



Securities and
Exchange
Commission
PHILIPPINES

SEC Oversight Assurance Review



1st Public Inspection Report
June 2022

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Foreword

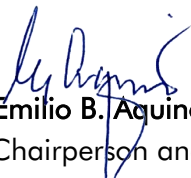
As a gateway to doing business in the Philippines, the SEC is in a prime position to transform the country into one of the best business hubs and a capital market of choice in Southeast Asia.

The SEC believes that to ensure a well-functioning capital market that can contribute to the country's economic development, high-quality financial information and high-quality audits play an essential role. Consistent with this belief and our core mandate to protect the investing public, the SEC officially launched the SEC Oversight Assurance Review (SOAR) Inspection Program in 2017. This program is the prime SEC initiative and the first on-site inspection by a local regulator to promote high-quality, more credible and transparent financial reporting. The review of audits of financial statements of publicly-listed companies is focused on ensuring that auditors comply with the relevant standards, are competent, and are independent. These are central to the auditor's ability to identify and assess the risks of material misstatement of the financial statements due to errors or fraud and respond appropriately to identified or suspected fraud.



The SEC conducted the first cycle of SOAR Inspection from 2018 to 2021. Given our transparency commitment to our stakeholders, the publication of the first edition of the Public Inspection Report summarizes the observations on audit quality from the first inspection cycle. These include the common inspection findings, common root causes of these findings and notable best practices of audit firms. We, at the SEC, hope that this report provides an excellent source of information for the key players of the financial reporting ecosystem – management of the companies or the preparers of financial statements; those charged with governance, such as the Board of Directors and Audit Committees that oversee the financial reporting process; external auditors that perform independent audits; other regulators and standard-setters that safeguard the interest of the general public; and creditors and investors that rely on financial information when making economic decisions.

The public can expect this regular publication of audit quality observations after every cycle of the SOAR inspection. Moving forward, the SEC will continuously take on various initiatives and further increase our engagement with our stakeholders to drive improvements in audit quality and fulfill our mandate as the champion of investor protection.


Atty. Emilio B. Aquino, CPA, CSEE
SEC Chairperson and CEO




Message

Over the past two years, we have witnessed the unprecedented challenges brought about by COVID-19 in our country and worldwide. The pandemic resulted in severe economic disruptions, thereby increasing the uncertainty and unpredictability in capital markets. These ultimately affected management's judgments and estimates when preparing financial reports. The pandemic, however, also provided the impetus to business organizations, including government agencies such as the SEC, in putting forth varying activities to cushion any severe and adverse impact that hamper daily tasks. A good example is the evolution of technologies during the pandemic, which has recalibrated our operations to ensure the continual flow and delivery of services.



While the country was subjected to varying levels of community quarantine and most audit firms adopted work-from-home arrangements, the SOAR Inspection Team quickly transitioned to virtual or remote inspection and leveraged the audit firms' technologies to adapt to the changing environment brought by the pandemic. Given the increasing demand for high-quality financial information, especially during heightened uncertainty, the SEC endeavored to complete the first cycle of SOAR Inspection in 2021 despite the circumstances.

On behalf of the Commission *En Banc*, I would like to commend the Office of the General Accountant, especially the SOAR Inspection Team, for their hard work and commitment in ensuring that the SEC continues to proactively fulfill its role as the champion of investor protection.


Atty. Karlo S. Bello
SEC Supervising Commissioner
for the Office of the General Accountant

Message

The SOAR Inspection Program was one of the most awaited initiatives of the SEC. And indeed, from its inception, it has significantly contributed to the Commission's core mandate to protect public interest by promoting high-quality audits, and credible and transparent financial reporting.

The implementation of the SOAR Inspection Program entailed several years of preparation and stakeholders' engagement. It has required the creation of a new division under the Office of the General Accountant, recruitment of the right people, conduct of capacity-building training, dialogues with various stakeholders, and transition to virtual inspections during the pandemic. Our memberships in the International Forum of Independent Audit Regulators (IFIAR) and the ASEAN Audit Regulators Group benefit our team through our participation in annual inspection workshops, dialogue with audit firms, and plenary meetings.



Completing the first cycle of the SOAR Inspection and the publication of the first edition of the SOAR Public Inspection Report was such a remarkable feat and key milestone. The successful implementation of the SOAR Inspection Program was made possible with the full cooperation of the audit firms and their strong commitment to providing high-quality audits. This sense of commitment can help bridge the audit expectation gap in the market.

The successful launch of the SOAR Inspection Program would also not be possible without the support of our former Chairperson, Teresita J. Herbosa, and the assistance of the U.S. Agency for International Development (USAID). The USAID and its consultants, through the Integrity for Investments Initiative program, provided several technical assistance, including the SEC's peer exchange and policy discussions in 2017 with the U.S. Public Company Accounting Oversight Board and the U.S. Securities and Exchange Commission in Washington, D.C.

I also want to acknowledge our former SEC Commissioner, Antonieta Ibe, for her invaluable contributions to the program since its inception. She also led the SEC's admission to the IFIAR, a testament to the work carried out over several years for the development of the audit oversight in the Philippines.

The SEC will continue to work together with the audit firms and other stakeholders to uphold the entrusted mandate in protecting the public interest.


Atty. Emmanuel Y. Artiza, CPA
SEC General Accountant





Acronyms

AARG	ASEAN Audit Regulators Group
AQI	Audit Quality Indicator
CPA	Certified Public Accountant
EQC	Engagement Quality Control
EQCR	Engagement Quality Control Reviewer
FIR	Final Inspection Report
IFIAR	International Forum of Independent Audit Regulators
IOSCO	International Organization of Securities Commissions
LOF	Letter of Findings
MC	Memorandum Circular
PFRS	Philippine Financial Reporting Standards
PLC	Publicly-listed Company
PSA	Philippine Standards on Auditing
PSQC	Philippine Standard on Quality Control
PSQM	Philippine Standard on Quality Management
ROSC	Report on the Observance of Standards and Codes
SEC	Securities and Exchange Commission (Philippines)
SEC MC	SEC Memorandum Circular
SOAR	SEC Oversight Assurance Review
SOQC	System of Quality Control
SOQM	System of Quality Management
SRC	Securities Regulation Code
TCWG	Those Charged with Governance

Definition of Terms

Accounting Standards	Set of standards adopted by the Philippine Financial Reporting Standards Council that govern the preparation of financial statements, as approved by the Board of Accountancy and Professional Regulation Commission, and adopted by the SEC Philippines as part of financial reporting rules. These standards are adopted from the International Financial Reporting Standards issued by the International Accounting Standards Board.
Audit Firm/ Firm	A partnership registered and accredited with the SEC and engaged to conduct an audit of the financial statements.
Audit Sampling	The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population (PSA 530 par. 5a).
Auditing Standards	Set of standards used by auditors when conducting an audit of financial statements and promulgated by the Auditing and Assurance Standards Council, as approved by the Board of Accountancy and Professional Regulation Commission, and adopted by the SEC Philippines as part of financial reporting rules. These standards are adopted from the International Standards on Auditing issued by the International Auditing and Assurance Standards Board.
Auditor	Person or persons conducting an independent audit, composed of the engagement partner and other members of the audit team.
Other Audit Firms/ Individuals	Audit firms or individual auditors who perform audits of financial statements of a company other than a publicly-listed company (PLC).
Professional Skepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence (PSA 200 par. 13I).
Publicly-listed Company	Entities with equity or debt securities listed in an exchange.
Six Largest Audit Firms	Top six SEC-accredited audit firms with client portfolio that collectively comprise the highest market capitalization of all PLCs and with the most employed audit professionals in the Philippines.
Small and Medium-sized Audit Firms	SEC-accredited audit firms engaged in the audits of PLCs, other than those categorized as six largest audit firms.
Those Charged with Governance	The person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process (PSA 260 par. 10a).





Executive Summary

High-quality audits are essential to boost the confidence and trust of users of the financial statements. Reliable financial information is the key to financial stability, continued growth and economic development as it enables investors to make well-informed decisions that facilitate the efficient allocation of capital.

The SEC Oversight Assurance Review (SOAR) Inspection is an initiative by the SEC aimed to supplement its continued efforts in promoting audit quality. During the first cycle of the SOAR Inspection, **the SEC inspected all of the 17 audit firms that have clients with equity or debt securities listed in an exchange.** The SEC observed key areas that audit firms can improve on within their systems of quality control (“firm-level”) and their conduct of individual audits (“engagement-level”).

In the firm-level review, the **policies and procedures on engagement performance ranked at the top of the list with the highest frequency of inspection findings.** This particular element of quality control pertains to policies and procedures on matters that are relevant to promoting consistency in the quality of engagement performance, including supervision and review. Next in the list, arranged in order of frequency of the findings, pertain to policies and procedures on monitoring; independence and ethics; human resources; acceptance and continuance; and leadership responsibilities.

In the engagement-level review, **accounting estimates, including fair value estimates, have the highest frequency of inspection findings.** This inspection theme remains to be the most challenging area in the audit as it involves significant management judgment and bias which requires auditors to be more cautious and exercise professional skepticism when challenging management’s assumptions. There were also some significant engagement-level findings pertaining to testing the adequacy of financial statements’ presentation and disclosures; understanding and testing internal controls; fraud procedures; revenue recognition; audit report; and group audits.

To date, all completed remedial actions to address the noted inspection findings, both at the firm and engagement levels, were sufficient and satisfactory. **The SEC commends these audit firms for their commitment to audit quality by performing root-cause analyses** in order to develop long-term solutions to the identified inspection findings.

As the SOAR Inspection is primarily aimed at improving audit quality for investor protection, **the SEC will continue to increase engagement with relevant key stakeholders to facilitate dialogues on audit-related matters.**

Introduction



SOAR Inspection Program

Background

In 2003, the SEC started the accreditation of auditors of its regulated entities. This accreditation involves an evaluation of the audited financial statements and serves as SEC’s quality assurance review of auditors, short of actual on-site inspections. In 2017, the World Bank’s Report on the Observance of Standards and Codes (ROSC) on Accounting and Auditing¹ recommended establishing an independent, comprehensive system of audit quality assurance with risk-based inspection in the Philippines. The World Bank believes that such system would enhance investors' confidence and boost capital performance. Moreover, the International Organization of Securities Commissions (IOSCO) sets out the principles of securities regulations,² which include the following:

1. Auditors should be subject to adequate levels of oversight and should be independent of the issuing entity that they audit;
2. Auditors should follow audit standards of a high and internationally acceptable quality; and
3. The regulatory system should ensure effective and credible use of inspection, investigation, surveillance, enforcement powers and implementation of an effective compliance program.

As the SEC continues to adhere to its commitment as a member of IOSCO and in order to consider the World Bank's recommendations in ROSC, the SEC officially launched the SOAR Inspection Program through the issuance of Memorandum Circular (MC) No. 9, Series of 2017.

Pursuant to the powers, functions, and authority vested to the SEC, the SOAR Inspection Program was implemented (see **Figure 1**).



Figure 1: Legal Basis of the SOAR Inspection Program

<p style="text-align: center;">Securities Regulation Code (SRC) Section 5</p> <p style="text-align: center;">Powers and functions to protect investors and ensure full and fair disclosures about securities</p>	<p style="text-align: center;">Revised SRC Rule 68</p> <p style="text-align: center;">Authority to make, amend and rescind accounting rules and regulations as may be necessary to carry out the provisions of the SRC</p>
<p style="text-align: center;">Revised Corporation Code Sections 162 and 163</p> <p style="text-align: center;">Power to impose monetary penalties to auditors for willful certification of incomplete, inaccurate, false or misleading statements or report</p>	<p style="text-align: center;">SEC MC No. 12, Series of 2021</p> <p style="text-align: center;">Sets out the revised rules and regulations on the implementation of the SOAR Inspection Program</p>

¹ World Bank, “Report on the Observance of Standards and Codes on Accounting and Auditing,” September 28, 2017.

² IOSCO, “Objectives and Principles of Securities Regulation,” May 2017.

SOAR is an initiative of the SEC to do an on-site review of the quality control policies and procedures of accredited audit firms auditing companies with equity or debt securities listed in an exchange and review portions of the audit work on selected audit engagements of these audit firms from time to time.

