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**Audit Quality Control: Development of Self-Assessment
Checklist for Small and Medium Audit Practices in Malaysia**

RESEARCH AREA: AUDITING

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Audit Quality Control: Development of Self-Assessment Checklist for Small and Medium Audit Practices in Malaysia

ABSTRACT

In July 2006, the Malaysian Institute of Accountant (MIA) has adopted the ISQC 1 as part of the approved standard of auditing in Malaysia. In assisting the implementation of ISQC 1 among audit firms, a guideline on the ISQC 1 requirement is essential. This paper provides insights on the development of International Standards on Quality Control 1 (ISQC 1) self-assessment checklist for small and medium audit firms in Malaysia. The checklist is developed based on ISQC1 requirements, ISQC 1 manual and MIA By-Laws. This checklist is also in-line with ISQC 1 questionnaires prepared by other countries such as Australia and Pakistan. It is then validated by audit practitioners. It is hoped that this audit quality system would assist the small and medium audit firms in improving and enhancing their audit service quality with the aspiration to be at par with the larger audit firms.

Keywords

audit quality, quality control system, ISQC 1, self-assessment, small and medium audit practices

1.0 INTRODUCTION

Audit quality is viewed as one of the important factors that affect the credibility of financial statements (Arrunada, 2004). Users are more likely to demonstrate high level of confidence on the information presented in the financial statements if the audit of the financial statements is perceived to be of high quality. Assessment on audit quality of audit firms ensures that an audit firm's processes are systematic and effective (Brinkley, 2006). Auditing the auditors through external evaluations is becoming a driving force of continuous improvement for the profession (Brinkley, 2006). To compete successfully in this environment, audit firms must continually strive to improve audit quality and hence, maximize client satisfaction.

Recent development concerning audit quality control by International Federation of Accountant (IFAC) has required audit firms to comply with the International Standards on Quality Control

(ISQC 1). Malaysian Institute of Accountant (MIA) has, in July 2006, adopted the ISQC 1 as part of the approved standard of auditing in Malaysia. In essence, ISQC 1 focuses on the quality of audit performed by the audit firms and they are expected comply with the standard. Nevertheless, evidence showed that the implementation to of ISQC 1 is rather limited in Malaysian small and medium audit firms (Omar & Johari, 2007). Small and medium audit firms tend to operate based on non-standard operating procedures, which essentially does not reflect total compliance to the ISQC 1.

Based on the guidelines stated in the ISQC 1, compliance to the standard is perceived as high audit quality. Although large audit firms have been argued and associated with high audit quality (DeAngelo, 1981), very limited studies have measured audit quality using an objective measure (Krishnan & Schauer, 2000). Past studies have indirectly inferred that large audit firms as a proxy for high audit quality (DeAngelo, 1981; Carcello et al., 1992; Krishnan & Schauer, 2000). However, it is still unclear how and why the levels of audit quality differ among small and medium firms. Hence, the objective of this study is to assess the framework on efficiency and effectiveness of the small and medium audit firms. Subsequently, based on that framework, standards and benchmark information would be developed.

This study is hoped to contribute to the improvement in the quality control of small and medium audit practices in Malaysia. This study is not aimed to strengthen the proposition that larger audit firms deliver higher audit quality compare to the smaller ones, but to provide a more objective appraisal of audit quality in small and medium audit firms. The self-assessment quality control checklist extends previous studies in the development of an objective measure. The current paper focuses on the first part of this bigger study that highlights the development of a suitable checklist for the purpose of measuring audit quality. The checklist would enable audit firms to self-assess their service and to recognize

any deficiency that could have compromised audit quality.

2.0 LITERATURE REVIEW

2.1 The Search for Audit Quality

The demand for auditing services arises from a need to facilitate dealings between the parties involved in business relationships-shareholders, creditors, public authorities, employees and customers, etc (Arrunada, 2000). The accounting profession has faced increasing pressure from external parties to monitor and improve the quality of the audit process (Sutton, 1993). There are numerous of previous research done on studying multi-aspects of audit quality. The strong interest in examining audit quality is partly due to the concern of issues such corporate collapse, expectation gaps and corporate governance.

One of the main areas in audit quality literature is the association between audit quality with audit firm size. As suggested by DeAngelo (1981), larger firms provide higher-quality audits because larger firms have fewer incentives to compromise their standards to ensure retention of clients in comparison with smaller firms. Audits performed by large audit firms are perceived to be of higher expected quality than audits by small firms. Also, Palmrose (1988) finds that large auditors have lower litigation rates than small auditors. Similarly, Dupoch and Simunic (1982) also found that audit quality is a function of the number and extent of audit procedures performed by the auditor and that larger firms have more resources with which to conduct tests. In addition, Moore and Scott (1989) demonstrate analytically that audit firm size and the extent of audit work undertaken are positively related.

Although past studies have supported that high audit quality is related to firm size, the extent of audit quality for each firm requires a more objective measurement of audit quality. For example, Carcello et al. (1992) assessed audit quality based on the perceptions of auditors, preparers and users. Using twelve components of audit quality, Carcello et al. (1992) suggested that four components to be most important in determining audit quality. The components include audit team and firm experience with the client, industry expertise (especially within the audit team), responsiveness to client needs, and compliance with the general standards

(competence, independence, and due care) of generally accepted auditing standards (GAAS).

