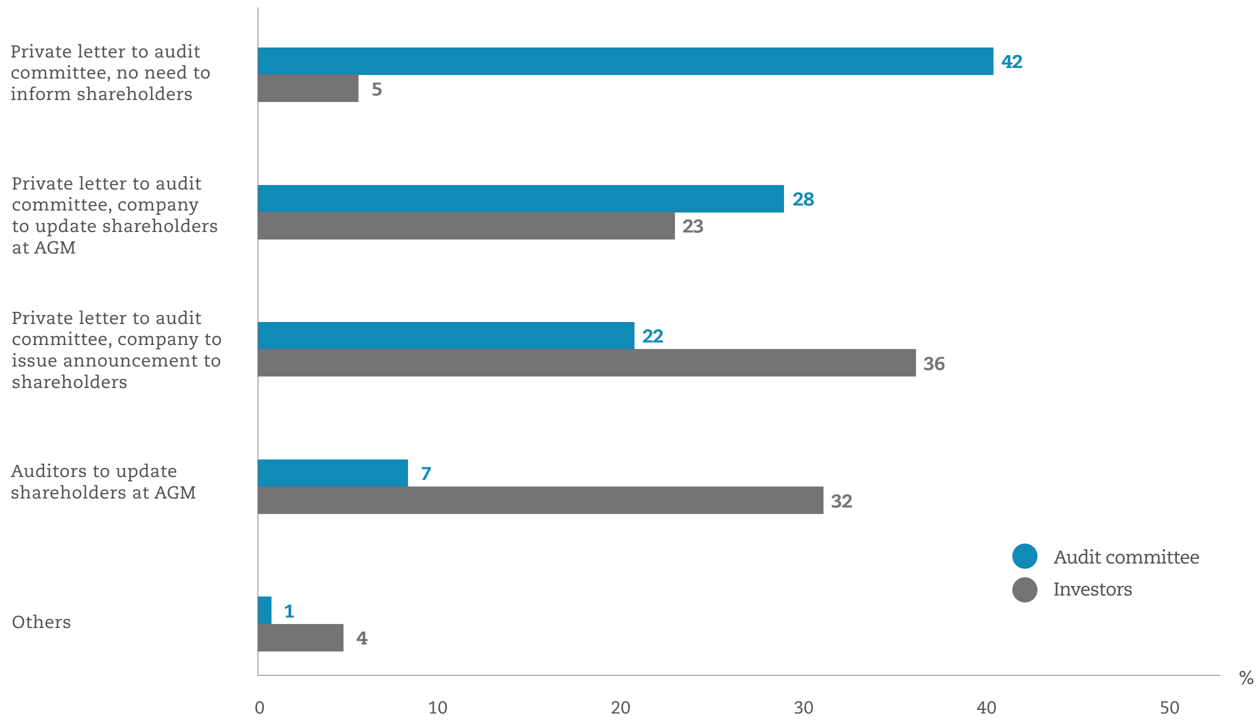
14. Other Information (OI) comprises financial and non-financial information in the annual report, other than financial statements and the auditors' report. In Malaysia, examples of OI include, but are not limited to, management discussion and analysis (MD&A), chairman's statement, corporate governance report, directors' report, financial statistics, etc.

A significant 82% of audit committee members believed that the auditors' duty to report in the EAR, whether OI in the annual report has been materially misstated, provides investors with greater confidence over the OI disclosed. A total of 76% of investors agreed that the auditors' report on OI did give them greater confidence over that information.

When companies are unable to provide all OI to the auditors before the auditors sign off the EAR, auditors report this in the EAR, and the auditing standards require the auditors to perform the necessary work on the OI when they receive it. Where no material misstatement is found, there will be no further communication from the auditors on the OI received subsequent to the date of auditors' report.

In practice, the review of annual reports and EARs found that over 90% of OI was delivered by the auditors' report date. However, when asked whether it is important to them that the auditors provide a statement to conclude that there is nothing to report, 73% of surveyed audit committee members and 78% of investors said it was. Views were evenly split among audit committee members about whether there should be further communication to investors, whether through the AGM or an announcement. Most investors wanted an update to close the loop, whether at the AGM or otherwise.