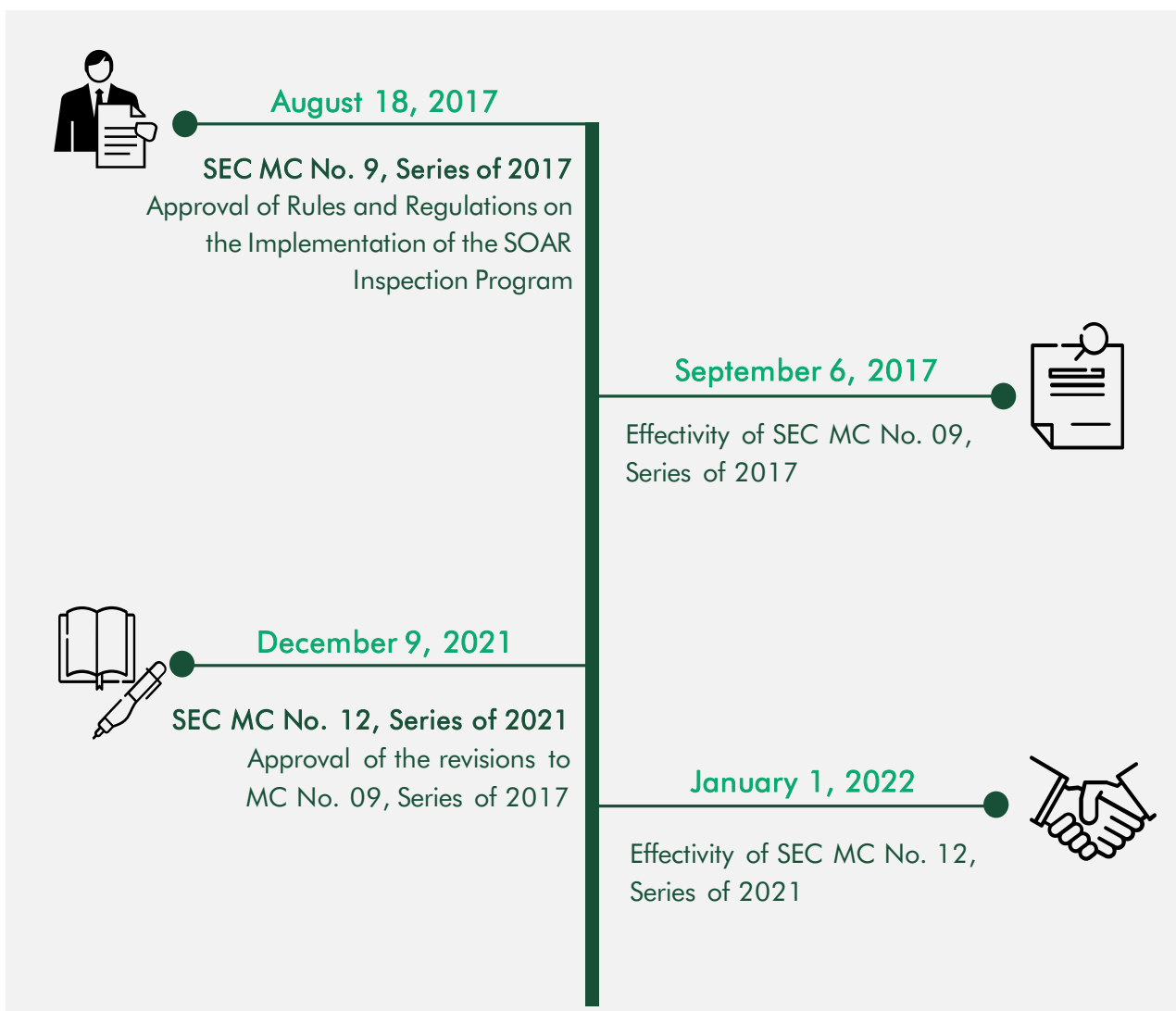
Audit firms and engagements subjected to the SOAR Inspection are selected using a risk-based approach. Audit engagements that may pose

difficult or complex issues are identified, considering risk factors such as the PLCs' nature, industry, market capitalization, and audit issues likely to be encountered.

In 2021, the SEC issued the revised rules and regulations on the implementation of the SOAR Inspection Program ("Revised SOAR Rules"), as illustrated in **Figure 2**. A summary of the significant revisions to the SOAR Rules can be found in **Appendix I** of this report.



Figure 2: SOAR Rules Implementation Timeline



Membership with International Organizations

In its pursuit to ensure that the implementation of the SOAR Inspection Program is globally consistent and on par with its counterparts from different jurisdictions, the SEC sought membership with different international organizations.

November 2018

Admission to the International Forum of Independent Audit Regulators (IFIAR)

The IFIAR comprises independent audit regulators from 54 jurisdictions from Africa, North America, South America, Asia, Oceania and Europe. Its mission is to serve the public interest, including investors, by enhancing audit oversight globally.

April 2019

Membership to the ASEAN Audit Regulators Group (AARG)

AARG is composed of Singapore's Accounting and Corporate Regulatory Authority, Indonesia's Pusat Pembinaan Profesi Keuangan, Malaysia's Audit Oversight Board, Thailand's Securities and Exchange Commission and Philippine's SEC. Formed in 2011, AARG aims to foster closer collaboration amongst audit regulators to further promote audit quality in the ASEAN region while complementing IFIAR's effort to uphold the standards of audit quality globally.

Membership in these organizations provides an excellent opportunity for the SEC to learn from other regulators' practical experience and better understand the audit firms' culture and the evolving audit environment in order to effectively implement the SOAR Inspection Program.

SOAR Inspection Process

The SOAR Inspection commences upon the issuance of the Firm Notification Letter and ends when the SOAR Inspection Team issues an Evaluation Report of Audit Firm's Remediation. This entire process takes approximately 20 months.

Issuance of Audit Firm and Engagement Notification Letters

60 calendar days (audit firm) and 30 calendar days (engagement) before the start of inspection



Issuance of Letter of Findings (LOF)

Within 45 calendar days after the end of inspection fieldwork



Issuance of Inspection Report

Within 45 calendar days from receipt of audit firm's reply to LOF



Remediation Process

Within 12 months after the issuance of the Inspection Report



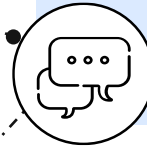
Inspection Fieldwork

At least two weeks



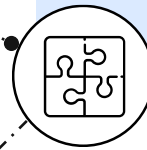
Audit Firm's Reply to LOF

Within 30 calendar days after the issuance of the LOF



Submission of Remediation Plan

Within 60 calendar days after the receipt of the Inspection Report



Issuance of Evaluation Report of Audit Firm's Remediation

Within 30 calendar days from end of remediation process



What is an Inspection Finding?

Inspection findings are the quality control findings at the firm level and significant audit deficiencies at the engagement level, that are included in the Inspection Report issued to audit firms. Upon receipt of the Inspection Report, audit firms have 12 months to remediate these findings.



Firm-Level Review

- ⇒ Relates to non-compliance with the requirements of Philippine Standard on Quality Control (PSQC) 1 (Redrafted), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance Related Services Engagements*
- ⇒ May indicate areas where an audit firm's system of quality control (SOQC) has failed to provide reasonable assurance of quality in the performance of audits



Engagement-Level Review

- ⇒ Relates to significant non-compliance with the Philippine Standards on Auditing (PSA), relevant regulatory requirements or audit firm's policies and procedures
- ⇒ Includes insufficient audit procedures and evidence to appropriately respond to the assessed risks of material misstatements at the financial statement and assertion levels
- ⇒ Includes failure to identify, or to appropriately address, material misstatements in the financial statements
- ⇒ **Does not necessarily mean that the financial statements were misstated or that an audit failure has occurred**



Sanctions for Violations Identified During Inspection

Inspection findings that remained unresolved, contested or with remedial actions that are deemed not satisfactory, after the allowed period of remediation, shall be published on the SEC website. The publication of inspection findings shall include the audit firm's name and its responses to the inspection findings.

The following administrative sanctions may also be imposed on audit firms or auditors covered by the inspection:

Censure

Monetary fines

Require to engage a consultant to design policies and improve compliance

Require additional professional education and training

Downgrading of SEC accreditation

Suspension or revocation of SEC accreditation

Other sanctions that will be subsequently determined and issued by the SEC

Scope of Inspection



SEC-accredited Audit Firms & Auditors

The SEC's accreditation of audit firms and external auditors serves as a quality assurance review or quality control mechanism to promote integrity of financial reports and transparency in the financial system. Under the Revised SRC Rule 68, SEC-regulated entities should be audited by independent auditors accredited by the SEC under their respective categories: Groups A, B or C.

The accreditation level requirement is dependent on the nature of the companies audited. For example, Group A accreditation is required for audit firms or external auditors that audit PLCs and public companies; Group B is required for those that audit investment houses, broker and dealers of securities; and Group C accreditation is required for financing and lending companies, and transfer agents, among others. Presented in **Figures 3** and **4** are the breakdown of the total SEC-accredited audit firms and external auditors as of December 31, 2021.



Figure 3: Number of SEC-accredited Audit Firms per Category

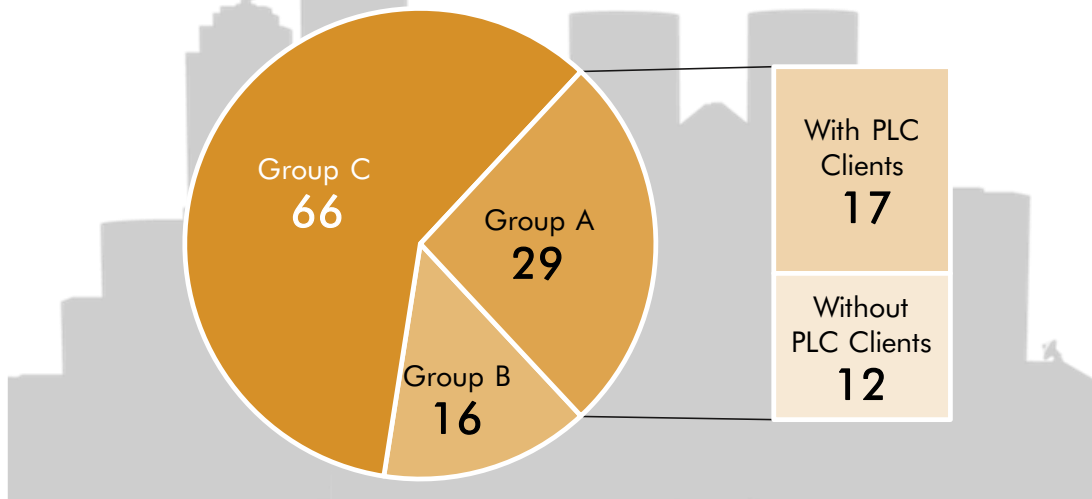
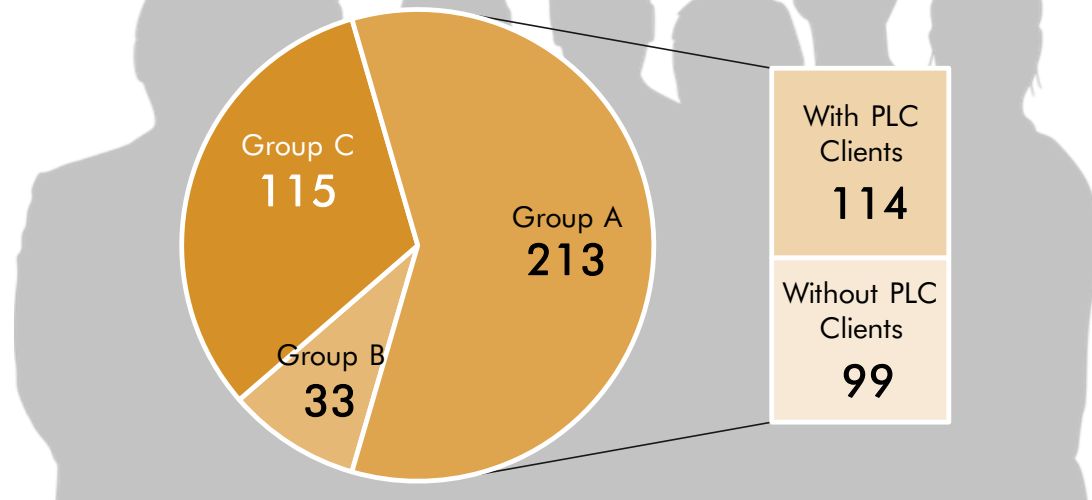


Figure 4: Number of SEC-accredited External Auditors per Category



Inspected Audit Firms

The 17 Group A-accredited audit firms (see **Figure 3**) that have PLC clients were inspected in the first cycle of the SOAR Inspection. **Figure 5** shows the client portfolio and total number of employed audit professionals of these 17 audit firms.

The audit firms who handle the audits of PLCs are categorized in this report either as the “**Six Largest Audit Firms**” or “**Small and Medium-sized Audit Firms**”. The six largest audit firms are the top six firms: a) with client portfolio that collectively comprise the highest market capitalization of all PLCs; and b) with the most employed audit professionals.

Figure 5 shows that the six largest audit firms are engaged by 253 or 88% of all the PLCs. It also shows that the PLCs comprising 99% of the total market capitalization are audited by this group. Accordingly, these firms have the most labor pool (i.e., 7,859 or 89% of the audit professionals of all the subject audit firms).

PLCs in the Philippines

As of December 31, 2021, there were a total of 292 PLCs in the Philippines, 287 of which engaged the audit services of 17 local audit firms. The other five PLCs were audited by foreign audit firms and the Philippine Commission on Audit. By regulation, only the 17 local audit firms are within the scope of the SOAR Inspection Program. **Figure 6** shows the distribution of these PLCs across different industries according to market capitalization.

