Accountancy Quality Assurance Board

2012
ANNUAL REPORT – Quality Assurance

INTRODUCTION & OVERVIEW

The Board is pleased to present its sixth annual report set out in accordance with the requirements of Article 7(19 & 20) of the Accountancy Profession Act, CAP 281. Included in this report, one will find details of the Quality Assurance Oversight Committee (QAOC), its annual work programme, and the findings from monitoring visits to audit practitioners carried out by the Quality Assurance Unit (QAU) throughout 2012.

Because of the resignation of one of our inspectors and the difficulty in finding a replacement the QAU had to resort to other Statutory Audit Quality Assurance institutions to assist it in the carrying out of monitoring visits throughout 2012. While the number of visits during 2012 was reduced due to the recruitment problem, the fact that the first cycle of visits was carried out in four rather than the six year cycle allowed by Directive 4 of the Accountancy Profession Act, still leaves the Unit in line with the number of annual visits required by Law for 2012 for non public interest entity audits. Visits to firms forming part of the larger international audit networks, which audit all of the public interest entities, were carried out in accordance with the three year cycle required by the directive.

Apart, from the carrying out of visits, the QAU has also provided support and advice to the Accountancy Board. Members of the QAU team have also been involved on a number of sub committees concerning the audit and accountancy profession in Malta. The QAU team processes annual returns submitted by all warrant holders as well as firms and seeks to enforce remedial action against those who are in default of their regulatory obligations, in spite of the loss of a full time administrative clerk, who has not yet been replaced on a full time basis. . Enforcement is a vital and onerous part of the Quality Assurance process which cannot be overlooked and one augurs that the necessary resources will be directed to this area in 2013. This was clearly set out in the 3 years Plan presented by the QAU to the QAOC on the 10 November 2012. This latter document, which also indicated the key problem areas being faced by the QAU and the proposed way forward, was presented to the Accountancy Board on the 8 January 2013. A Steering Committee of the Accountancy Board has since been specifically set up to discuss these proposals and to develop a medium to long term strategy for the QAU as well as look into other short term options available to resolve this setback.

The head of the QAU represented Malta on a number of international as well as European fora concerning audit policy and regulation. As representative of the local audit oversight board he attended meetings of the European Group of Audit Regulators as well as those of the International Forum of Independent Audit Regulators. He also regularly attends meetings of the European Audit Regulatory Committees and European Audit Inspections Group.

Throughout 2012 and the current year I, on behalf of the Ministry of Finance, the Economy and Investment, participated in the Working Parties on Company Law held with regard to the Proposals for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities and to the Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.

Charles Rapa

Chairman Accountancy Board

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QUALITY ASSURANCE OVERSIGHT COMMITTEE

SECTION 1 - COMPOSITION AND FREQUENCY OF MEETINGS

The Quality Assurance Oversight Committee (QAOC) as set out in Directive 4 of the Accountancy Profession Act is composed of five individual members appointed for a period determined by the Board which shall not exceed three years.

During 2012, the composition of the QAOC changed to the following five Committee members:

Chairman
Mr. Godfrey Leone Ganado FIA, CPA

Members
Ms. Heather Briers FCA;
Mr. Alfred Lupi FCCA, BSc Econ, FIA, CPA;
Mr. Guido Mizzi FCCA, FIA, CPA; and
Mr. Peter Paris FIA, CPA

Secretary
Mr. Marcel P. Coppini FCCA, FIA, CPA

The Committee held a total of two meetings during the year – in April and October 2012.