Figure 19: How should updates by auditors on OI be communicated?



Views were evenly split among audit committee members about whether there should be further communication to investors, whether through the AGM or an announcement. Most investors wanted an update to close the loop, whether at the AGM or otherwise.

SECTION

4 Paving the Way Forward

The EARs' positive impact in the first year of implementation indicates that continued improvement and engagement between all stakeholders should reap significant benefits in enhanced financial reporting and auditing.

The results signal that companies and audit committees may need to raise their own expectations of the EAR. Investors and audit committee members saw room for general improvement in KAMs on top of the matters covered in the survey.

Yet the generally constructive attitudes revealed in the surveys and focus groups suggest there is reason for optimism in the endeavour to improve. As many as 64% of investors felt that investors would become increasingly familiar with, and make better use of, the EAR to engage the board of directors and management of the companies. While this is a positive outlook, there are still others who are concerned that EARs will become boilerplates and investors will begin to lose interest in them. Audit committees members were more optimistic, with 82% believing that the EARs will lead to further investors' engagement.

The promise and opportunity is there, but it will require vigilance and attention to user needs, as well as great attention to how issues evolve year to year, so that the process does not revert into boilerplate or conservative and generalised language.

'Most year-one EARs comprise only one or two KAMs. I expect the number of KAMs to increase as we get into year two. Businesses face several challenges and the number of KAMs must reflect the increased complexity.'

Survey respondent, audit committees

'KAMs cannot just be written down. What has been disclosed impacts operations and results. Thus, the same content cannot be appearing [in the future]. Rather management must now take remedial measures to look deeper into how operations are run.'

Survey respondent, audit committees

All parties within the reporting ecosystem have a role to play for EARs to continue to develop and provide more value to users.

Investors

- **Take advantage of the new insights** to engage and form better understanding of a company and its management, and so improve accountability.
- If KAMs are unclear, **seek clarification from auditors and management.** This will 'coach' the auditors to deliver more user-centric KAMs and condition management to support the auditors in mitigating risks and enhance their own corporate reporting on the same issues.

Auditors

- **Embrace the greater opportunity** to demonstrate and enhance the value of audit.
- As far as possible, **use simple and easy-to-understand words.**
- **Be** as **specific** to the circumstances of the company as possible.
- **Work closely with the audit committees**, engage them early in the process and enlist their support to counter any potential resistance by management.
- Consider how to cater to investors' requests to share the outcomes of KAMs to **'close the loop'** on how KAMs are being addressed in the audit. Audit committees might also have a role to play in providing closure on issues identified in the KAMs.

Management

- **Be aware of the risk** of falling behind good governance practices. Companies with a good focus on corporate governance are using KAMs to improve transparency and open engagement channels with investors and other stakeholders. Transparency drives trust, which in turns allows the capital market to better reflect each company's value.
- **Do not put up hurdles** to prevent your auditors from providing genuinely tailored and useful KAMs. This will result in a widening of the gulf between the top companies and smaller companies with less well-developed corporate governance, especially as investors become more sophisticated in managing their investment risk.
- Embrace KAMs as reported by the auditors and know that the **number of KAMs does not always directly correlate to the quality** of management as it is also reflective of the complexity of the business environment in which the company operates and other unique circumstances inherent in its industry.

Audit committee

- **Seize the opportunity to educate** other directors and drive improvements to companies' corporate governance practices and financial reporting functions. Although the KAMs are not new to the audit committees, the dynamics of the conversation have changed between audit committees and the external auditors, as well as with the executive directors, given the public disclosure of the issues.
- **Help the rest of the board understand and better manage their responsibilities** over those issues.
- **Play a mediating role** between the auditors and management to facilitate KAMs disclosures that are **truly valuable to the investors**.