Industry Overview

As illustrated in **Figure 6**, the PLCs from the Property Industry contributes the highest share to the total market capitalization of all PLCs. This is primarily attributable to the developments in the industry as further exhibited by the launching of the 2020 Implementing Rules and Regulations of the Real Estate Investment Trust (REIT) Act by the SEC.



Figure 5: Audit Firms’ Portfolio

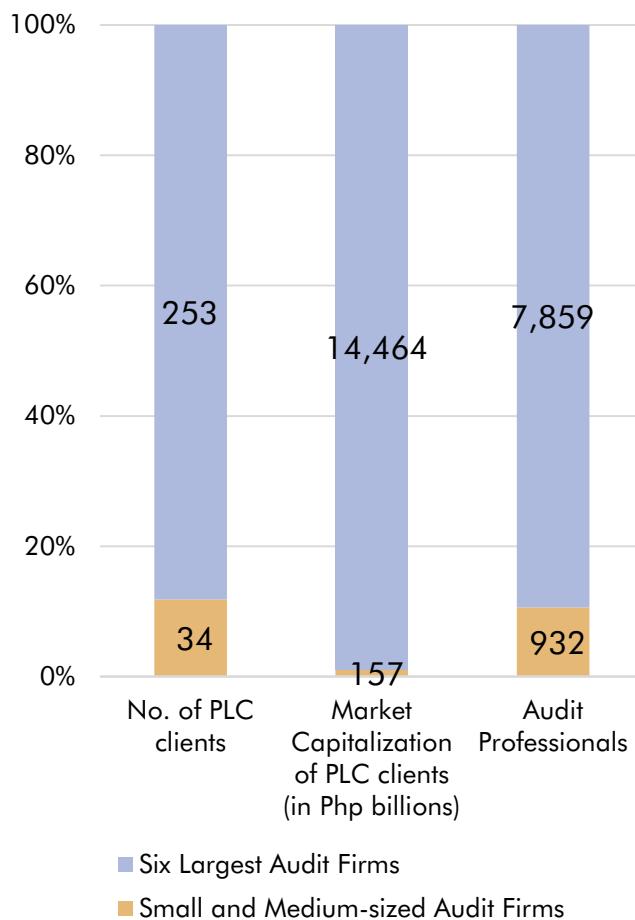
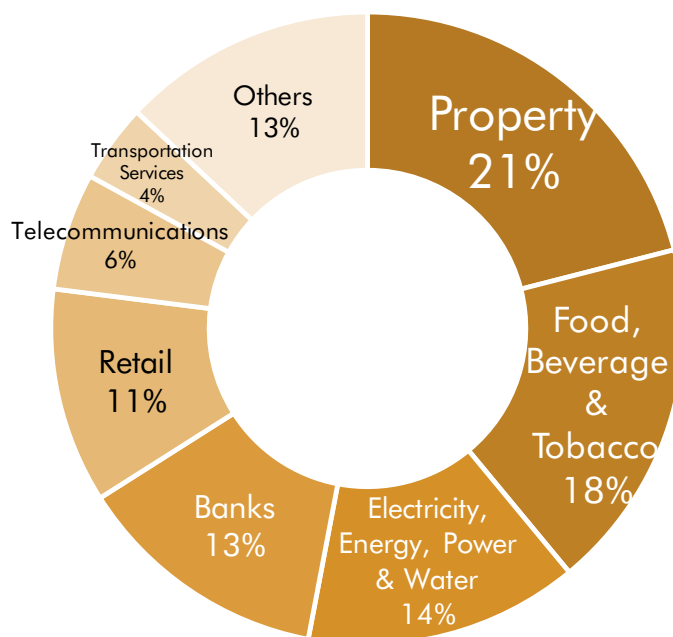


Figure 6: Market Capitalization of PLCs per Industry³



³ Obtained from the SEC Database.

Since the launch of REIT, seven property companies listed its shares for public offering. Aside from the Property Industry, the PLCs from the Food, Beverage and Tobacco Industry; and the Electricity, Energy, Power, and Water Industry also comprise a significant portion of the total market capitalization of all PLCs in the Philippines. In the past two years, two more companies from these industries went public.

PLCs from the top three industries collectively belong to the Industrial Sector. This sector, accounting for 30% of the Philippine Gross Domestic Product (GDP), rebounded, on 8.2% growth in 2021 with the implementation of more granular and less stringent lockdowns, sustained

growth in public infrastructure spending, improving consumer confidence, and the roll-out of the COVID-19 vaccination program. The growth in this sector fueled the economic recovery of the Philippines in 2021, with the GDP expanding by 5.6%, after it contracted by 9.6% in 2020 amidst the COVID-19 pandemic.⁴

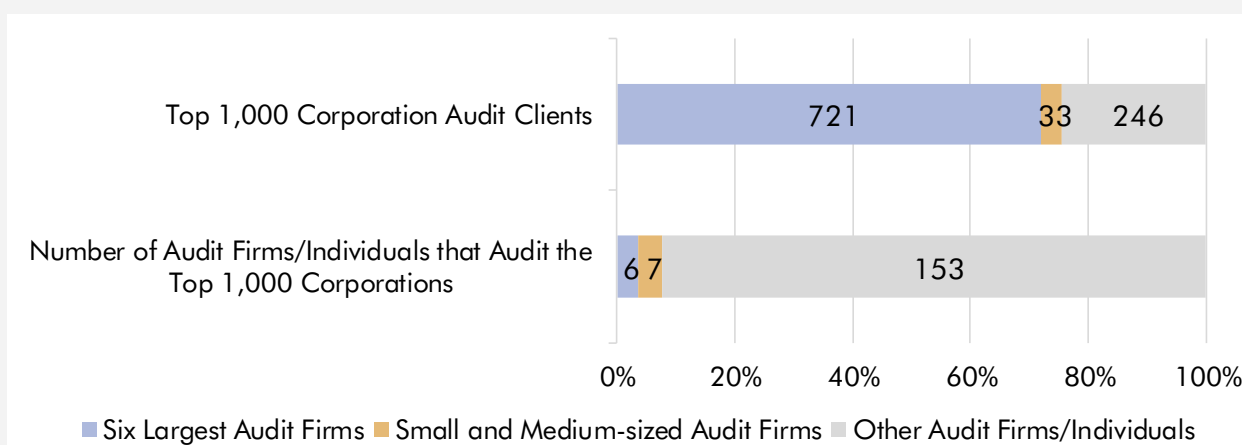
The government spending on infrastructure through the continuation of the “Build, Build, Build Program”, as supported by the steady vaccination of the Philippine population leading to greater mobility and revival of businesses, is expected to maintain the country’s economic growth, in 2022.⁵

Top 1,000 Corporations in the Philippines⁶

In the list of top 1,000 corporations in the Philippines, which is determined based on gross revenues, only 90 or 9% are PLCs. The audits of the financial statements of 12% of these PLCs were covered in the first cycle of SOAR Inspection.



Figure 7: Distribution of Top 1,000 Corporations in the Philippines



As shown in **Figure 7** above, 721 or 72% of the top 1,000 corporations are audit clients of the six largest audit firms in the Philippines while 33 or 3% are audit clients of small and medium-sized audit firms. This chart further shows that the auditors of 754 or 75% of the top 1,000 corporations are within the scope of the SOAR Inspection Program. Contrastingly, 246 or 25% of the top 1,000 corporations are audited by 153 other audit firms/individuals which are outside the scope of the SOAR Inspection Program.

⁴ Asian Development Bank, “Asian Development Outlook 2022: Mobilizing Taxes for Development,” April 2022.

⁵ World Bank, “Philippines: Boosting Private Sector Growth Can Strengthen Recovery, Create More Jobs,” December 07, 2021.

⁶ Obtained from the SEC Database.

Coverage of First Cycle of Inspection



17

Audit Firms

All firms engaged in the audits of PLCs



20

Audit Partners

Partners



44

Audit Engagements

Composed of audits of 23 PLCs and 21 significant components of PLCs

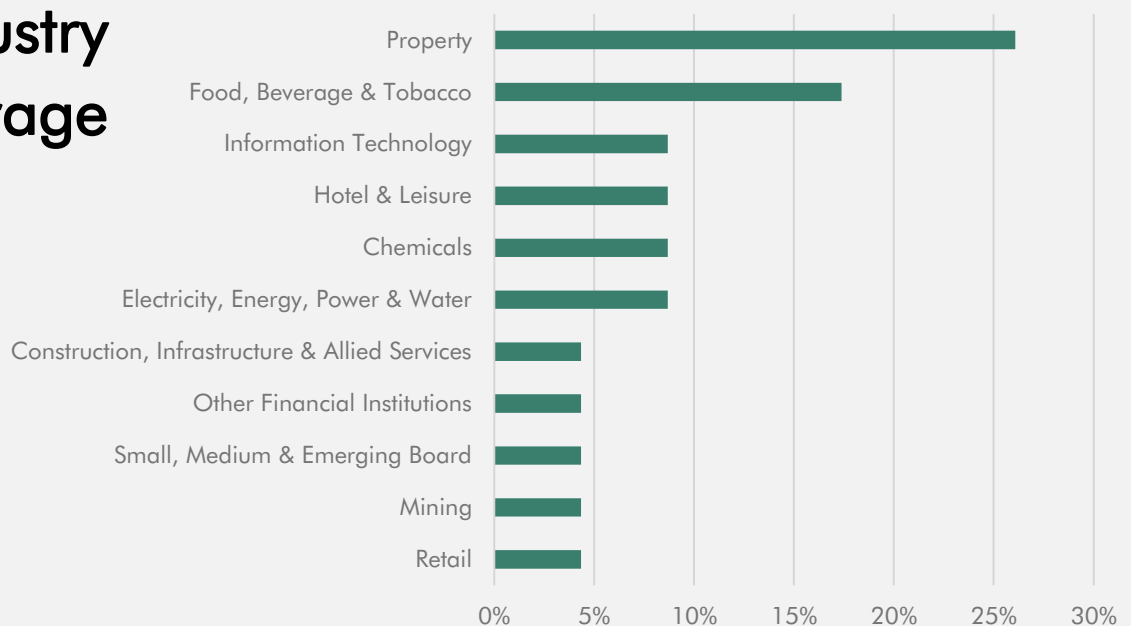


22%

of Total Market Capitalization

of all PLCs

Industry Coverage



Firm-level Observations



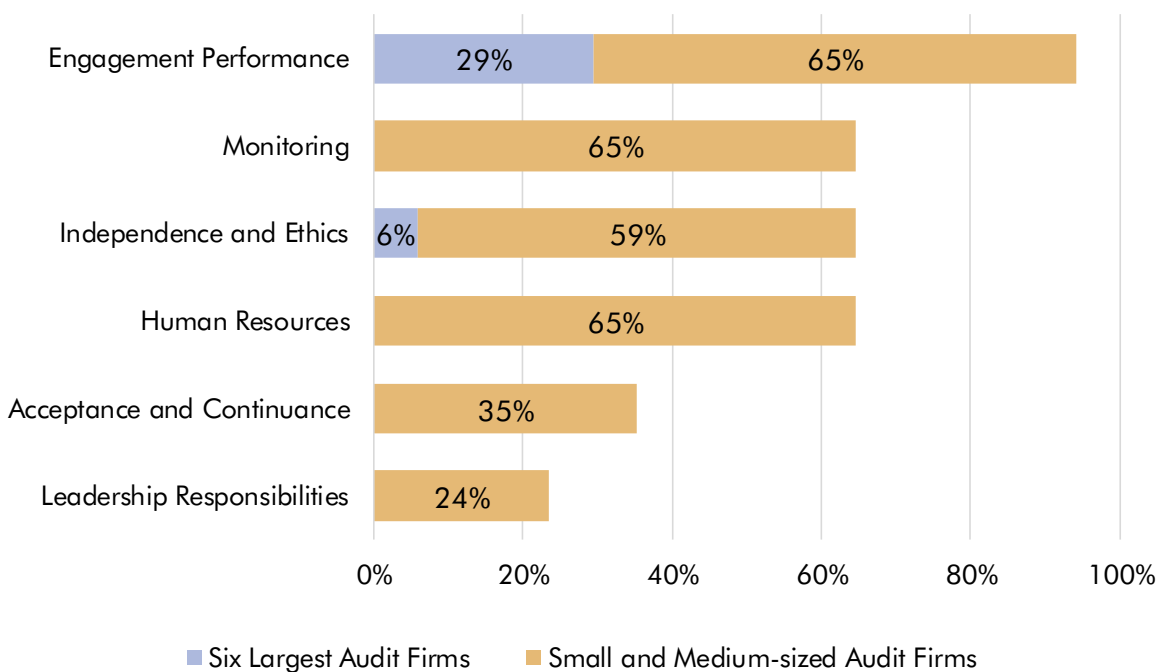


Common Inspection Findings & Root Cause Analysis

The SOAR firm-level inspection evaluated the audit firms' compliance with the six elements of PSQC 1. As shown in **Figure 8**, majority of areas that needed improvements pertained to the audit firm's policies and implementation related to engagement performance. This section summarizes the common firm-level inspection findings, risks and recommendations:



Figure 8:
Percentage of Audit Firms with Quality Control Findings



Leadership Responsibilities

Common Inspection Finding	Risks	Recommendations
<p>Overriding Commitment to Quality</p> <p>Performance evaluation of partners of certain audit firms is based solely on commercial factors without consideration of audit quality and ethical factors</p>	<p>⇒ May put greater focus on commercial factors</p> <p>⇒ May not drive the right behavior of partners</p> <p>⇒ May result in inadequate disciplinary actions</p>	<p>Audit firms should clearly establish performance evaluation policies and procedures with a greater focus on quality-related factors to promote an internal culture based on quality. Audit firms may consider the following quality factors:</p> <p>⇒ Strict compliance with internal quality control policies and procedures;</p> <p>⇒ Timely assembly of final audit files;</p> <p>⇒ Results of internal and external reviews and monitoring; and/or</p> <p>⇒ Compliance with relevant ethical requirements, including independence.</p>



Tone at the Top

Consistent actions and messages demonstrating the importance of quality by those in a leadership position provide significant influence to the creation of a culture of quality within an audit firm. Such culture ultimately

influences the behavior of audit firm personnel towards quality engagements. There were observations that the ultimate responsibility for the audit firm's quality was not specified in the policies and procedures.