Sutton (1993) argued that there is a need for accounting researchers to developed objective measure in evaluating process quality. Sutton (1993) has attempted to develop a set of factors for influencing various stages of the audit process. The selection of the factors is done by the auditors of large audit firms. An audit quality factor is defined to the participants as any variable affecting the audit team's ability to achieve the level of audit quality desired. He identified four stages of audit process: engagement planning, interim fieldwork, year-end fieldwork and final administration. The study also develops the monitoring process or performance indicators for each quality factors included in the respective stages (Sutton, 1993). His results support that there exists a consensus among experienced auditors on a set of key audit quality factors which have a significant impact on overall audit quality.

Krishnan and Schauer (2000) examined the association between auditor size and audit quality for a sample of non-profit organizations. Using the compliance score analysis on eight GAAP reporting requirements to assess audit quality, they found that audit reporting was inconsistent among the non-profit organizations. Of the eight reporting requirements examined, noncompliance is highest for those that pertain specifically to non-profit organizations such as disclosures about pledges and donated materials. Results also show that the extent of noncompliance decreases as one moves from the small non-Big 6 (now known as Big 4) to the large non-Big 6 and from large non-Big 6 to the then Big 6.

The development of objective audit quality has been further extended to cover firm level rather than engagement level only. For example, a guideline has been presented by expert representatives from State Auditors Institution (SAI) concerning audit quality for public auditors. After a series of discussion and meetings, the committee finalize that there are three different audit quality attributes that should be taken care of (Mazur et al., 2005). First, it involves the quality control system. Second, the study also includes one important attributes of audit quality which is quality assurance. Last, the audit quality control system includes the institutional management such as managing human resources, institutional risk and external relations. This

guideline is proposed for all SAIs to apply in both courts and offices, and to all audits, both regularity and performance.

2.2 International Standard on Quality Control

In 2004 the International Auditing and Assurance Board (IAASB), of the International Federation of Accountants (IFAC) has approved the International Standard on Quality Control (ISQC 1) concerning the Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements. In line with the requirement by IFAC, Malaysian Institute of Accountants (MIA) has imposed that all registered accountants and auditors (practitioners) in Malaysia to comply with the new Quality Control standards by 30 June 2006. The standards introduce several new concepts and requirements in respect of quality control within auditing firms. As a result, practitioners face with additional responsibilities in respect of implementing new quality control safeguards and procedures.

ISQC 1 is different from ISA 220 “*Quality Control for audits of Historical Financial Information*” which sets out the quality control standards to be applied to individual audit engagements. On the other hand, ISQC 1 deals with firm wide quality control which provides reasonable assurance that firms and its personnel comply with professional standards and regulatory and legal requirements; and reports issued by the firm or engagement partners are appropriate in the circumstances (Holt, 2006, p.14). ISQC 1 sets out six quality control elements that must be rigorously and comprehensively addressed. It covers (1) leadership responsibilities for quality within the firm; (2) Ethical requirements; (3) Acceptance and continuance of client relationships and specific engagements; (4) Human resource; (5) Engagement performance; and (6) Monitoring. The standard requires audit firms to document evidence of the operation of each of the six elements of its quality control system and retain that documentation for an appropriate period.

3.0 METHODOLOGY

The development of the checklist involved three different stages. First, the researchers formed common themes of ISQC 1 dimensions based on several sources. This study refers to the ISQC1 requirements (MASA 2007), ISQC 1 manuals

issued by MIA, MIA Practice Review Questionnaires, MIA By-Laws, Australia Questionnaires on Quality Control for Firms and Pakistan’s ISQC 1 Review Self-assessment Questionnaire. A series of brainstorming sessions has been conducted to identify the critical factors for each element of ISQC 1.

Second, a review with two representatives from the MIA was conducted. The representatives were the manager of technical development and the manager of practice review. MIA requires a practice review for all audit firms which includes compliance on the ISQC 1 and ISA 220. Both of the representatives have thoroughly checked the format, design and questions of the checklist. The checklist was further revised according to their comments.

Third, this study also uses a focus group interview with ten audit practitioners to evaluate each item of the checklist. This method has been applied previously in Sutton (1993). In this session, the practitioners provide their inputs and discussed in details the relevancy and usefulness of each question. The conclusion of this session was marked by group consensus. Participants were also required to provide their feedback on the overall format of the checklist.

4.0 PROPOSED SELF-ASSESSMENT CHECKLIST

There are seven dimensions of the quality control in ISQC 1 (refer to figure 1). Details of the definition for each dimension are shown in Appendix 1.