SECTION 2 - SUMMARY OF ACTIVITIES DURING 2012

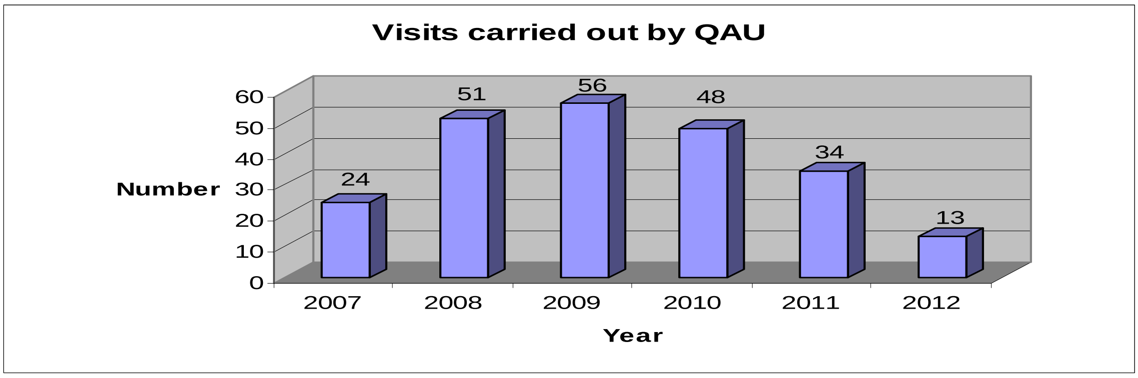
2.1 Quality assurance visits

Based on declarations made in the Annual Returns covering the year ended 2011, locally there were a total of 154 sole practitioners providing statutory audit services. In addition up until year end there were 56 registered audit firms, of which 4 were newly registered and another 2 de-registered during 2012.

Since the first year of operations in 2007, the Quality Assurance Unit (QAU) carried out a total of 226 quality assurance visits covering all audit practitioners. The number of visits carried out by the QAU on a yearly basis is illustrated in Chart 1.

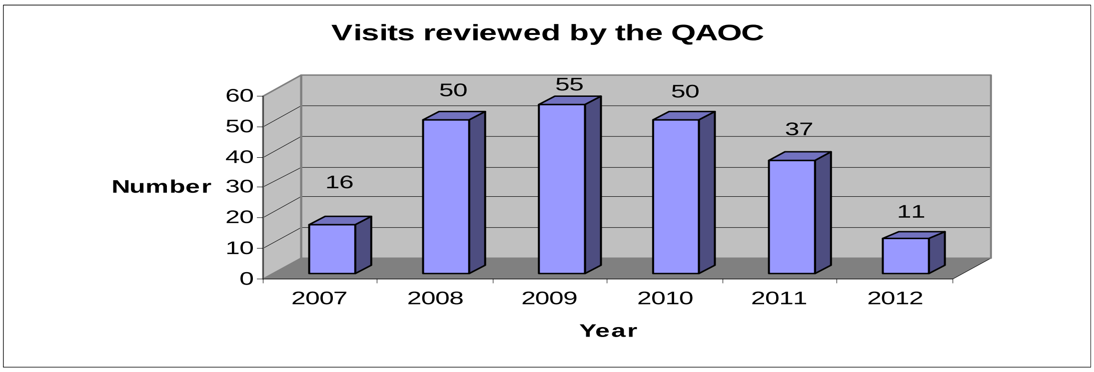
Due to lack of resources, the reviewers carrying out quality assurance visits was reduced to just one full time reviewer and another reviewer working reduced hours during most of 2012. As a result, the number of visits carried out by the Unit was drastically reduced when compared with prior years. Furthermore, a substantial portion of the unit's time was dedicated to Accountancy Board related matters.

Chart 1 – Visits carried out by the QAU



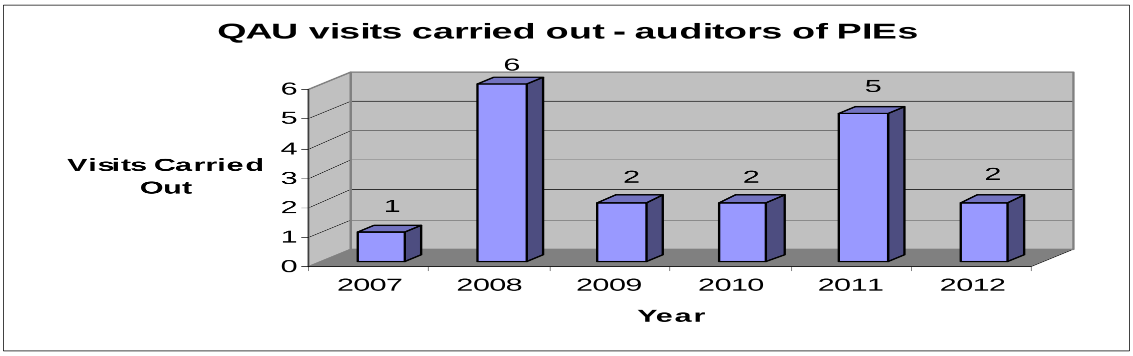
Once all related visit documentation is prepared by the QAU reviewers, visit work-packs are reviewed internally by the Head of QAU. On completion of the internal review, the QAU passes on its recommendations based on its findings to the QAOC for its review and assessment. During the two QAOC meetings held in 2012, the QAOC has reviewed and closed down 11 visits bringing the total visits reviewed by the QAOC to 219. The number of visits assessed by the QAOC on a yearly basis is illustrated in Chart 2 below.