Conclusion

The study confirms that the quality of communication by the auditors has improved as a result of more specific information being disclosed about the audits of listed companies; in particular, by putting the spotlight on significant areas of judgements made by their board of directors in the financial statements, and the audit approach towards those matters. The key audit matters also have the positive effect of enhancing the quality of disclosures in the associated matters within the financial statements, thereby improving the transparency of key issues to the investors and other stakeholders.

Auditors and audit committees should strive to educate investors and management that the number of KAMs included in an auditors' report is not a good measure of the quality of a company's governance and financial reporting. At the same time, investors should take advantage of the new insights to better understand companies' performance and guide their investment decision making. Investors should also seek to ask more pertinent questions relating to KAMs during Annual General Meetings to the directors and management as well as auditors. These can further drive improvements in companies' finance and accounting functions and help minimise boilerplate disclosures.

Moving forward, as Malaysia progresses into the second year of EAR implementation, stakeholders should be able to see an increased flow of useful and relevant information to the capital market. This will help to reduce speculation and promote further understanding of the financial statements. Investors will be further empowered to engage in more relevant and meaningful discussions with the directors and management of the companies in which they invest.

Appendix

Malaysian Approved Standard on Auditing ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

ISA 701 deals with the auditors' responsibility to communicate KAMs in the auditors' report.

According to ISA 701, KAMs are matters of most significance in the audit of the financial statements and have to be determined from the matters communicated with those charged with governance (i.e. Board of Directors).

In determining KAMs, the auditor is required to take the following into account:

(a) Areas of higher assessed risk of material misstatement or significant risks.
(b) Significant auditor judgements relating to areas in the financial statements that involve significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
(c) The effect on the audit of significant events or transactions that occurred during the period.

ISA 701 also stipulates the form and content of the report – a separate section should set out the KAMs, each with reference to the related disclosure(s), if any, in the financial statements, and should set out the reason the matters were determined to be KAMs – and how the matters were addressed in the audit.

Relevant extracts from Bursa Malaysia's Main Market Listing Requirements

CHAPTER 15
15.12 Functions of the audit committee

Without limiting the generality of paragraph 15.11 above, a listed issuer must ensure an audit committee, amongst others, discharge the following functions:

(1) review the following and report the same to the board of directors of the listed issuer:
  - (g) the quarterly results and year-end financial statements, before the approval by the board of directors, focusing particularly on –
    - (i) changes in or implementation of major accounting policy changes;
    - (ii) significant matters highlighted, including financial reporting issues, significant judgments made by management, significant and unusual events or transactions, and how these matters are addressed; and
    - (iii) compliance with accounting standards and other legal requirements;

15.15 Audit committee report

(3) The audit committee report must include the following:
  - (d) a summary of the work of the audit committee in the discharge of its functions and duties for that financial year of the listed issuer and how it has met its responsibilities;

CHAPTER 9
APPENDIX 9B, Part A, *Quarterly report* (paragraphs 9.22(2) and 9.40)

(15) If the audit report of the listed issuer's annual financial statements for the preceding financial year were to contain a modified opinion or material uncertainty related to going concern, disclosure of the following:
  - (a) the modified opinion or material uncertainty related to going concern; and
  - (b) status of those key audit matters that relate to the modified opinion or material uncertainty related to going concern (including steps taken (if any) to address those matters).

9.19 Immediate announcements to the Exchange

A listed issuer must immediately announce to the Exchange the events set out below. This requirement is in addition to the other announcement requirements which are imposed under this Chapter and other parts of these Requirements, and are not exhaustive:

(37) any modified opinion or material uncertainty related to going concern in an external auditors' report. The announcement must set out the full details of such modified opinion or material uncertainty related to going concern and include the following:
  - (a) all key audit matters disclosed in the external auditors' report;
  - (b) steps taken or proposed to be taken to address those key audit matters that relate to the modified opinion or material uncertainty related to going concern; and
  - (c) the timeline for the steps referred to in sub-paragraph (b) above;

www.sc.com.my
www.mia.org.my
www.accaglobal.com