The SEC reminds auditors the importance of the assignment of roles and responsibilities within the audit firm. The person assigned with the responsibilities for the SOQC should have the necessary experience and authority.

Relevant Ethical Requirements

Common Inspection Findings	Risks	Recommendations
<p>Channel of Communication</p> <p>Lack of an effective ethics reporting channel</p>	<p>⇒ May lead to an unwanted culture where the audit firm's personnel fear retaliation from superiors or colleagues</p>	<p>Audit firms should establish a channel where any noted independence breaches can be communicated, such as introducing a confidential ethics hotline or any other means. This would encourage its personnel and third parties to communicate to an appropriate person without fear of reprisal. Audit firms should use effective communication methods such as e-mails, meetings and posters at high-visibility locations to ensure that all of the audit firm's personnel are appropriately informed of the reporting channels.</p>
<p>Threats to Independence</p> <p>Lack of safeguards to address self-review threats when providing non-assurance services</p>	<p>⇒ May undermine the importance of the fundamental principles under the Code of Ethics for Professional Accountants in the Philippines ("Code of Ethics") which may affect the exercise of professional judgment due to preconception or bias leading to inappropriate conclusion and opinion</p>	<p>Audit firms should review the prevailing requirements of the Code of Ethics for services that are prohibited to be offered to existing audit clients to avoid breaches of independence requirements.</p>
<p>Independence Monitoring/Tracker</p> <p>Lack of monitoring that would track investments or relationships to ensure that independence requirements are complied with</p>	<p>⇒ May fail to identify breaches of independence requirements and take appropriate actions to resolve such situations if policies and procedures are not in place</p>	<p>Audit firms should establish a mechanism where it can effectively detect breaches of independence requirements and take appropriate actions as needed. It may use a monitoring system subject to regular updating with appropriate review by the Ethics Head, as necessary.</p>

Acceptance and Continuance

Common Inspection Finding	Risks	Recommendations
<p>Risk Assessment</p> <p>Lack of formal policies and procedures in performing the risk assessment process for new and continuing client relationships and engagements</p>	<p>⇒ May pose a potential reputational risk to the audit firm if the client's associated risks are not carefully identified, assessed, and evaluated</p> <p>⇒ Inappropriate classification of client and engagement risks (e.g. high, moderate or low risks) affects the overall engagement planning and strategies</p>	<p>Audit firms should establish a robust screening process before accepting and continuing client relationships and engagement to ensure risk factors are carefully identified, assessed, and evaluated. This may include obtaining information from a variety of internal and external sources through discussions with third parties and performing background searches.</p> <p>Audit firms should also establish clear guidelines in their policies regarding the identification, assessment and evaluation of identified risks and their impact on the overall audit strategies.</p>

Human Resources

Common Inspection Findings	Risk	Recommendations
<p>Training</p> <p>⇒ Lack of independence education for all personnel who are required to be independent</p> <p>⇒ Lack of structured policies regarding the minimum training requirements</p>	<p>⇒ May affect the overall performance of partners and staff</p>	<p>In an environment where audit firms continue to face high staff turnover, loss of knowledge is a key risk. Audit firms should ensure that their personnel remain competent by maintaining a competency-based training program, which includes independence education, to enable them to deliver high-quality audits. Further to training, audit firms may also consider a proper and effective coaching style.</p>

Labor Pool During the COVID Crisis

Staffing is an enduring concern in the audit profession as high staff turnover continues to challenge audit firms every year. This issue was further compounded by the recent shift from the 10-year basic education into the K-12 curriculum, which despite being a much-needed reform towards globalization of the Philippine education system, resulted in a gap in the country's workforce.

With the health risks and restrictions brought by the COVID-19 pandemic, the licensure examination for Certified Public Accountants (CPAs) were postponed multiple times since 2020.

These recent developments further exacerbated the concern of audit firms' labor pool shrinkage. As a direct result, audit firms resort to supplement their workforce with non-CPAs to meet their commitments on audit engagements.

The SEC acknowledges the challenges faced by auditors in the recruitment of qualified staff during these difficult times. However, the SEC underscores the importance of observing certain ethical measures relative to employment of non-CPAs. In some audit firms, it was observed that there were no separate policies in place on the recruitment, promotions and career advancements of the non-CPA personnel. This practice fails to ensure that the audit firm’s personnel have sufficient competence, capabilities and commitment to ethical principles.

Non-CPAs may not be qualified to act as primary auditors. Should non-CPAs be involved to assist in the audit, audit firms should ensure that direct supervision is in place.

As shown in **Figure 9**, both the six largest audit firms; and the small and medium-sized audit firms, similarly experience an average attrition rate of roughly 30%. This means that on the average, 3 out of 10 employees leave the audit firm on any given year. It can also be observed that large audit firms have a narrower range of attrition rates, from 27% to 33%.

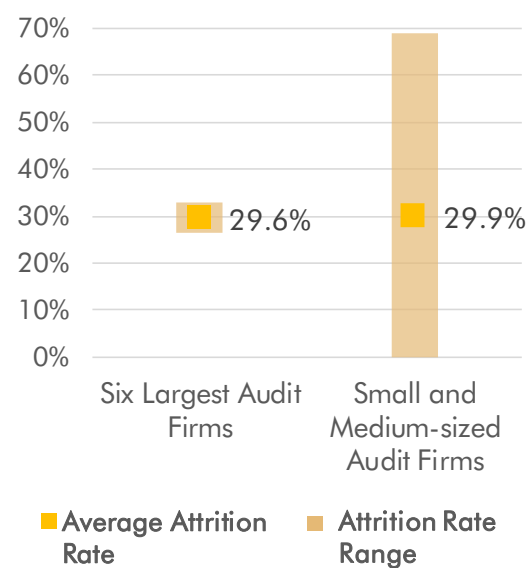
On the other hand, there were observations of zero separations in one of the inspected small and medium-sized audit firms, while another experienced as high as 69% attrition rate.

The impact of resignation or separation varies, depending on the size of the audit firm. It should

be noted, however, that small and medium-sized audit firms have less personnel; thus, the impact of separations to their attrition rates is greater.

This perennial concern of high staff attrition is addressed primarily by improvement of staff retention initiatives, especially for high-performing staff. Giving recognition to performing employees and providing them with incentives and competitive compensation will enhance their job satisfaction. Another initiative is by promoting a positive working environment where the partners and managers are directly engaged in asking and providing feedback which will help in keeping the more junior personnel be more engaged in their work. This will create an environment where they feel valued, heard and empowered.

Figure 9: Average Attrition Rate and Attrition Rate Range



Engagement Performance

Common Inspection Findings	Risks	Recommendations
<p>Consultations</p> <p>Lack of effective consultation with individuals within or outside the audit firm, on significant technical, ethical and other matters</p>	<p>⇒ May result in poor application of professional judgment or to inappropriate conclusions</p>	<p>Audit firms should promote a culture in which consultation with individuals within or outside the audit firm, is recognized as a strength and encourages personnel to consult on difficult or contentious matters. Audit firms should also use standardized documentation of consultation that are available to all personnel and communicate consultation procedures firm-wide.</p>

Engagement Performance

Common Inspection Findings	Risks	Recommendations
<p>Engagement Review</p> <p>Insufficient time and inadequate procedures of engagement partners and engagement quality control reviewers (EQCR) in reviewing assigned engagements</p>	<p>⇒ May result in an inadequate review of the work of less experienced team members who may not be sufficiently capable of detecting exceptions in the audit and that may result in inappropriate conclusions</p>	<p>Audit firms should formalize policies to monitor whether sufficient time is spent by the engagement partners and EQCRs on assigned engagements. PSA 220 (Revised) and the new Philippine Standard on Quality Management (PSQM) 2 require audit firms to establish policies to ensure that the reviewers have sufficient time to perform the duties assigned to them.</p>
<p>Assembly of Final Audit Files</p> <p>Failure to assemble the final audit files within the 60-day time limit, as prescribed by the PSA, from the date of the auditor's report</p>	<p>⇒ May imply poor audit quality or that the procedures were not complete when the audit report was signed</p>	<p>Audit firms should impose stricter enforcement of firm policies on assembly of final audit files. The use of software tools would help ensure that confidentiality, safe custody, integrity, accessibility and retrievability of audit files are maintained.</p>

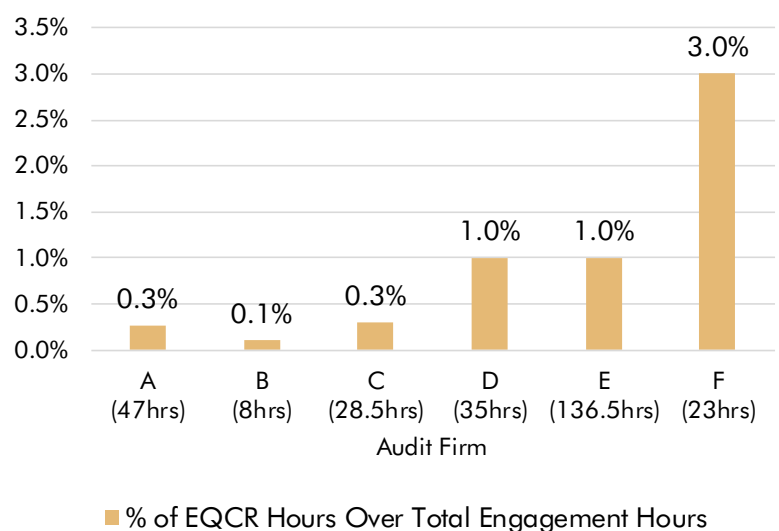
Emphasis on Sufficient Review

The engagement quality control (EQC) review is an important part of the audit firm's quality control process in order to ensure consistent application of the audit firm's procedures. If there is lack of evidence that the EQCR challenged the significant judgments made by the auditors and that the evidence of review is only limited to the sign-offs on the audit documents, it is difficult to demonstrate that EQC review is sufficiently robust to be effective in maintaining audit quality.

It was observed that across all the six largest audit firms, EQCRs have low involvement during the audit (see **Figure 10**). Low involvement of the EQCR may result in failure in challenging



Figure 10: EQCR Involvement in the Six Largest Audit Firms



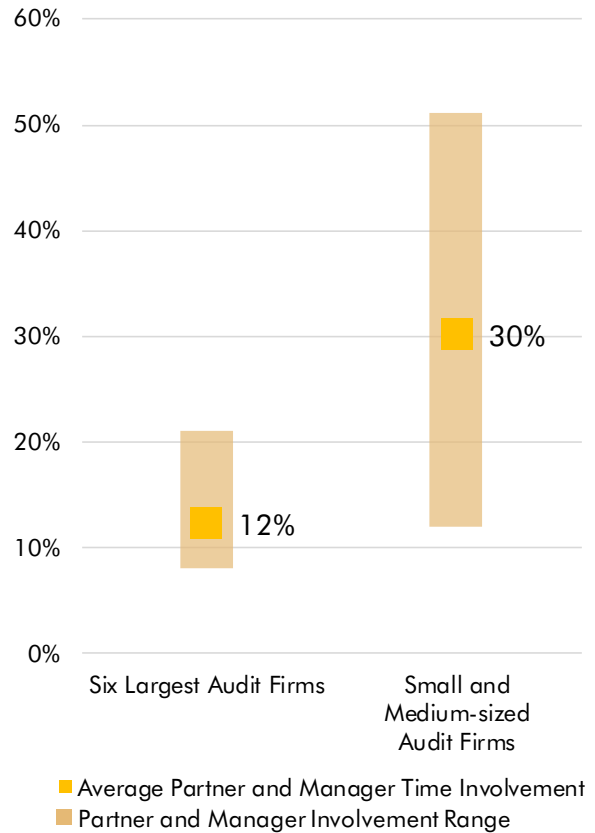
the audit work performed by the auditors which potentially could result in undetected issues.

