

**Observations –
Audit Reviews
Found in 2018**

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 for firm-wide quality inspections in the future, SLAASMB commenced firm-wide audit quality inspections since early 2018.

2. Inspection Findings

SLAASMB conducted a total of 50 inspections on audit engagements conducted by 10 audit firms during the year compared with 100 audit engagements conducted by 13 firms during the year 2017. The 50 inspections conducted on audit engagements comprised of 31 regular audit inspections approached through a risk based focus which enabled in-depth inspections into the predetermined specific areas and 19 thematic inspections. In comparison, the 100 inspections conducted in 2017 comprised of 85 regular audit inspections and 15 thematic inspections. The audits inspected during the year included 26 audits carried out by 4 firms which are members of international networks.

2. Enforcements on non-compliances

Based on the severity of the findings of the inspections, SLAASMB adopted diverse measures in its effort of making the auditors to correct 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 Observation continued along with follow up on compliance to previous Directions issued. In this process of attempting to enhance the audit quality throughout the audit industry, areas for improvement were communicated to some firms during the year. Based on the significance of the issue, during 2017, SLAASMB had

referred the deficiencies to CA Sri Lanka and had issued a direction to an SBE requiring its financial statements to be re-audited and republished. The SBE had responded stating the practical difficulties in implementing the direction and the matter has been referred to the Attorney General and is awaiting a response.

2.1 Letter of Warning issued

During the year 2018, two letters were issued by SLAASMB to two audit firms warning the said firms on the failure to exercise the fundamental ethical principle of due care when conducting an audit of a SBE. Accordingly, the Board issued letters of warning to KPMG and B V Fernando & 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 Letters of Assistance issued

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 as letters of assistance termed as “Letters of Observation”. Such deficiencies were identified in 11 audit engagements conducted by 8 firms.

2.3 Suggestions for Improvements

Suggestions for improvements were communicated in relation to 7 audit engagements carried out by 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 assistance included:

3.1 Failure to ensure compliance with the applicable financial reporting framework

- Failure by the auditor to identify the incorrect recognition of the income tax liability and corresponding deferred tax asset in relation to loans written-off in a

finance company, which had been fully claimed in the company`s tax returns, resulting in overstatement of assets and liabilities.

- Failure to assess the existence of control over an investee company by a parent company and to identify the requirement to prepare and present consolidated financial statements.

3.2 Failure to obtain sufficient appropriate audit evidence

- Failure to assess the reasonableness of the forecast of revenue for the period hedged, the basis of assessing the highly probable sales and of the determination of the forecasted foreign currency exchange rates, when forecasted foreign currency revenue had been hedged against foreign exchange risk.

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

- Absence of evidence of any communication had with the Audit Committee in relation to the audit engagement of a registered finance company.

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

- Failure to perform tests of controls to obtain sufficient appropriate audit evidence on the operating effectiveness of the controls of a registered finance company which uses an IT system for its operations. Certain controls were observed to have been identified for the Information System (IS) audit testing by the auditor. However, testing of certain application controls which specifically relates to automated controls like data validation, editing and processing have not been tested by the IS Audit team.
- Failure to perform an adequate level of risk assessment procedures when, the auditor had identified the system change which had taken place during the year, of a manufacturing company, as a specific risk, at the planning stage of the audit. The

performance of the risk assessment procedures and the results of such procedures were not adequately evident from the audit working papers.

- Failure to respond to the risks identified despite the auditor planning to perform certain Tests of Controls (TOCs) and substantive procedures in relation to revenue, not identifying the key controls and not performing TOC's to ensure operating effectiveness of relevant controls. Significant lapses were also observed in relation to the substantive testing.

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

- Failure to adopt due care in ascertaining the accuracy of the ageing of loans and receivables when determining the adequacy of the impairment allowance of a finance company.
- Failure to verify the reasonableness of the fair value of property, plant and equipment on which a revaluation gain of Rs. 1.5 billion had been recognized.
- Not maintaining professional skepticism in auditing the accounting estimates in a bank by failing to identify the adoption of an inappropriate loss given default (LGD) rate which was not in accordance with the requirements of LKAS 39, when estimating the collective impairment allowance for all incurred losses of the loan portfolios. Further, the auditor had not recognized the bank's failure to group the loans and receivables on the basis of similar credit risk characteristics and had not identified the failure by the bank to use recent observable data of historical loss experience to reflect current circumstances and conditions.

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

- Failure to perform audit procedures on journal entries in response to risk of fraud.

- Failure to select an appropriate representative sample of journal entries to test the characteristics which the auditor had identified as susceptible to management override of controls and fraud.

4. Firm-wide audit quality inspections

As a part of the capital market development program implemented by the Government, proposals have been made to amend the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995. A significant proposal in the amendments is to make the Sri Lanka Standards on Quality Control 1(SLSQC1) mandatory, for auditors who audit financial statements of all specified business enterprises (SBEs).

While the Act No. 15 of 1995 is in the process of being amended, SLAASMB has requested audit firms which conduct audits of a significant number of SBEs to volunteer to be subject to an inspection on compliance with the requirements of SLSQC 1, as means of enhancing the audit quality of firms. Accordingly the firms, Ernst and Young and KPMG have volunteered and firm-wide quality inspections have taken place on the said two firms on the topic ‘Tone at the top and audit quality’. The field work of the said firms has been completed and the reports are expected to be issued in 2019.

Such process will enhance the readiness of both SLAASMB and of audit firms, enabling smooth functioning of the firm-wide quality inspections, when it becomes mandatory.

- **Thematic inspections**

During 2018, SLAASMB conducted thematic inspections on the theme of Communication with Those Charged with the Governance, for a sample of 19 audits, representing 6 audit firms. Report on observations of the said thematic inspections conducted during 2018 is expected to be issued during 2019.

However, in 2017, SLAASMB conducted thematic inspections on two themes, namely on Engagement Quality Control Reviewer (EQCR) and Communications with Those Charged with Governance for a sample of 15 audits representing 6 audit firms. The reports on the

findings of these two themes were published in July 2018 and the reports on the findings of these inspections can be found in the SLAASMB's website.

<http://slaasmb.gov.lk/wp-content/uploads/2018/08/EQCR-Report-2017.pdf>

<http://slaasmb.gov.lk/wp-content/uploads/2018/08/TCWG-Report-2017.pdf>

Accordingly, the report on existence of effective engagement quality control review procedures was intended to promote a better understanding of the role of the EQCR in an audit engagement and on how the EQCR can contribute to enhance audit quality.

Similarly, the report on Communication with Those Charged with the Governance, focused on the effectiveness of the two-way communication between the auditor and those charged with governance. The report of this inspection intends to foster better dialogue with Those Charged with Governance in order to enhance the audit quality.

Further, the thematic inspection reports include some suggestions for improvement on the adoption of the two themes.