

**Keynote address by Nik Mohd Hasyudeen Yusoff, Executive Chairman of the Audit Oversight Board, Securities Commission Malaysia, at the ICAA-MICPA forum on “Improving Corporate Governance in the Malaysian Capital Market – The Role of the Audit Committee” 11 August, 2011.**

Ladies and Gentlemen,

I would like to record my appreciation to the Institute of Chartered Accountants in Australia (ICAA) and the Malaysian Institute of Certified Public Accountants (MICPA) for providing me with this opportunity to address the participants of this forum. Initiatives such as this would certainly reinforce our collective efforts in enhancing the quality of governance in the Malaysian capital market, in line with the theme of the recently launched Capital Market Masterplan 2 (CMP2) – Growth with Governance.

Audit committees influence the quality of governance in various ways. They are expected to assess the risks and control environment, oversee financial reporting, evaluate the internal and external audit processes and review conflict of interest situations and related party transactions<sup>1</sup>. Let me confine my focus on the role of audit committee in overseeing financial reporting and external auditing.

The growing complexity of financial reporting

Ladies and gentlemen,

Businesses today are more sophisticated and complex than ever before. It is now common for Malaysian businesses to operate overseas, apply complex business models, have high reliance on technology, use sophisticated financial instruments such as derivatives to reduce earnings volatility and transact in variety of currencies. Investors on the other hand demand more information in an increasingly shorter time frame. These complexity and demand has significantly influence financial reporting, an obligation which all listed companies are required to comply.

The effect of the shift from historical cost to fair value accounting is still being felt in many markets, particularly after the experience during the global financial crisis. Added to this is

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<sup>1</sup> Corporate Governance Guide - Towards Boardroom Excellence. Published by Bursa Malaysia.

the increasing demand for disclosure, requiring more information not traditionally captured by the traditional accounting systems to be included in financial statements. As accounting standards now are principle-based which require preparers to exercise judgments, a mechanical approach towards financial reporting does not work anymore.

I have argued in the past that financial reporting is not a mere compliance obligation. It is part and parcel of the value creation process. What is reported in financial statements is the culmination of the effect of strategic decisions made by boards and the effectiveness of their implementation by management in markets which the companies choose to compete. The information provided through financial statements form the basis of many other decisions made by various stakeholders in the capital market.

### Setting the tone for financial reporting integrity

Ladies and gentlemen,

As financial statements should reflect the true financial performance of the reporting entities, the integrity of the financial reporting process is highly critical. While ultimate responsibility for the integrity of a company's financial reporting rests with the board of directors of the company, an audit committee represents an effective mechanism for providing assurance to the board on the accurate reporting of the company's financial information, and assisting the board to focus on issues relevant to such reporting<sup>2</sup>. Hence, audit committee should set a strong and clear tone to management on its expectations on the quality and integrity of financial reporting.

Among of the areas which require the attention of audit committees are:

- Whether the financial reporting architecture and systems employed are appropriate given the industry the company is involved in, business models adopted, funding structures, complexity of operations and requirements of accounting standards.
- Whether the key risks in financial reporting, including the risks of fraud, have been identified and appropriate and effective controls are put in place.
- Whether key accounting policies have been properly adopted and effectively implemented. This includes ensuring the bases of management estimates and

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<sup>2</sup> The Benefit of Audit – A director's guide on assessment of audit quality. Published by the Institute of Chartered Accountants in Australia and the Malaysian Institute of Certified Public Accountants, 2010

judgments, which should be supported by realistic assumptions, are properly recorded.

- Whether the financial reporting function is operated by qualified professionals who keep themselves updated with the developments in financial reporting. They need to be supported by appropriate financial reporting systems and effective internal control. It is also important to ensure that they are able to prepare a full set of financial statements (including notes to the accounts) in compliance with accounting standards and other regulation.

Given the dynamic nature of the present business environment, the above matters need to be regularly reviewed as failure to make timely changes in policies or process could compromise the integrity and quality of financial reporting.