Furthermore, it was also observed that the EQCR of some audit firms were involved too late in the audit process resulting to insufficient time for the auditors to address the issues raised. The SEC would like to remind auditors that PSQM 2 includes a new explicit requirement that the audit firm’s policies and procedures should require that the EQCR has sufficient time to perform the review.

Aside from the EQC review, the review and supervision of the engagement partner and manager is vital to ensure the consistency in the quality of engagement performance. **Figure 11** shows the partner and manager involvement as a percentage to the total engagement hours. It was observed that the involvement of partners and managers from the six largest audit firms is lower than the small and medium-sized audit firms.



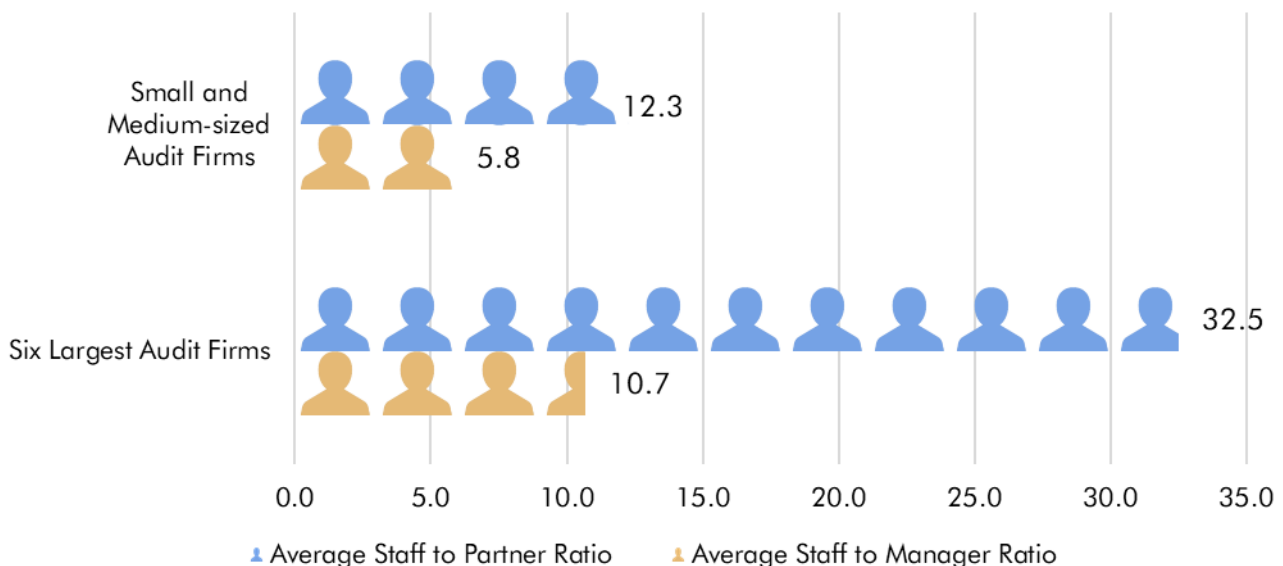
Figure 11: Partner and Manager Involvement Ranges



As shown in **Figure 12**, the average ratio of staff to partners and managers are higher for the six largest audit firms. This suggests that those partners and managers have greater direction, supervision, and review responsibilities. Lower ratios are generally preferable as this would indicate that partners and managers could give greater attention to supervise an audit.



Figure 12: Average Staff to Partner and Manager Ratios

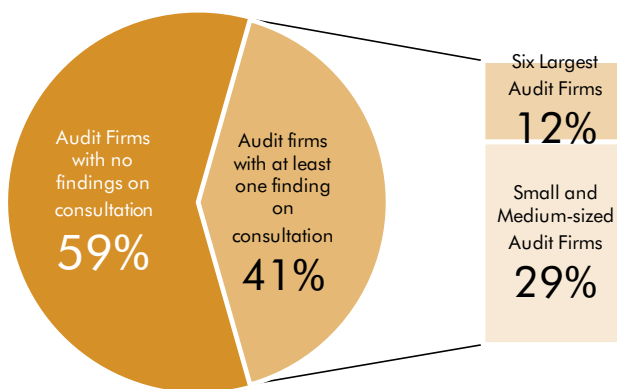


Continuously Build a Consultative Culture

Consultations indicate good audit quality where auditors seek advice on difficult and contentious matters arising from the audit. Due to greater uncertainty resulting from COVID-19, consultations on such complex matters should be expanded. There were observations that some audit firms (as shown in **Figure 13**) failed to ensure that appropriate consultations take place within the audit firm due to lack of robust policies and resources to conduct consultations.



Figure 13: Percentage of Audit Firms Inspected with and without Findings on Consultation



It is important for audit firms to develop and implement effective consultation mechanisms such as using a standardized consultation memorandum and designating qualified internal consultants. The audit firm personnel shall also be informed of the audit firm's consultation policies and procedures to encourage them to consult and be more engaged in the development of a culture of consultation within the firm. Audit firms are also encouraged to consult outside the firm, if deemed necessary, for contentious and difficult matters.

Need for Digital Shift

The world becomes increasingly digital to drive efficiencies in business operations and it is important for auditors to keep up with the digital transformation. It was observed that majority of

small and medium-sized audit firms (see **Figure 14**) still do not use audit software in their audit engagements which could have helped to achieve efficiency and improve audit quality. The use of audit software would ensure that confidentiality, safe custody, integrity, accessibility and retrievability of audit documentation are maintained. There were observations during the inspection that some working papers under review were not completely retrieved due to improper archiving of files.



Figure 14: Percentage Utilization of Audit Software



**Firms without audit software pertain to small and medium-sized audit firms.*

Audit software uses mechanisms to protect the confidentiality and integrity of audit documentation and prevents unauthorized modifications on the files after completion of the audit. Electronic files also eliminate storage costs of paper files where the file retention requirement, as prescribed by the Revised SRC Rule 68, is up to 10 years.

There were also some observations of failures in archiving audit files on time, while some audit firms allowed for extensions of time limits set in their policies. Delays in archiving are mainly due to inefficiencies in the preparation and assembly of audit documentation which could be addressed by digitalizing the audit process.

The use of audit software would also facilitate timely reviews and better project management which would ultimately result in quality audits.

Audit firms should continually challenge the status quo to enable a cultural change in the audit processes. Audit tools and software should be viewed as long-term investments and imperative part of digital transformation to achieve sustainability in the audit profession.

Monitoring

Common Inspection Findings	Risks	Recommendations
<p>Monitoring Process</p> <p>Lack of robust monitoring processes in the audit firm’s SOQC</p>	<p>⇒ May result in the failure to identify and address deficiencies in the audit firm’s SOQC</p>	<p>Audit firms should establish procedures to ensure that its SOQC are relevant, adequate and are operating effectively. These may include designating a suitably qualified individual to be responsible for the monitoring process and evaluating the firm’s SOQC on a cyclical basis, including an inspection of at least one completed engagement for each partner.</p>
<p>Root Cause Analysis</p> <p>No established framework to investigate the root causes of deficiencies</p>	<p>⇒ May result in the failure to identify and determine appropriate measures to remediate the deficiencies</p>	<p>Audit firms should perform causal analyses in order to identify the root cause of the findings and implement the necessary improvements or action plans in order to systematically address the issue.</p>
<p>Complaints and Allegations</p> <p>No established policies and procedures to deal with complaints and allegations of non-compliance with the requirements of the standards, regulatory and legal requirements</p>	<p>⇒ May cause improper handling of complaints and allegations for errant personnel</p>	<p>Audit firms should establish communication channels where their personnel can come forward and raise concerns without fear of reprisal. It shall also include policies and procedures for the investigation process where the partner supervising the investigation has sufficient and appropriate experience, has authority within the audit firm and is not involved in the engagement.</p>

Identify What Caused the Issues in the First Place

The monitoring process primarily involves a periodic evaluation of the audit firm’s SOQC. This process includes inspection of completed engagements for each engagement partner on a cyclical basis. Upon completion of the inspection process, audit firms and auditors often focus on

exterior symptoms rather than determining the root causes of the issue resulting to short-sighted and ineffective remediation. Performing root cause analyses would significantly aid audit firms and auditors to avoid deficiencies to become systemic and recur in the subsequent cycles. Core processes in the audit firm’s SOQC should be modified, if diagnosed as the real root cause of the problem.



Best Practices

The PSAs and PSQC 1 set the minimum requirements for audit firms to comply. Audit firms that aim to be successful in the long term need to maintain a culture of compliance. In some cases, however, **some audit firms go beyond compliance and observe best practices which are above the minimum requirements of these standards.**

Minimum hours of involvement of partners and managers



The standard requires that engagement partners must have sufficient time to adequately discharge their responsibilities. PSQC 1, however, is not explicit that the same requirement applies to EQCR. It was observed during the inspection that some audit firms have developed policies requiring minimum involvement of partners and managers for audits of public-interest entities. Some audit firms have required the EQCR and engagement partner minimum involvement of 2% and 5% of total engagement hours, respectively. Another audit firm has used a benchmark of at least 10% involvement of all partners and managers in the engagement.

The SEC would like to reiterate that the upcoming quality management standard includes a new requirement which states, in part, that the EQCR shall have sufficient time to perform the review.

Shorter time limits for assembly of final audit files



The standard requires that the assembly of final audit files shall be completed on a timely basis which is ordinarily not more than 60 days from the date of the audit report. There were notable observations that some audit firms have tighter deadlines, particularly for audits of PLCs. Some audit firms already use a 45-day deadline during our inspection. As a remediation measure, another audit firm just recently revised their time limits to 30 days for audits of non-PLCs, and 14 days for PLCs.

We commend such audit firms for their proactive implementation of archiving policies to further enhance audit quality. Such policies work well with the implementation of paperless audit to boost efficiency throughout the audit. This is also a reminder for other audit firms that the assembly of final audit files is just an administrative task and shall not take significant amount of time to complete. If these audit firms can do it, surely others can too.

Maintaining and going beyond a culture of compliance sets individual behavior across the audit firm



Keeping the right people

Some audit firms have developed notable staff retention initiatives to keep high-performing staff. There are audit firms that promote work-life balance for its people by implementing working hour limits in the office. In doing so, quality working hours are maximized and negative impact of overwork is avoided. There are also audit firms that offer recognition to top performers within the audit firm on an annual basis by providing awards that are monetary or in kind. Another audit firm has included its staff in its profit share program which further increases the staff's job satisfaction.

These are examples of good practices in order to keep the right people. It is also important to promote the involvement of partners, managers and staff within the audit firm by implementing a strong coaching environment and effective feedback mechanism. In that way, people will be more empowered and engaged to do more.



Hot reviews

One of the requirements of PSQC 1 is for audit firms to establish a monitoring process to provide it with reasonable assurance that the SOQC are operating effectively. Most audit firms require a cyclical review of completed engagements for each engagement partner. These reviews are carried out after the audit report is issued.

During our inspections, there were observations of a few audit firms that have implemented "hot reviews" which is another type of review of audit work and are carried out prior to signing of the audit report. The primary aim of this review is to ensure that adequate feedback is given to those audit staff carrying out the work. Hot reviews are usually carried out by more experienced managers not connected with the audit engagement.

Completion milestones

The standard requires that the work of less experienced team members should be reviewed by more experienced team members. Some audit firms have implemented mechanisms to ensure that proper reviews are carried out at appropriate stages throughout the audit. Such monitoring procedures track each phase of the audit to ensure that they are completed and signed off on a timely basis. Some audit firms have integrated these completion milestones in their audit software tools to ensure proper procedures are followed such as ensuring that client acceptance and agreement of terms of the engagement are completed prior to commencement of audit. This approach reduces the likelihood of lapses in the audit process.





Enhanced independence compliance monitoring

Independence is the central facet of external auditing. Maintaining independence of both the audit firm and the auditor is a strict requirement. As such, audit firms use various monitoring procedures to ensure their compliance.

It was observed that one of the audit firms inspected has used a more robust independence compliance monitoring system when compared to the monitoring procedures used by other audit firms. The audit firm has used a similar independence monitoring form used by other audit firms where material financial interests and relationships are reported. One notable observation from this audit firm is that it has a separate independence team to verify the contents of this monitoring form. This team checks the completeness and accuracy of the form by investigating the personnel's income tax return, bank statements, personal relationships, and other relevant sources of information available. By employing this more active monitoring process, the audit firm will be able to check whether or not the audit firm's personnel receive income from investments other than those reported in its independence monitoring form.

