

Audit Inspections – 2019

1. Introduction

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) continued to improve the risk based audit inspection approach, adopted in 2016 as an initiative towards enhancing the audit quality, in its endeavor to improve the audit quality environment, with the aim of enhancing reliability of the financial statements.

SLAASMB continued monitoring compliance with Sri Lanka Auditing Standards by conducting regular audit inspections and thematic inspections during the year. Further, as a measure to prepare the audit market environment for firm-wide quality inspections in the future, SLAASMB continued the work relating to firm-wide audit quality inspections which commenced in 2018 on firms volunteered to be inspected.

In addition, SLAASMB carried out audit inspections focused at Key Audit Matters (KAM), as a proactive mechanism to review the level of communications of KAM in independent auditor's report with the application of Sri Lanka Auditing Standard 701 in the year 2018.

Accordingly, SLAASMB conducted a total of 45 inspections on audit engagements conducted by 7 audit firms during the year compared with 50 audit engagements conducted by 10 firms during the year 2018. The 45 inspections conducted on audit engagements comprised of 33 regular audit inspections approached through a risk based focus which enabled in-depth inspections into the predetermined specific areas and 12 thematic inspections. 10 of the 33 regular inspections comprised of audit inspections focused on KAM. In comparison to the 45 inspections carried out during the year, 50 inspections conducted in 2018 comprised of 31 regular audit inspections and 19 thematic inspections. The audits inspected during the year included 29 audits carried out by 4 firms which are members of international networks.

2. Enforcements on non-compliances

Based on the severity of the observations made during the inspections, SLAASMB adopted diverse measures in its effort of making the auditors to improve themselves in order to achieve the aim of improving the audit quality environment. During the year, measures such as issuing of letters of warning and letters of Observations continued. In this process of enhancing the audit quality throughout the audit industry, areas for improvement observed were communicated to respective firms during the year. Based on the significance of the issues, where necessary, SLAASMB had referred the deficiencies in audit quality to CA Sri Lanka and to The Securities Exchange Commission of Sri Lanka.

2.1 Letter of Warning

During the year 2019, two letters were issued by SLAASMB to two audit firms warning the said firms on the failure to comply with Sri Lanka Auditing Standards (SLAuSs) and failure to exercise the fundamental ethical principles of professional competence and due care when conducting the audit of an SBE. Accordingly, SLAASMB issued letters of warning to the audit firms, KPMG and Carter de Costa & Co., requiring the said firms to act diligently and in accordance with the requirements of applicable auditing standards when conducting audits of financial statements, in the future.

2.2 Letter of Assistance

When regular audit inspections results in finding non-compliances with standards which are material but not significant as to require further action under the statute, such deficiencies are communicated to the audit firms by letters of assistance termed as “Letters of Observations”. Such deficiencies were identified in 15 audit engagements conducted by 6 firms.

2.3. Suggestions for Improvements

When improvements are required in audits to improve audit quality, such improvements are communicated as suggestions for improvements. During the year, suggestions for improvements relating to 6 audit engagements were communicated to 2 firms. The auditors of such firms are expected to improve on the areas identified in their future audits.

3. Observations made on regular audit inspections

Significant deficiencies communicated by letters of observations included:

3.1. Failure to express an appropriate audit opinion

Failure by the auditor to express an appropriate audit opinion was observed in following instances;

- Not expressing an adverse opinion when financial statements contained misstatements that had a pervasive effect on the financial statements.
- Not appropriately establishing the basis for expressing a qualified opinion on the financial statements of a public listed company.
- Not drafting the audit qualifications in a clear and understandable manner to reflect the material misstatements, both detected and undetected, which may affect the true and

fair view of the financial statements, when expressing the audit opinion on the financial statements of a public listed company.

- Not appropriately resolving previous year's audit qualifications when expressing an unqualified opinion on the financial statements of a public listed company.
- Not expressing a modified opinion when the financial statements of a public listed company had contained material misstatements and the auditor had been unable to obtain sufficient appropriate audit evidence. In this instance, the auditor had expressed an unmodified opinion and reported such matters in the other matters paragraph.