Chart 2 – Visits reviewed by the QAOC



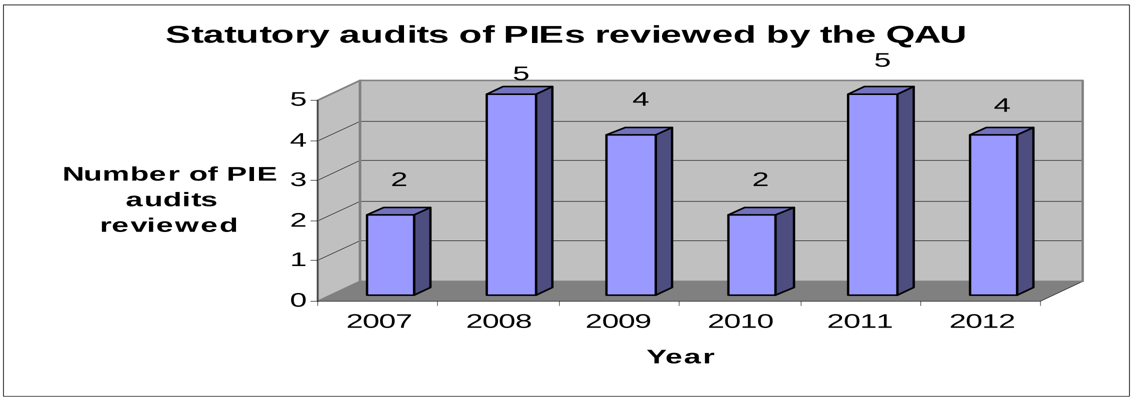
As per the 2011 transparency reports submitted by firms carrying out audits of Public Interest Entities (PIEs) (as required by section 18 of the Accountancy Profession Act (Cap 281)), there were 9 audit firms auditing PIEs of which 2 audits firms were subjected to QAU visits in 2012. The number of auditors / audit firms visited by QAU on an annual basis is shown in Chart 3.

Chart 3 – Visits to auditors of Public Interest Entities



The QAU as part of its monitoring cycle reviewed a total of 4 audit files of public interest entities during 2012. Since it began its monitoring process in 2007, the QAU has reviewed a total of 22 statutory audits of public interest entities as illustrated in Chart 4.

Chart 4 – Public-Interest Entity Audits Reviewed by the QAU



On the basis of information submitted by audit entities carrying out public interest entity audits in their 2011 transparency report, there were 39 listed entities (Bonds & Equity), 24 credit institutions (of which 6 are listed) and 49 insurance companies (of which 1 is listed). 88% of the public interest entities are audited by the Big 4 audit firms.

2.2 Overview of visits carried out in 2012

During the course of 2012, the QAU carried out a total of 13 visits. This represents a decrease of 21 visits when compared with the prior year as depicted in Chart 1. The QAU also reviewed 2 practices carrying out audits of public interest entities (of which one was a Big 4 firm) for which more time was dedicated to these visits. The QAOC approved 11 reports as shown in Chart 2. These related to the following types of audit practices:

- 2 full-time sole practitioners;
- 2 part-time sole practitioners;
- 2 firms with more than five principals;
- 2 firms with less than five but more than two principals; and
- 3 firms with less than three but more than one principal.