Coaching and feedback mechanisms

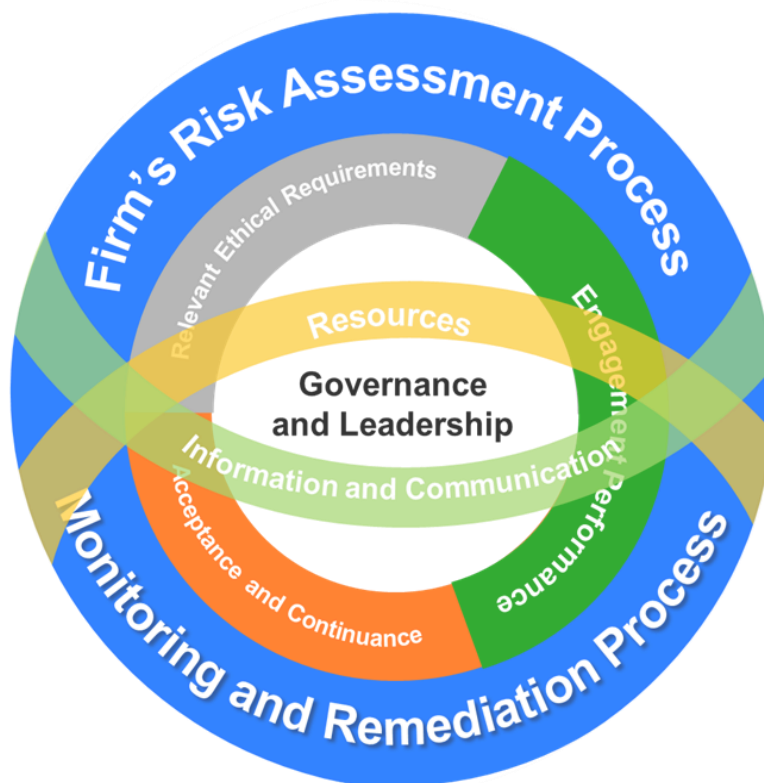
Coaching by more experienced staff is one of the effective methods to develop the competence of firm personnel. It is essential to create a positive working culture where employees can learn from mistakes and improve as they work.

We observed that some audit firms have developed more robust coaching and feedback mechanisms compared to others. Some of these audit firms require all its personnel to undergo a semi-annual coaching and feedback process to encourage openness of communication and help improve weaknesses while on the job. To better support the personnel's development, one of the techniques applied by these audit firms is to set performance goals at the start of the fiscal year. The goals are then discussed with the personnel's coach who can help in establishing steps and develop measurable metrics towards the achievement of the goals set initially. The performance of each personnel is then evaluated towards the end of the period to measure progress based on a set of criteria to develop a deeper understanding of each personnel's strengths and weaknesses. Upward and downward feedback is also provided to the personnel to achieve a more holistic performance appraisal. Discussions on the evaluation of progress are usually performed through one-on-one dialogue between the personnel and coaches.

Constant communication is key to the development of a successful coaching culture. The development of effective coaching and feedback mechanisms will help build trust and confidence within the audit firm.



What is the Philippine Standard on Quality Management 1 (PSQM 1)?



- ⇒ This replaces PSQC 1 and requires audit firms to **design a system of quality management (SOQM)** to manage the quality of engagements performed by the audit firm.
- ⇒ PSQM 1 consists of eight components that are integrated and does not operate in a linear manner. The audit firm's risk assessment process and information and communication are the two new components introduced by the standard.
- ⇒ SOQM are required to be designed and implemented by **December 15, 2022**.

Key Improvements in PSQM 1⁷

Introduction of a Risk Assessment Process



Establish
Outcome-based
Quality
Objectives



Identify and
Assess Quality
Risks



Design and
Implement
Responses

An audit firm's design of its risk assessment process may be affected by the nature and circumstances of the audit firm, including how the audit firm is structured and organized

Stronger Governance and Leadership

Audit firm's culture must recognize and reinforce:

- It's role in serving the public interest
- The importance of quality in the audit firm's strategic decisions and actions, including those related to the audit firm's financial and operational priorities

Expanded Categories of Resources

- Broadened categories: Human, Technological, and Intellectual
- Recognized the growing use of service providers for activities related to the SOQM

New Information and Communication Component



Ensure continual flow of information within the audit firm, and with engagement teams



Embed the need to exchange information in the audit firm's culture



Communicate with external parties

Robust Practice Monitoring Procedures

- Design and perform monitoring activities
- Evaluate findings and identify deficiencies: Audit firms are required to investigate the root cause of deficiencies
- Design and implement remedial actions to address identified deficiencies that are responsive to the results of root cause analysis
- Evaluate SOQM at least annually
- Communicate



Scalability: Audit firms may customize the design, implementation and operation based on the nature and circumstances of audit firms of different sizes and complexities. Quality risks and responses to these risks, are tailored to the audit firm.

⁷ IAASB, "Introduction to ISQM 1: Fact Sheet", December 17, 2020.

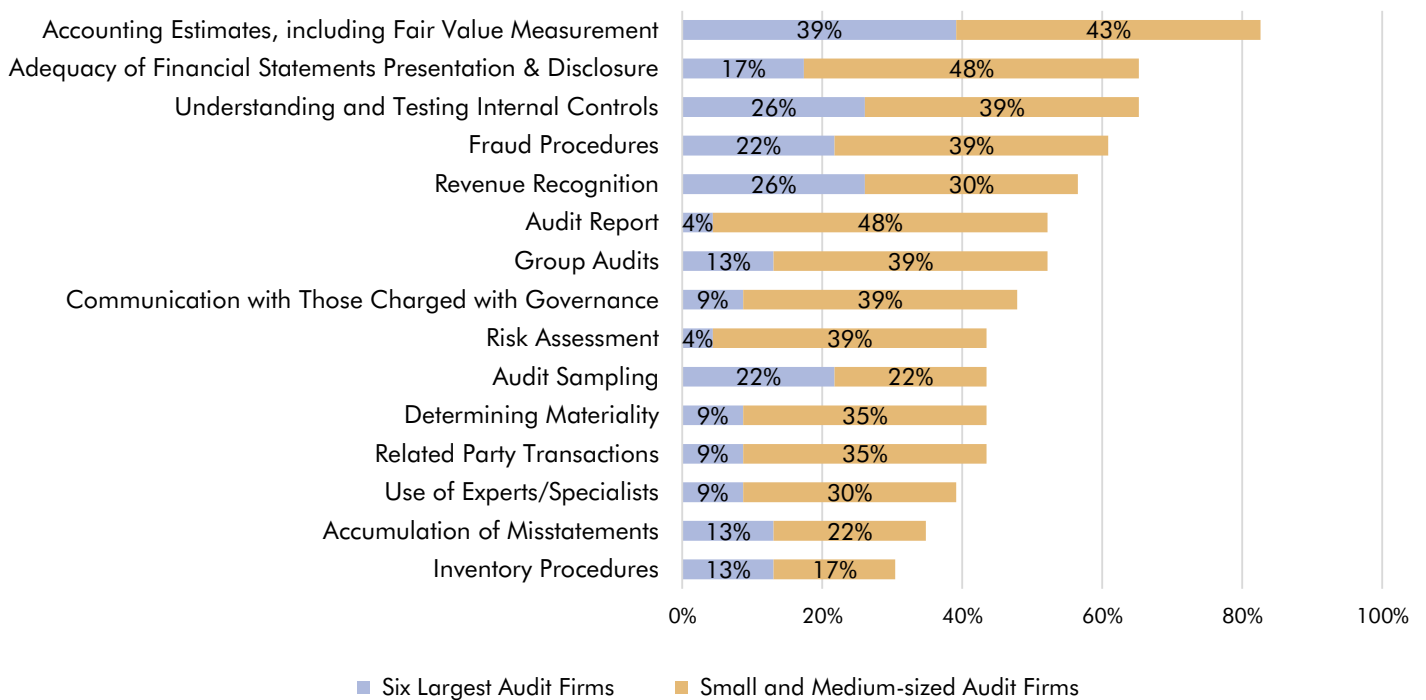
Engagement-level Observations



Common Inspection Findings

Presented in **Figure 15** are the top 15 most common engagement-level findings noted by the SOAR Inspection Team.

Figure 15: Percentage of Inspected PLCs with at Least One Inspection Finding



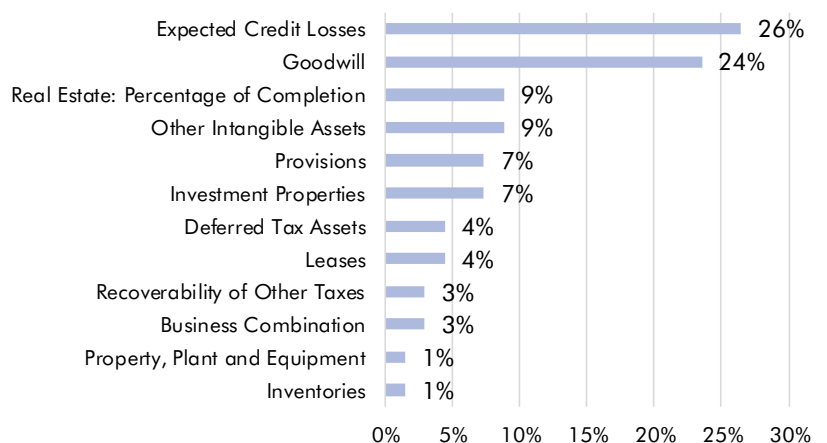
Accounting Estimates, including Fair Value Measurement

Accounting estimates, including fair value measurements topped the list of the most common inspection findings, with 82% of the inspected audits of PLCs having at least one finding related to estimates.

This pattern is consistent with the results of the IFIAR Inspection Survey where accounting estimates has consistently been the inspection theme with the most findings from 2016-2021.

As illustrated in **Figure 16**, deficiencies for accounting estimates are usually in areas

Figure 16: Audit Areas with Findings Related to Accounting Estimates





of expected credit losses for receivables from either third parties or related parties, impairment of goodwill, percentage of completion, and impairment of other intangible assets with indefinite useful lives. It has been observed that certain auditors failed to exercise professional skepticism when evaluating and challenging the reasonableness of management’s estimates and assumptions including testing the accuracy of the data, inputs, and models used.

Notably, a number of auditors also failed to obtain management’s assessments when

performing impairment tests. Some auditors simply relied on management’s assertion that the related assets were not impaired.

In terms of risk assessment, certain auditors performed insufficient procedures to obtain an understanding of the processes and controls related to the development of the estimates. Consequently, this resulted to failure to support the auditor’s conclusion that the estimation uncertainty does not give rise to a significant risk.

Adequacy of Financial Statements Presentation & Disclosure

The financial statements and corresponding notes are the entity’s primary responsibility. The auditor, on the other hand, is responsible to express an opinion as to whether or not the overall presentation of the financial statements, including the related disclosures, are in accordance with the requirements of the applicable financial reporting framework.

It was observed that procedures to evaluate the adequacy of the presentation and disclosures in the financial statements were insufficient for at least 65% of the audits of PLCs covered in the SOAR Inspection. As a result, auditors failed to identify misstatements in the classification of certain account balances in the financial statements as well as deficiencies in the disclosures. There were also instances where the auditor failed to test the appropriateness and completeness of the disclosed segment information.

Understanding & Testing Internal Controls

In obtaining an understanding of controls relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented. Some of the common findings on understanding and testing internal controls are as follows:

Failure to understand and test the operating effectiveness of controls of significant accounts or classes of transactions

Failure to test the accuracy and completeness of information produced by management

Failure to obtain persuasive audit evidence to support the conclusion of reliance on manual and IT-dependent manual controls

Lack of procedures to test key information technology general and application controls

Fraud Procedures

The rise of various accounting scandals and corporate failures overseas resulted to a growing expectation gap between the public's perception of the role and responsibilities of the auditor related to fraud in an audit of financial statements. Although the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management, auditors should perform sufficient procedures to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatements caused by fraud or error.

In the SOAR Inspections, however, there are a number of deficiencies in the auditors' response to the risks of material misstatements of the financial statements due to fraud. These mostly include failure to perform tests of journal entries, in accordance with the requirements of PSA 240, in response to the risk of management override of controls. Often, auditors do not consider their understanding of PLCs' businesses when selecting journal entries to be tested. Further, we noted instances where the auditors failed to perform the required fraud inquiries with management, internal audit, and those charged with governance.

There were also instances where the auditor identified fraud risks related to an account but the procedures performed were not specifically responsive to address the identified fraud risks.

Revenue Recognition

The Philippine Financial Reporting Standards (PFRS) 15, *Revenue from Contracts with Customers* became effective for reporting periods on or after January 1, 2018. With the implementation of the new accounting standard, certain auditors did not perform the following procedures to obtain reasonable assurance that the PLCs' revenue recognition policies comply with the requirements of PFRS 15:

- ⇒ Review the elements of the contracts with customers;
- ⇒ Evaluate appropriateness of management's judgments when determining the performance obligations and the timing of the satisfaction of these performance obligations;
- ⇒ Ascertain that revenues were recorded in the appropriate period; and/or
- ⇒ Check the adequacy of the presentation and disclosures related to revenue.

Further, certain auditors failed to perform procedures necessary to appropriately respond to the risks of fraud on revenue recognition. There were also instances where the auditor failed to sufficiently document its reasons for concluding that there is no risk of material misstatement due to fraud, related to revenue recognition.