3.2. Failure to obtain sufficient appropriate audit evidence

Failure by the auditor to obtain sufficient appropriate audit evidence from test of controls and substantive procedures to support financial statement assertions were observed as follows:

- Not assessing whether the alternate audit procedures performed had achieved the objective of the originally planned audit procedures.
- Failure to assess the appropriateness of the point at which the revenue had been recognized, considering the point at which risks and rewards of the goods/ services had passed to the customer. Accordingly, the assertions of completeness, accuracy and cut-off had not been tested appropriately.
- Not carrying out appropriate audit procedures to check the recognition and measurement of gem stock carried as investment and inventory.
- Failure to assess the accuracy of valuation of inventories as at the end of the reporting period when the auditor had not relied on the company's inventory control system and had identified inventories as a high risk area in the combined risk assessment.
- Not performing planned audit procedures to obtain sufficient appropriate audit evidence in relation to revenue.
- Not evaluating the reliability and comparability of the data used for substantive analytical procedures in relation to revenue and cost of sales.
- When only substantive analytical procedures had been performed as test of details, relating to revenue and cost of sales, not designing substantive analytical procedures which are suitable to obtain sufficient appropriate audit evidence.

3.3. Failure to communicate with Those Charged With Governance (TCWG)

Following observation was made in relation to not maintaining effective two-way communication in an audit of financial statements:

- Non-availability of evidence of the effective two-way communication had with the Audit Committee in relation to the audit engagement of a public listed company.

3.4. Failure to perform adequate audit procedures relating to the risk assessment

Observations on not fulfilling the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal controls are as follows:

- In deciding on test of controls (TOCs) to be performed, not identifying the appropriate critical control as the relevant control to mitigate the identified control risk, when the auditor had decided on the level of control risk.
- Not evaluating internal controls when assessing the control risk relating to revenue. In the absence of a proper risk assessment, fact that the audit procedures designed and performed addressed the risk of material misstatements at the financial statements and assertion level could not be assessed.
- Despite having previous experience with the company, the auditor had failed to plan the audit procedures appropriate to the nature of the inventory i.e. gem stock. Accordingly, the auditor had not checked inventory quantities and the date of the valuation, resulting in failing to ensure the assertions of completeness and valuation of inventory.
- When a number of revenue related controls had been identified as relevant controls by the auditor, failure to plan and perform TOCs to test the operating effectiveness of such controls.
- Failure to test the operating effectiveness of controls which were identified by the auditor as critical controls relating to revenue.
- Failure to evaluate the results of audit evidence obtained by testing operating effectiveness of controls relating to revenue.

3.5. Failure to perform adequate audit procedures relating to accounting estimates including fair value accounting estimates and related disclosures

Instances where the auditor has failed to obtain sufficient appropriate audit evidence on fair value estimates are as follows:

- Not assessing the probability/ likelihood of the occurrence of the significant assumptions relating to estimating recoverable value of an investment and failing to obtain sufficient appropriate audit evidence of firm commitment on the restructure of the investee's capital structure, a key assumption affecting the entire computation of the recoverable value of the investment.
- Failure to verify the reasonableness of the fair value of the property, plant and equipment which were revalued.
- Not maintaining professional skepticism when auditing the accounting estimates of a bank, by failing to identify the application of an inappropriate loss given default (LGD) rate by the bank, when estimating the impairment allowance for the loan portfolios.

3.6. Failure to adequately address the risk of fraud in an audit of financial statements

Observations on failure to address risk of fraud by the auditor includes:

- Failure to appropriately address the risk of frauds in relation to revenue recognition, when the auditor had identified conditions that caused the auditor to believe that the sales agreements were not authentic.
- Failure to perform appropriate audit procedures focusing on characteristics of fraudulent journal entries and other adjustments in the general ledger to address the fraud risk.

4. Observations made on Key Audit Matters (KAM) inspections

Sri Lanka Auditing Standard 701, which came into effect in the year 2018, deals with the auditor's responsibility to communicate key matters, in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication. This new extended auditor's report is expected to be more informative and more transparent for the intended users by assisting them in understanding those matters that, in the auditor's professional judgment, were of most significant in the audit of the financial statements of the current period. Communicating key audit matters also assists users of the financial statements in

understanding the entity and areas of significant management judgment in the audited financial statements, as such matters are areas of focus in performing the audit.

In the process of KAM inspections, key audit matters in independent auditor's report were analyzed in the first year of reporting, i.e., 2018 with a proactive mechanism to review the level of communications of KAM in Sri Lanka. The aim of this process was to improve future application of KAM with compliance of Sri Lanka Auditing Standard 701 in order to achieve the objective of the new extended auditor's report. Following lapses in the application of KAM were observed and communicated to the auditors;

- The auditor had not included a KAM paragraph in the audit report of a public listed company. Accordingly, the auditor had failed to exercise professional competence and due care in expressing the audit opinion.

- Failure to perform audit procedures disclosed under KAM.