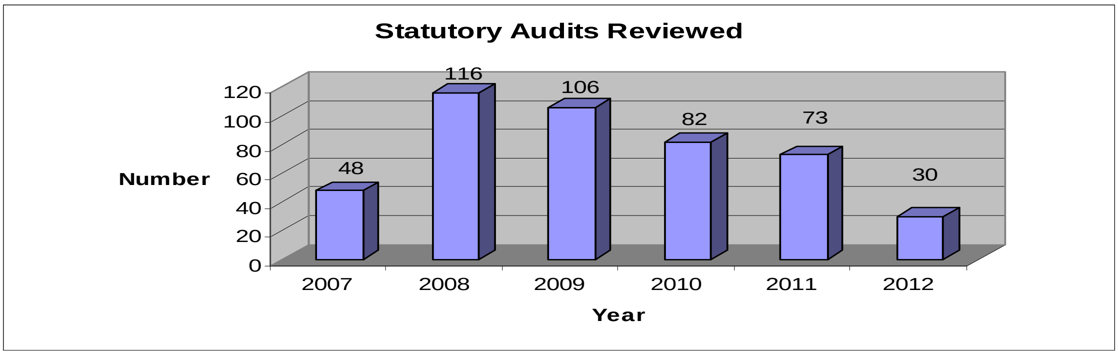
The QAOC has since its inception reviewed a number of audit files. This is illustrated in Chart 5 and shows that in 2012, a total of 30 audit files were reviewed. The drop in audit files reviewed during 2012 was due to the fact that fewer visits were carried out during the year. Furthermore, throughout the year the QAU based its review on files which exceed the small company audit exemption thresholds as laid down in article 185(1) (b) of the Companies Act.

Apart from visit cycle criteria, set out in Directive 4 to the Accountancy Profession Act, the selection of practices to be visited is risk based which emanates from desk top monitoring of annual returns submitted, along with media reports or complaints on practitioners made to the Accountancy Board.

The QAU also adopts a risk based approach in the selection of audit files for review. Amongst other things one looks at inherent industry risks related to the file reviewed, as well as other possible risks emanating from ethical and independence issues, audit report modifications, as well as the stature of the entity whose file is to be reviewed. One also ensures that all audit engagement partners have at least one audit file reviewed during our inspection.

Other than reviewing the quality of auditing standards being applied by audit practices on the clients they audit, QAU reviewers also assess the quality control procedures being adopted by these practices to ensure that the audit quality of the practice is not only maintained but also improved.

Chart 5 – Audit files reviewed by the QAOC



2.3 Overview of 2012 inspection reports

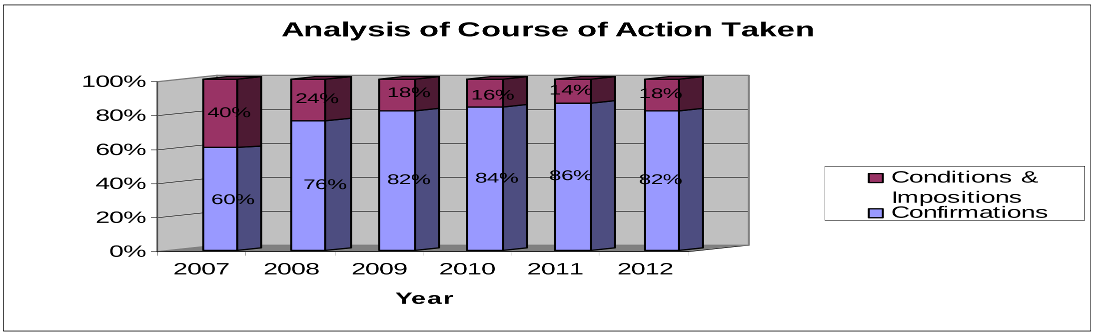
As in past years, reports are assessed on the basis of the incidence, magnitude and gravity of visit findings, as well as the level of commitment and ability of the firm or sole practitioner to address the problems identified. In its closing down letter to the practitioners visited the QAOC communicates the sanctions, impositions or any other corrective action, if any, which the QAOC may deem appropriate.

During 2012, a number of visits were carried out to practitioners and firms who had already been visited in the first cycle of reviews as well as other newly registered practices/firms. Also one of the visits carried out and concluded in 2012 was a follow-up visit.

Again the type and gravity of the findings noted during the reviews were fairly consistent with that of prior years. As a consequence by the end of the year, the QAOC had asked practitioners/firms on 82% of visits for just confirmations as opposed to 86% in 2011, 84% in 2010, 82% in 2009, 76% in 2008 and 60% in 2007.

Furthermore, conditions including impositions such as follow up visits, hot file reviews and external audit compliance reviews and external cold file reviews were sanctioned on 18% of practitioners/firms visited in 2012 when compared to 14% in 2011, 16% in 2010, 18% in 2009, 24% in 2008 and 40% in 2007. This is illustrated in Chart 6.