"The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential management override of controls and recognizing the fact that audit procedures that are effective for detecting an error may not be effective in detecting fraud." (PSA 240 par. 8)

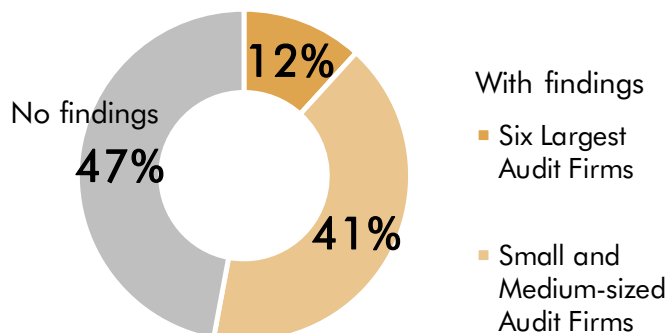
Audit Report

The auditor's report is the primary output of an audit of financial statements as it contains the auditor's opinion as to whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. To form this opinion, auditors should conclude if sufficient appropriate audit evidence has been obtained and whether the procedures required by the PSAs were performed. This includes ensuring that the identified key audit matters were appropriately addressed in the audit.

On certain audit engagements, there were observations that the auditors failed to sufficiently perform procedures described in the key audit matter section of the audit report. Auditors are reminded that their audit documentation should be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: the nature, timing, extent, and results of the audit procedures performed; the audit evidence obtained; the significant matters arising during the audit including the conclusions reached thereon; and, significant professional judgments made in reaching those conclusions.



Figure 17: Results of Inspection of Procedures to Address the KAM Described in the Auditor's Report



Group Audits

Majority of the inspected audits of PLCs include an audit of the group or consolidated financial statements. PSA 600 requires the group auditors to perform adequate group audit procedures in order to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements. However, in certain inspected audits, the group auditors failed to perform sufficient group audit procedures including the following:

- ⇒ Insufficient consolidation procedures:
 - Failure to obtain an understanding of the group-wide controls particularly on the financial statement close process, including the consolidation process;
 - Lack of procedures to evaluate the appropriateness, completeness and accuracy of the eliminating entries and consolidation adjustments;
- ⇒ Failure to obtain sufficient appropriate evidence from the procedures performed by the component auditors on the financial information of the components; and
- ⇒ Incomplete accumulation of the identified uncorrected misstatements at the consolidated level.

Other noted deficiencies relate to poor group audit planning and communication which include failure to identify and assess risks of material misstatements due to fraud at the group level.

The restrictions in travel brought about by the COVID-19 pandemic raised significant challenges in the conduct of group audits specifically on the examination of financial information of the significant components and on the review of the work performed by component auditors.

Communications with Those Charged with Governance (TCWG)

In certain audit engagements, the SOAR Inspection Team noted that auditors failed to discuss with TCWG the required communications listed in **Figure 18**.

The SEC would like to emphasize that effective two-way communication between the auditor and TCWG is essential in understanding matters related to the audit regarding: responsibilities of the auditor in relation to the financial statement audit; the overview of the planned scope and timing of the audit; and in developing a constructive working relationship while maintaining the auditor's independence and objectivity. Further, this will assist TCWG in fulfilling their responsibilities to oversee the financial reporting process, thereby reducing the risks of material misstatement in the financial statements.



Figure 18: Required Communications with TCWG

Auditor's responsibilities in relation to financial statement audit

Planned scope and timing of the audit, including the type of work to be performed on financial information of a group's components

Significant findings from the audit, including the identified uncorrected misstatements

Identified Key Audit Matters

Auditor's compliance with independence requirements

Risk Assessment

PSA 315 requires auditors to assess the risk of material misstatement, whether due to fraud or error. The auditors' risk assessment procedures determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. Risk assessment procedures, when properly performed, contribute significantly to good quality audits. The SOAR Inspection Team noted the following deficiencies in the auditors' risk assessment procedures:

⇒ **Failure to identify and assess the risk of material misstatements due to fraud:** Some auditors rely on their past experiences with management when assessing the susceptibility of the financial statements to material misstatements due to fraud. This resulted to failure to evaluate the fraud risk

factors. Some auditors also failed to assess the risks of material misstatements due to fraud at the group level.

- ⇒ **Failure to appropriately identify and assess the risk of material misstatement either at the financial statement or assertion level:** Some auditors performed their traditional audit procedures without prior assessment of the risk of material misstatement at the financial statement and assertion levels. This approach resulted to failure to appropriately respond to the assessed risks in the audit.
- ⇒ **Failure to perform sufficient procedures to obtain an understanding of the entity's control environment.**

Audit Sampling

Audit sampling is one of the most fundamental audit techniques. It allows auditors to be able to draw a reasonable conclusion about the entire population and complements the auditor's responsibility to obtain sufficient appropriate audit evidence. Interestingly, the SOAR Inspection Team identified a number of deficiencies related to audit sampling. There were certain cases where sampling was insufficient to reduce sampling risks to an acceptable level. There were also instances where the auditors failed to completely test the selected samples or that the number of samples tested were inconsistent with the sample size generated using the sampling tool of the audit firm.

In addition, other common findings related to audit sampling include the following:

- ⇒ Failure to verify the completeness and accuracy of the population used for sample selection;
- ⇒ Failure to identify the population from which the samples were drawn;
- ⇒ Failure to provide rationale or basis for sample size and selection;
- ⇒ Failure to investigate exceptions noted; and
- ⇒ Failure to project misstatements from differences noted in the samples tested.

Others

Other notable findings in the SOAR inspections relate to matters described below. Auditors are reminded to continuously exercise professional skepticism and due care in the execution of audit procedures, specifically on the following areas:

- ⇒ **Reassess materiality** using the final audited balances and determine whether the audit procedures remain appropriate;
- ⇒ Provide sufficient support for concluding that the use of a **less conservative materiality** within the prescribed range is appropriate;
- ⇒ Complete **accumulation of misstatements** identified during the audit and evaluate their impact to the financial statements;
- ⇒ Perform procedures to evaluate management's assessment of the company's ability to continue as a **going concern**;
- ⇒ Obtain sufficient evidence regarding the PLC's compliance with relevant **laws and regulations**;
- ⇒ Extend **subsequent event procedures** up to the date of the auditor's report;
- ⇒ Identify **litigations and claims** involving the PLC that give rise to risks of material misstatements; and
- ⇒ **Assemble the audit documentation** on a timely basis after the date of the auditor's report.



Common Root Causes

Lack of Professional Skepticism

In most of the inspected audit engagements with significant findings, there was a notably lack of challenge culture. Auditors would often rely on, and corroborate management's judgments and estimates while some conclusions were solely based on inquiry with management. Auditors are required to maintain professional skepticism throughout the audit, which includes a critical assessment of both corroborating and contradictory evidence. This also includes questioning the reliability of documents and responses to inquiries and other information obtained from management and TCWG.

Further, the belief that management and TCWG are honest and have integrity does not relieve the auditor of its responsibility to maintain professional skepticism throughout the audit or allow the auditors to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

In exercising professional skepticism, auditors should also be alert to circumstances that would suggest the need for audit procedures in addition to those required by the PSAs.

Insufficient Review and Supervision

The common inspection findings discussed in this section could have been avoided or prevented if there were sufficient and timely review and supervision. Engagement partners are primarily responsible for the supervision and review of an audit. Audit firms should instill a culture that encourage discussions among members of the team and allow junior auditors to raise questions to the more experienced auditors for them to

Lack of challenge culture: Auditors would often rely on, and corroborate management's judgments and estimates while some conclusions were solely based on inquiry with management.

clearly understand the objectives of the assigned work. This is of paramount importance, especially if a work-from-home setup is being adopted.

Engagement partners and the senior auditors of the team should also ensure that reviews are completed at appropriate stages during the audit so that significant matters are resolved on a timely basis.

Weak Technical Competence

In 2018, both PFRS 9, *Financial Instruments* and PFRS 15, *Revenue from Contracts with Customers* became effective. These two accounting standards brought significant changes on how financial instruments and revenues are recognized and measured. Our inspections showed a number of circumstances where auditors failed to appropriately design and execute procedures to test compliance with the new accounting standards.

Auditors should continuously receive adequate training on accounting and auditing standards to keep them updated with the ever-changing accounting landscape.

Lack of Detailed and Documented Audit Methodology

Some audit firms lack a detailed and documented audit methodology. Specifically, certain audit firms fail to develop matter-specific guidance materials such as determination of materiality, group audit scoping and sampling. There were observations that auditors rely on standardized templates or work programs that fail to meet the requirements of the PSAs.

The use of such templates, without any guidance or documented audit methodology, can become a mere checklist exercise for auditors. Having a detailed and documented audit methodology, that is frequently updated to consider the effectivity of new auditing and accounting standards, promotes consistency in the quality of engagement performance, especially on highly judgmental areas.

The graphic consists of three overlapping, semi-transparent geometric shapes (squares/trapezoids) in shades of green and grey, stacked vertically and slightly offset to the left.

Emerging From the Pandemic

*The auditor's responsibility
persists despite the pandemic.*

Over the past two years, the world has seen how different organizations have been challenged by the impact of the COVID-19 pandemic. At the start of the pandemic, the imposed community quarantine restrictions found a lot of businesses scrambling for different ways to sustain their operations while ensuring the safety of their employees. As the pandemic continued, uncertainties on economic recovery hounded these businesses. Even with the roll-out of the vaccination programs and the easing of community quarantine restrictions to open the Philippine economy, there is still a continued period of heightened uncertainty especially as businesses accelerate recovery to immediately recoup incurred losses and missed opportunities during the height of the pandemic and to demonstrate their potential.

These challenges and uncertainties, further highlight the importance of management's responsibility to ensure that its financial information is transparent of its current financial condition. Estimates and judgments made by management when preparing the financial

statements should consider the risks brought by the COVID-19 pandemic. Disclosures on these judgments and estimates should be sufficient to ensure that the users of the financial statements are well-informed and guided when making investment decisions. Consequently, the auditor's responsibility to obtain reasonable assurance about whether these financial statements as a whole are free from material misstatements, whether due to fraud or error, persists despite the pandemic.

In spite of the disruption in the "traditional way" of conducting an audit (i.e., limited access to physical copies of documents, inability to conduct in-person discussions with clients and discussions among the team), audits should continue to be performed in accordance with the requirements of the PSAs. Given the continued uncertainty and unpredictability, auditors should consider the following matters which may create risks of material misstatements that are new and intensified in the prevailing circumstances:

Risk Assessment

As part of risk assessment procedures, auditors should obtain a better understanding of how the pandemic changed the entity's organizational structure, governance, and its business model. Particularly, with the COVID-19 pandemic speeding up the digitalization efforts of most businesses, auditors should understand how the client's current business model integrates the use of information technology. An improved and updated understanding of the client's environment will help the auditor to identify new risks of material misstatements at the financial statement and assertion levels.

Audit Evidence

Despite the easing of community quarantine restrictions, a number of businesses still implement work-from-home arrangements. Further, in relation to group audits, the ongoing pandemic may continue to result in mobility restrictions. These circumstances could continue to hamper the auditor's ability to obtain audit evidence. Auditors, however, should devise alternative procedures to ensure that sufficient appropriate audit evidence are obtained to support their conclusions. Auditors should perform robust procedures to test the accuracy and completeness of any information provided by the entity.

Accounting Estimates

Due to the continued uncertainties and unpredictability of economic recovery, management may face increasing pressure to show immediate improved financial performance. Further, breakdowns in internal controls over financial reporting as a result of work-from-home arrangements, may present an opportunity for fraudulent financial reporting or misappropriation of assets. All these factors may increase the risk of material misstatement due to fraud.

Auditors, therefore, need to consider the existence of possible bias in management's judgments and estimates. Robust audit procedures should be performed in order to challenge the reasonableness of the assumptions used and to ascertain the appropriateness of these assumptions in the context of the applicable financial reporting framework.

Going Concern

Several industry sectors felt the slump in the country's economic condition as a result of the pandemic, which caused reduced revenues, financial losses and liquidity concerns. These may lead to increased risks in the entity's ability to meet its obligations as they fall due.

Auditors should perform robust procedures to evaluate how management took into consideration the following events and condition in their assessment of the entity's ability to continue as a going concern: (1) loss of a major market, key customer(s), revenue and labor shortages; (2) significant deterioration in the value of assets used to generate cash flows and current assets including inventory; (3) measurements affected by increased uncertainty; (4) counterparty credit risk; and (5) the entity's solvency.

The pandemic created many challenges in the accounting and auditing landscape.

Now more than ever, the role of auditors as gatekeepers who protect the public interest, should not be undermined.