Ex:

- In assessing the reasonableness of the valuation of the land, the auditor has considered valuation information of only one property even though the audit procedures indicated that information from several similar property valuations have been considered.
- In assessing the appropriateness of FV, price ranges at which similar buildings within close proximity were transacted had not been checked by the auditor, despite such audit procedure being disclosed under KAM.

5. Thematic inspections

The thematic inspections conducted since 2017, as a part of the annual programme of regular inspections of individual audits, are deliberately narrow in scope, and are chosen to focus on a specific aspect of the audit in a greater depth than is generally possible in regular inspection of audits. Accordingly, a thematic inspection looks at the application of firms' policies and procedures in respect of a specific area or aspect of the audit selected by SLAASMB, to enable comparison among audit firms with a view of identifying both good practices and areas of common weaknesses.

Thematic Inspections conducted during 2018

During the year, the results of the thematic inspections conducted during 2018 on Communication with Those Charged with Governance (TCWG) on 19 audit engagements conducted by 5 firms were analyzed and the work relating to the preparation of the report was in-progress.

The objective of the aforesaid thematic inspection was to ascertain the practices of firms on having dialog with TCWG and the extent of communication. The communication enables the auditor to develop a constructive working relationship with TCWG, while

maintaining the auditor's independence and objectivity. Further, these communications will enable TCWG to fulfill their responsibility of overseeing the financial reporting process. Thus, the effective communication between the auditor and TCWG, is expected to result in strengthening the audit quality environment of the country. In ascertaining the effectiveness of such dialog, SLAASMB was instrumental in taking a further step by conducting discussions with Audit Committee members of the inspected SBE's, in their capacity of TCWG.

This initiative paved way for SLAASMB to assess the level of importance placed by TCWG on having effective communication with auditors. These discussions supported SLAASMB to convey the importance of effective communication with auditors and the responsibility vested on the members of Audit Committees in the capacity of TCWG in selecting and evaluating the statutory auditor of the company and in assessing the quality of the audit service extended by the auditor.

Findings of the thematic inspection creates a platform to compare the related best practices within the audit profession. Further, SLAASMB has also highlighted the areas to be focused by the Audit Committee members in their capacity of TCWG in order to form the base to effectively discharge their duties in relation to the conduct of an effective audit in the future. The Report on the findings of these inspections can be found in the SLAASMB's website (<http://slaasmb.gov.lk>).

Thematic Inspections conducted during 2019

During 2019, SLAASMB focused on the theme Related Parties which was selected due to the complex business structures which leads to complicated networks of relationships and transactions among related parties. SLAASMB has conducted thematic inspections on the said theme, on a sample of 12 audit engagements conducted by 4 audit firms. The report of the thematic inspections conducted in 2019 on the theme- related parties is in-the-process of being finalized.

6. Firm-wide Audit Quality Reviews (AQR)

Consequent to the need for a revision to the statute enacted more than two decades ago, and as a part of the Government's capital market development program, proposals were made to amend the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995. The said amendments included a proposal by which the Sri Lanka Standards on Quality Control 1(SLSQC1) would be made mandatory, for auditors who audit financial statements of specified business enterprises (SBEs).

While the Act No. 15 of 1995 is in the process of being amended, SLAASMB requested audit firms who conduct audits of a significant number of SBEs, to volunteer to be subject to an inspection on their compliance with the requirements of SLSQC 1. This quality focus inspection mechanism is expected to enhance the audit quality throughout the firm.

In response to the request made to four firms, the two firms, Ernst and Young and KPMG took the lead and volunteered to be subjected to firm-wide quality inspections by SLAASMB. In the initial step of implementing firm-wide quality inspections, the two firms were inspected on the topic 'Tone at the top and audit quality'. The inspection which commenced in 2018 continued during 2019 with the data gathering and analysis taking place. However, the field work of the inspections have now been completed and the reports are in the process of being issued in 2020.

This trial process is expected to enhance the readiness of the auditor towards the conduct of the firm-wide quality inspections and to streamline SLAASMB's regulatory approach, enabling the effective conduct of firm-wide quality inspections, when mandatory adoption is effective.

7. Future focus

SLAASMB expects to continue the regular audit inspections and thematic inspections with the aim of encouraging firms to improve on conducting audits communicated through letters of observations and reports on thematic inspections resulting in enhancing the quality of the audit market. In pursuing with the said objective, SLAASMB has undertaken to submit findings for the annual survey conducted by the International Forum of Independent Audit Regulators (IFIAR) in its attempt to pursue with the new metric of measuring *changes in the rate of audits inspected with the findings*, against a reduction of at least 25% over four years from 2019, relating to inspections of listed entities by firms of international networks.