Chart 6 – Analysis of Course of Action Taken

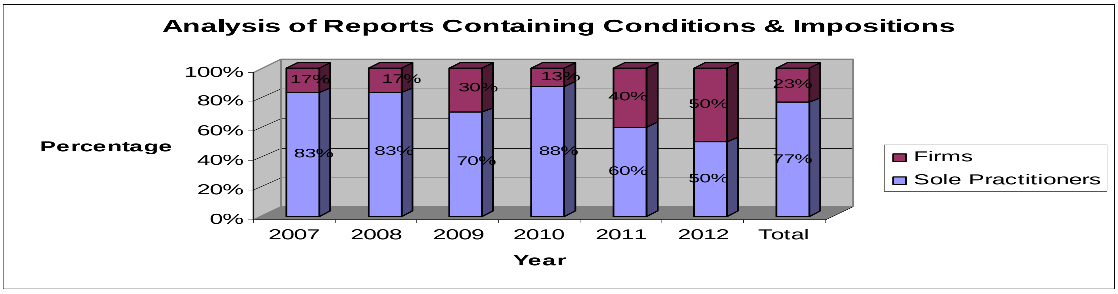


During 2012, conditions including impositions on practitioners/firms can be analysed as follows:

- 66% required hot file reviews to be carried out; and
- 34% required follow up visits to be carried out.

Furthermore, if one were to analyse the composition of reports issued featuring conditions & impositions one would note that conditions & impositions were sanctioned equally on sole practitioners and firms. As can be seen in Chart 7, apart from 2009, 2011 and during 2012, this trend has remained fairly consistent during the last six years.

Chart 7 – Analysis of Reports Containing Conditions & Impositions



2.4 Summary of 2012 inspection findings

The following list identifies the areas in which the more common weaknesses were noted and which require improvement based on the findings identified during the quality assurance visits carried out throughout 2012.

- *ISA 230 – Audit Documentation, ISA 500 – Audit Evidence & ISA 501 – Audit Evidence – Specific Considerations for Selected Items*

  Audit weaknesses continue to be identified in respect of adequate and appropriate audit documentation and evidence. In particular such issues were noted with greater frequency in the smaller practices reviewed. The defeciencies noted in this regard related to the following main areas:-

  - Inventories – inadequate audit testing in regard to completeness and accuracy of inventory valuation and existence;
  - Investments and Receivables – inadequate testing of impairment for impairment losses;
  - Property – in a number of instances it was noted that documentation in conjunction with the fair value of property held by the audit client was not being properly assessed and documented in the audit file; and
  - Income & cost of sales – It was noted in the course of our inspections that a number of the smaller practitioners still resort to a reconciliation of income and cost of sales figures to VAT returns, as the only audit procedure they apply when testing sales and cost of sales. This, in our view, provides little audit comfort, if any, in regard to completeness and accuracy of these balances in the income statement.

  On a more general basis our visits in 2012 have indicated that whilst audit practitioners argued that they exercised professional scepticism at all stages of the audit, the evidence of this on file was spasmodic. In particular, audit procedures adopted in regard to expert valuations, and financial models or other basis used for impairment provisions on investments, inventories, loans and other receivables are not being adequately challenged. In some instances, particularly with smaller practices, these were in fact not challenged at all.

  It was also noted that conclusions reached on the audit work carried out in specific areas at various stages of the audit were not adequately documented

- *ISA 240 – The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
  Documentation of fraud considerations in accordance with ISA 240 remains an area of concern. Although some improvement has been noted, documentation of fraud considerations during the completion stage of the audit remains weak.

- *ISA 315 – Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*
  During the course of our reviews, it was noted that on a significant number of visits the risk assessment process was weak. Practitioners and firms are reminded that ISA 315 requires that the auditor understands the entity's risk assessment process as follows:

  a) Identifying business risks relevant to financial reporting objectives;
  b) Estimating the significance of the risks;
  c) Assessing the likelihood of their occurrence; and
  d) Deciding about actions to address those risks.

  On the basis of such understanding the auditor will be in a position to design and implement tests to address the risks of material misstatement. For this reason, this understanding is critical in the adoption of a risk based audit approach.

- *ISA 320 – Materiality in Planning and Performing an Audit*
  The calculation of materiality and performance materiality has been an omission noted on a number of sole practitioners visited during the year. Calculating the overall materiality level should be part of the formulation of the auditor's overall audit strategy while still at the planning stage of the audit. Also there may be specific circumstances which require that different materiality levels are applied to particular classes of transactions, account balances or disclosures. Furthermore, the auditor is required by ISA 320 to determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. Revisions to such materiality calculations should be made if during the audit the auditor comes across information that would impact on such calculations.