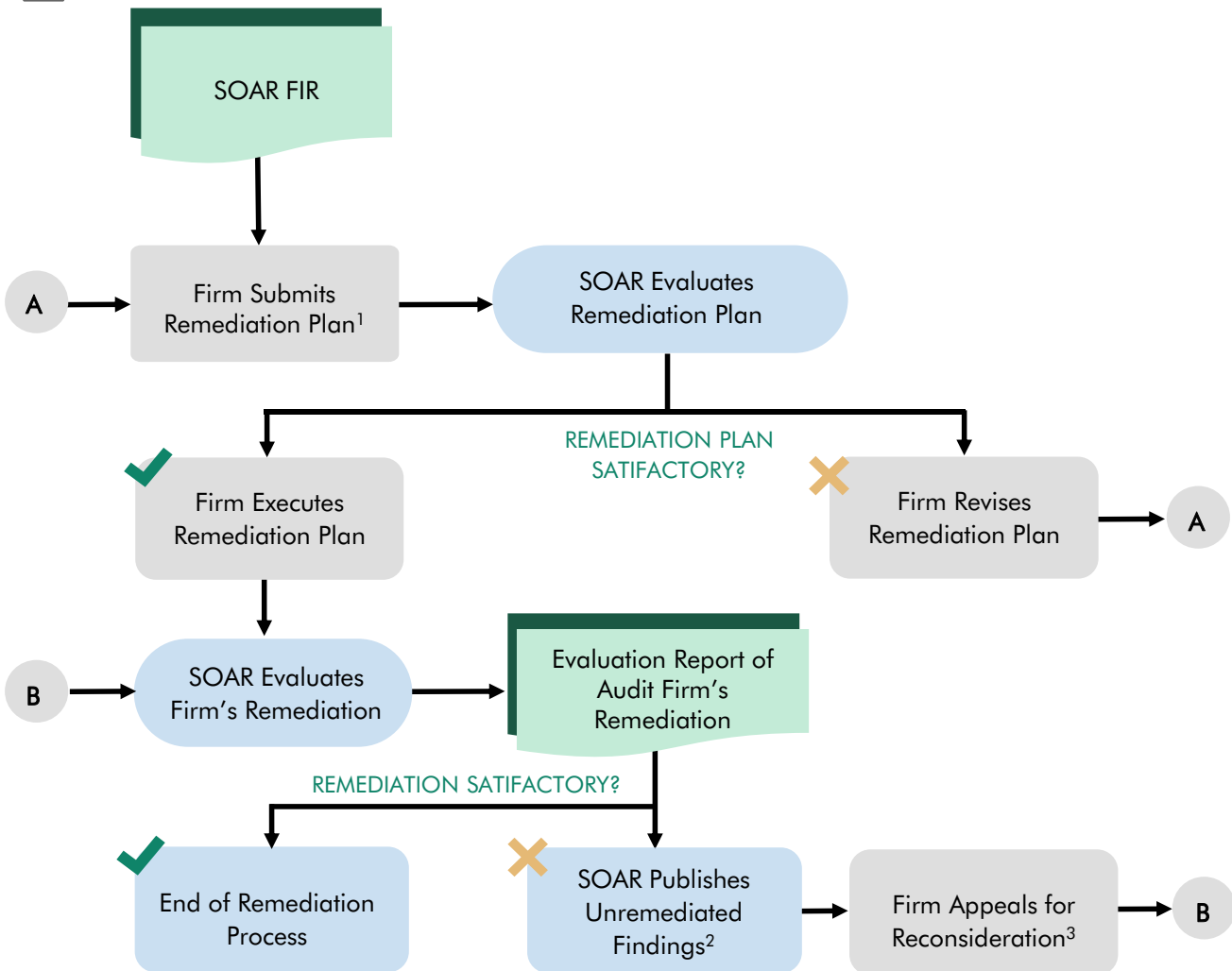
Remediation



REMIEDIATION PROCESS



Figure 19: SOAR Remediation Process



NOTES:

¹ The inspected audit firms are required to submit its written Remediation Plan, within six months from the issuance of the Final Inspection Report (FIR). Under the Revised SOAR Rules, the deadline for the submission of the written remediation plan was shortened to 60 calendar days from 180 days after issuance of the SOAR Inspection Report.

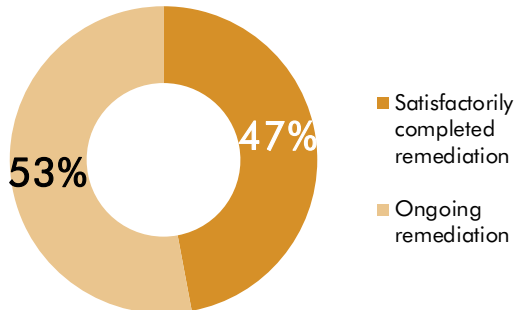
² Under the Revised SOAR Rules, the following will be published on the SEC website, 30 calendar days after the issuance of the Evaluation Report of Audit Firm's Remediation: a) inspection findings that are unresolved within the allowed period of remediation; b) inspection findings where the audit firm's remedial actions are deemed not satisfactory; and/or c) contested findings that attained finality in favor of the SOAR Inspection Team's position and the audit firm refuses to remediate.

³ Within 15 calendar days after the issuance of the Evaluation Report of Audit Firm's Remediation, the audit firm may seek reconsideration of the Commission's decision to publish the report by requesting the Commission *En Banc* to review the decision again.

OBSERVATIONS



Figure 20: Status of Remediation



As illustrated in **Figure 20**, 47% of the inspected audit firms have already satisfactorily addressed the SOAR inspection findings by employing necessary measures to prevent the issues from recurring. It was observed that in order to address the quality control findings, most audit firms revised their quality control policies and procedures; and established detailed procedures to ensure their compliance with the requirements of the standards.

Common Remediation for Quality Control Findings

- ⇒ Establish required minimum hours for the review and supervision of engagement partners and the review of the EQCR
- ⇒ Establish a system to monitor the auditors' compliance with the archiving deadlines
- ⇒ Institute robust monitoring procedures that comply with the requirements of PSQC 1
- ⇒ Establish an anonymous communication channel where personnel can communicate any breaches to independence requirements or any complaints and allegations
- ⇒ Revise policy on training requirements of the audit firm's personnel

At the engagement level, most findings were remediated by revising and improving the audit firm's practices in performing engagements and by enhancing its communication with audit clients.

Some audit firms showed their utmost commitment in improving audit quality by immediately developing remedial actions to address the findings and successfully completing the remediation procedures a few months ahead of the deadline, while some audit firms took time to address the inspection findings. The varying progress of remediation depends on the complexities of the findings; availability of resources; and coordination with the clients, the global network firm, and the SOAR Inspection Team.

Common Remediation for Significant Audit Deficiencies

- ⇒ Perform more robust procedures to challenge management's judgments and estimates
- ⇒ Require PLC clients to restate financial statements and/or provide additional disclosures
- ⇒ Improve understanding and testing of the design and implementation of controls
- ⇒ Enhance journal entries testing procedures to meet the requirements of PSA 240
- ⇒ Carry out a more detailed assessment on the PLC's compliance with PFRS 15

EXPECTATIONS

The SEC generally avoids prescribing specific remediation approaches or action steps to address the inspection findings. Audit firms and auditors are expected to identify the root causes of the findings and to come up with effective and sustainable solutions that are both preventive and corrective in nature.

To avoid the recurrence of findings, the SEC expects auditors to have a good understanding and appreciation of the societal value of their work and that is, to **serve public interest**. This can be achieved when audit firms commit to a culture of quality, thereby promoting consistent performance of quality audit engagements. Auditors are expected to always uphold the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.

Appendix



APPENDIX I: SIGNIFICANT CHANGES TO SOAR RULES

Changes from the SEC MC No. 09, Series of 2017	
Frequency of Inspection	Revised the frequency of inspection from once every three years to either once every two years or once every three years depending on the relative size of the audit firm's client portfolio, in terms of market capitalization of all PLCs
Alternative Mode of Inspections	Explicitly included the conduct of remote or virtual inspection as an alternative mode to on-site inspection, in cases of extraordinary events
Engagement Notification	Shortened the engagement notification period from 60 days to 30 days before the start of the inspection
Classification of Inspection Findings	Categorized inspection findings as either opportunities for improvements or enhancements; or significant audit deficiencies
Timelines upon Completion of the On-Site Inspection	<ul style="list-style-type: none"> ⇒ Removed the issuance of the Preliminary Inspection Report as this report appears redundant to the FIR ⇒ Changed the term FIR to SOAR Inspection Report ⇒ Revised the deadlines for the completion of LOF and the SOAR Inspection Report
Consultation with Resource Person/s	Enhanced the consultation process with resource person/s
Remediation Process	Shortened the remediation period from 12-18 months to 12 months only
Evaluation of Remedial Actions	Clarified the process on the issuance of the Evaluation Report of Audit Firm's Remediation
Publication of Inspection Findings on the SEC website	<p>Emphasized that the following shall be published on the SEC website:</p> <ul style="list-style-type: none"> ⇒ Inspection findings that are unresolved within the allowed period of remediation; ⇒ Inspection findings with remedial actions that were deemed not satisfactory as determined by the Inspection Team; and/or ⇒ Contested inspection findings that attained finality in favor of the SOAR Inspection Team's position and the audit firm refuses to remediate
SOAR Annual Inspection Report and Audit Quality Indicators (AQI) Framework	Included the publication of an Annual Inspection Report, to promote transparency of SOAR Inspection, and the publication of an AQI Framework
Communication with Audit Committees of PLCs	Requires the audit firms to communicate inspection findings and the actions taken to address findings, upon the request of the Audit Committee

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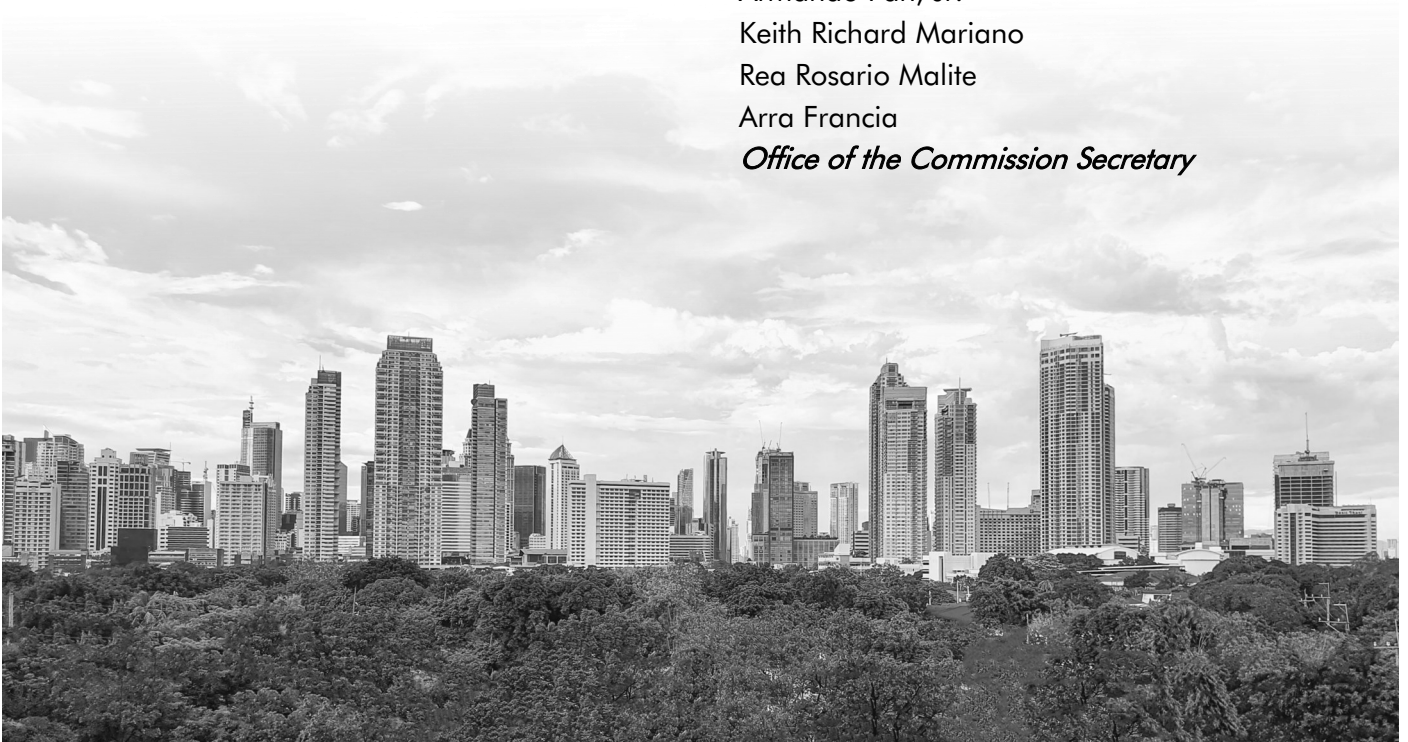
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**Securities and
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Commission**
PHILIPPINES

SEC Headquarters, 7907 Makati Avenue,
Salcedo Village, Bel-Air, Makati City
www.sec.gov.ph | secoga@sec.gov.ph