The challenging nature of the tasks faced by the members of audit committee necessitates for the committee to have a right balance of members with the skill sets that fit with the business of the company. While financial literacy is a must, the ability to make sense of the performance “on the ground” with the numbers reported from the financial reporting system would contribute highly to the effectiveness of the committee. More importantly, the integrity of financial reporting would significantly be influenced by the integrity and values of the members of the audit committee.

#### Deriving value from external audit

Ladies and gentlemen,

While external auditing is a requirement imposed by law on all companies in Malaysia, it should not be viewed as a necessary evil. Let me share with you some of the findings of a research conducted by the Association of Chartered Certified Accountants (ACCA)<sup>3</sup> on how audit committee chairmen in Singapore view the value of audit:

- The external audit is regarded as extremely valuable by chairmen of audit committee to meet their corporate governance responsibilities.
- Most of the audit commit chairmen surveyed were of the opinion that the most important criterion for the selection of auditor was the engagement partner's

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<sup>3</sup> Value of Audit: Views form Audit Committee Chairmen in Singapore. Published by ACCA.

expertise, knowledge of the company's industry and business and an informed audit team with international reach.

- They want the auditor to be independent and "speak their mind".
- The management letter was particularly important to them, who might not be otherwise informed of the weaknesses.
- The chairmen of audit committees surveyed find auditors' feedback on areas such as the quality of management's finance team and the competence and cooperation of staff, particularly those in foreign locations, useful.
- They are willing to pay reasonable fees for quality audits, and keeping them as low as possible was not a principle objective for them.

To enable the full value of the audit to be derived, the audit committee should consider the following issues:

- As the value of an independent audit is driven by the independence of the auditors, audit committee should ensure the firm appointed by the company is independent and are able to provide impartial opinion.
- The auditors have the resources, expertise and experience to perform the audit effectively including considering their audit methodology and the strength of their network.
- Whether the agreed fee and timing of the audit would enable the auditors to perform their work in accordance with the agreed scope effectively.

Last year, the ICAA and MICPA jointly published a document which provides audit committees with a guide to enable effective engagements with external auditors as well as highlighting key drivers of audit quality. This is a good reference in understanding the concept of audit quality and its key drivers.

### The role of the stakeholders in the financial reporting ecosystem

Ladies and gentlemen,

While the Audit Oversight Board will continue to engage auditors in our oversight activities, the attainment of our mission which is to foster high quality independent auditing to promote confidence in the quality and reliability of audited financial

statement of public interest entities in Malaysia will not be achieved if other stakeholders in the financial reporting ecosystem do not play their part effectively. We consider directors and members of audit committee as among those key stakeholders.

We would like to encourage audit committees to view high quality audit as a critical component in their risk management framework and in ensuring high quality financial reporting by their companies. By having this perspective, we trust audit committees would be more willing to support higher investment in audits. We have concern that due to competitive pressure, auditors would be willing to accept audit engagements at fees which do not allow them to perform quality audits. Such risk, if ever proven, would not only affect the auditors but also the reputation of their clients as well.

We would also like to encourage shareholders and investors to raised questions on audit quality to the board of companies whenever they have such opportunity. We believe that with higher demand of audit quality and the continued effort by audit firms to enhance the quality of their work, higher confidence in the quality and reliability of audited financial statements of PIE in Malaysia would be a recognisable feature of our capital market.

### Closing

Ladies and gentlemen,

This morning we are going to deliberate issues relating to how audit committee could contribute more in enhancing corporate governance in Malaysia. While this question is not new, what matters most is how much committed we are in making changes once the answers are discovered.

I would like to leave you with this quotation from Einstein on the subject of questioning "The important thing is not to stop questioning. Curiosity has its own reason for existing. One cannot help but be in awe when he contemplates the mysteries of eternity, of life, of the marvellous structure of reality. It is enough if one tries merely to comprehend a little of this mystery every day. Never lose a holy curiosity."

Thank you for your attention.