- *ISA 550 – Related Parties*
  During visits of both the smaller and larger practices and firms, it was noted that related parties continues to be an area for improvement. Although in many instances related parties had been identified as part of the risk assessment procedures at the planning stage of the audit, it was noted that there were inadequate procedures being applied for the identification of all related parties. Documentation also needs to be improved in relation to identifying the relationship between the entity and those related parties. Furthermore, practices and firms need to ensure that adequate testing of related party transactions is found on file.

- *ISA 570 – Going Concern*
  Going concern continues to be an area where the QAU, in a number of instances, has disagreed with the views taken and the audit report issued by the audit practitioners in particular with reference to the use of the going concern emphasis of matter paragraph found in a number of the audit reports issued. ISA 570 clearly sets out guidance in its application material as to how and when such emphasis of matter should be used and this goes far beyond than just exercising professional judgement Such emphasis of matter paragraph should only be used where the circumstances of a particular situation of the company warrant it.

In determining whether or not to use an emphasis of matter paragraph, it is vital that the auditor assesses whether or not there is a material uncertainty. It was noted that in a number of instances an emphasis of matter paragraph was included in the auditors' report, even when, as clearly documented on the audit file itself, no material uncertainty existed.

However once the auditor identifies that the going concern assumption is appropriate and a material uncertainty exists, the auditor, before including an emphasis of matter paragraph in the auditors report, is required to ensure that the financial statements include adequate disclosure such that they:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

In this regard, larger firms have argued that they included an emphasis of matter paragraph on the basis of ISA 706, stating that the objectives of the emphasis of matter paragraph was to draw the attention of readers of the financial statements, to management's disclosures in regard to the entity's going concern capabilities, simply on the basis of its magnitude and importance. ISA 706, it should be noted, specifically caters for situations other than those of going concern situations, which latter circumstances, and are adequately dealt with under ISA 570.

During the course of a number of visits carried out during the year, it was noted that although an emphasis of matter paragraph was being included in the audit report, adequate disclosure was not made in the financial statements.

In one instance, which was a local subsidiary of a foreign group, based on the audit documentation found, it was felt that an 'except for' going concern modification would have been more appropriate than the inclusion of an emphasis of matter paragraph.

Practitioners and firms are reminded of the importance of documenting one's considerations and conclusions to support the audit opinion given.

- *ISA 580 – Written Representations*
  Another weakness noted during the course of the QAU's visits was in relation to letters of representation. Although such letters were in place, it was noted that in a number of instances all the representations set out in ISA 580 in conjunction with the other ISAs were not always being included in the letter signed by management.

- *ISA 600 – Special Considerations – Audit of Group Financial Statements*

  When carrying out group audits, the group engagement partner is required to be satisfied that those performing the group engagement, including component auditors, have the appropriate competence and capabilities. The group engagement partner is also responsible for the direction, supervision and performance of the group audit engagement. In carrying out such obligations, the requirements of ISA 600 are to be adhered to. Our visits to the larger audit entities during the year indicated that in some instances, the following requirements of ISA 600 were not satisfied:

- No documentation was found in respect to the overall group audit strategy and audit plan as well as how the firm responded to the assessed risks;
- No audit work was carried out on the group companies which did not classify as significant components;
- The local firm's level of involvement in and conclusions on the component auditors' risk assessment were not clearly documented on file;
- Discussions held on the components' significant activities that were significant to the group were not kept on file;
- No documentation was found in respect to the firm's understanding of the consolidation process;
- Clearance on subsequent events was not obtained prior to signing off of the audit report; and
- Documentation of conclusions on the component auditors' adequacy of work and the sufficiency and appropriateness of audit evidence as noted in the summary review memorandum (supplied by the component auditors) was not kept on file.

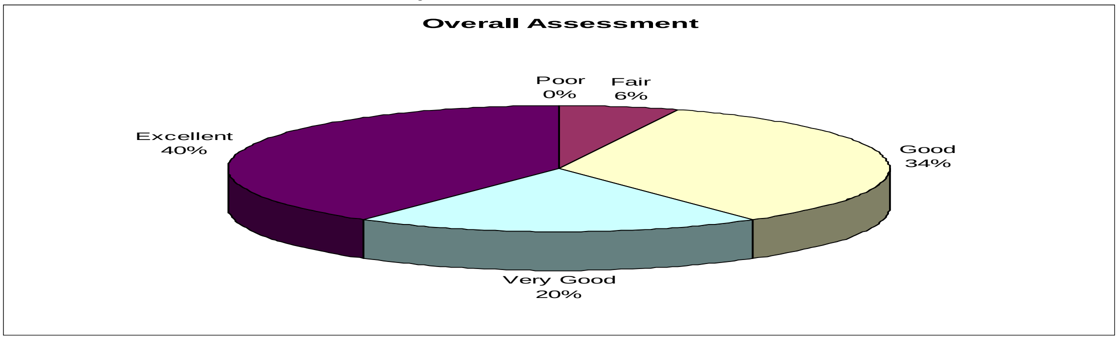
- *ISA 700 – Forming an Opinion and Reporting on Financial Statements*
  This is another area of concern for the QAU. A number of errors were noted when it came to the wording used in the auditor's report. In one instance, an audit report was issued without an audit opinion. Sole practitioners and the smaller firms are advised to revisit this standard and update all upcoming audit reports in line with the requirements set out in ISA 700.

SECTION 3 – FEEDBACK FROM AUDIT ENTITIES VISITED

Once a visit is finalised and reviewed by the QAOC, feedback on the quality assurance visit process is sought from both practitioners and firms visited. Such feedback is provided through the Evaluations Forms provided by the quality assurance unit. During the year, the number of evaluation forms received decreased in line with the drop in the number of visits carried out. Out of a total of 11 visits concluded by the QAOC a total of 7 (64%) evaluation forms were received. Of this total 1 evaluation form pertained to a visit which was finalised by the QAOC in 2011.

As in past years, overall feedback received from practitioners and firms was very positive. Chart 8 provides a graphical illustration of the summary of results:

Chart 8 – Evaluation Form Summary



SECTION 4 – ASSISTANCE FROM OTHER REGULATORY BODIES

4.1 Chartered Accountants Regulatory Board of Ireland (CARB)

During 2012, the Chartered Accountants Regulatory Board of Ireland (CARB) through Ms. Heather Brier's presence and contribution at QAOC meetings has again been an invaluable aide to the QAU. For reasons beyond their control, CARB was unable to provide the QAU the same support given to it in previous years. It is envisaged that this support will be resumed in the coming year.

4.2 The Institute of Chartered Accountants in England and Wales (ICAEW)

During the year, the Accountancy Board again asked for the assistance of ICAEW in respect of quality assurance matters primarily dealing with training assistance provided in the carrying out one of the Big 4 firm visits. During this visit, apart from a PIE and other entities of a certain stature, a local bank and insurance company were selected for review.

SECTION 5 - PLANS FOR 2013

For a number of years, but particularly in the last eighteen months, the QAU has been experiencing an acute shortage of qualified and experienced audit personnel to fill the role of QA reviewers. At present, the Unit has just one full time reviewer whilst another reviewer is working on reduced hours. While no effort is being spared by the Board to address this issue, until a solution is found to this impending problem it is envisaged that again during 2013, the unit will conduct no more than 18 visits as noted below:

- 12 full-time sole practitioners;
- 2 part-time sole practitioners; and
- 4 audit firms (2 of which are auditors of public interest entities).

The above number of visits will be reviewed if an additional, (possibly two) QA reviewer is engaged.

The QAU, through the support of the QAOC and the Accountancy Board looks forward to the challenges that audit regulation has ahead of it in 2013 and beyond. Amongst other things, provided that the much needed resources are made available, the QAU will, throughout 2013 seek to:-

- Resume technical and other working relationship with CARB, including attending team meetings, and training in Northern Ireland particularly on regulated entities;
- Foster alliances we have established with the ICAEW and look into other areas of co-operation with other accountancy bodies providing audit oversight;
- Continue to work closely with our European counterparts as indeed other international audit regulators;
- Work more closely with other local regulators, financial supervisors as well other stakeholders within the field of audit regulation and other related areas;
- Step up the enforcement mechanism in regard to regulatory breaches as well as in its supervision of sanctions and other conditions imposed on audit firms and other audit practitioners;

- Create more public awareness of the Quality Assurance process;
- Advise the QAOC and the Accountancy Board on key issues in regard to audit regulation; and
- Maintain and further develop the existing methodologies, the Accountancy Board portal, and other tools at its disposal.