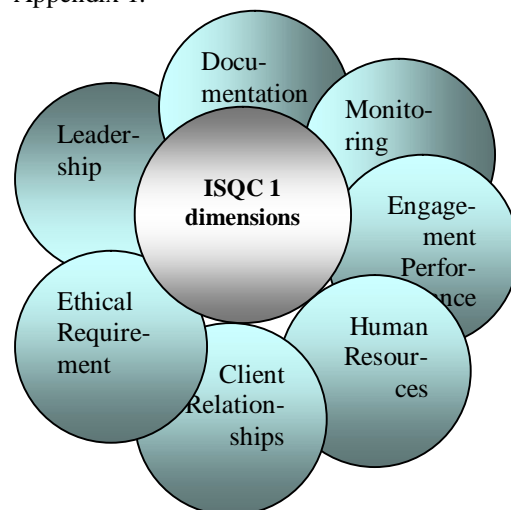


Figure 1: Dimensions of ISQC1 audit quality control dimensions

The structure of the checklist consists of two parts (refer figure 2). The first part presents questions on the policy and procedures and the second part presents questions regarding the practices.

Part	Explanation
Policy and Procedures	The part presents the questions on the policy and procedures on each elements of ISQC 1. The questions shall be answered using “YES” or “NO” option.
Practices	The part comprises of questions on the practices of each elements of ISQC 1. Each indicator shall be answered using four-scale options.

Figure 2: ISQC1 Self-assessment checklist - format

Questions on the practices shall be answered using four different indicators. The scale enables the audit firm to assess the degree to which practices and/or processes are in place that indicate adherence to the indicators. The audit firm may choose if the practices and/or processes are highly functional in the firm, operational, emerging or not evident (refer to figure 3). The firm should use the scale as an opportunity to ask itself challenging questions and to respond with accurate answers geared toward self-improvement.

Indicator	Explanation
Not evident	No evidence/ documentation exists
Emerging	Evidence indicates early or preliminary stages of implementation of practice
Operational	Evidence indicates practices and procedures are actively implemented
Highly functional	Evidence indicates practices and procedures are effectively and consistently implemented

Figure 3: Self-assessment checklist - Definitions of scale

Based on the discussion with the practitioners, the finalized questions for each dimension were agreed consensually. Details of the question items are shown in Appendix 2.

5.0 SCORE ASSESSMENT

An extension on this checklist is the development of score assessment. The score assessment would be weighted according to the importance of each dimension as well as the type of questions (either policies and procedures or practices). Audit firms may receive scores for each dimension as shown in Figure 4.

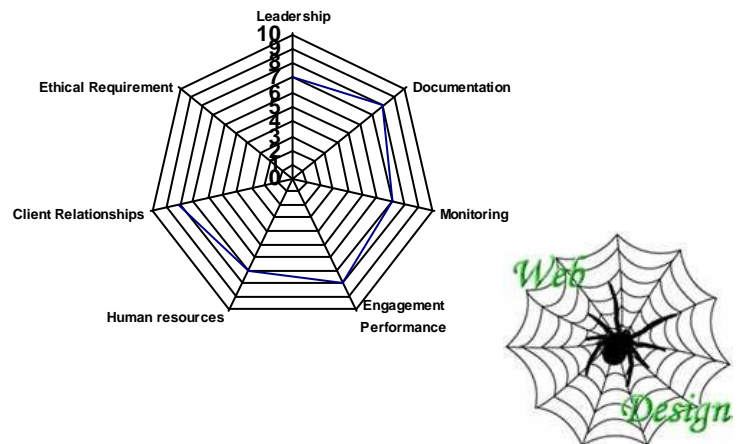


Figure 4: ISQC1 Self-assessment score

Once the determination of the scores of each dimensions has been calculated, audit firms will received the overall score. This score is ranked into five different scales (refer to Figure 5). The overall assessment score indicates the firm’s overall assessment of meeting the ISQC 1.

Level of achievement	Score
Good to best practice in many areas	91-100%
Good to best practice in at least one area	81-90%
Meets minimum standards	71-80%
Needs significant improvement in at least one area	61-70%
Needs significant improvement in many areas	0-60%

Figure 5: Overall score assessment

6.0 CONCLUSION

Very limited studies have examined the issue of audit quality directly in small and medium audit firms. This study develops a self-assessment checklist of audit quality control based on the requirements in ISQC 1 for small and medium audit firms. Using a focus group interview method, it is hoped that the feedback from the practitioner in small and medium audit firms may contribute to the understanding of audit quality. Furthermore, most past studies measure audit quality using audit firm size. This study, however, shows a direct proxy measure for audit quality.

The audit quality control assessment provides a practical implication such that this is to enhance audit quality among small and medium audit firms. A well-recognized audit quality of the organization would make customers' choices easier and lowers their expectation of risk. It also builds loyalty, leads to repeat business, and encourages current clients to refer the organization to others (Brinkley, 2006).

This self-assessment checklist is not meant for a pass-fail test or a competition. It is designed as a diagnostic tool in order to enhance understanding of each firm in comparison to the aspirational practices described in the ISQC 1. The score assessment could enable firms to pinpoint areas for improvement.

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Appendix 1: Definition of each ISQC 1 elements

No.	Element	Definition
1.	Leadership responsibilities for quality within the firm	The firm shall establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures shall require the firm’s chief executive officer (or equivalent) or, if appropriate, the firm’s managing board of partners (or equivalent), to assume ultimate responsibility for the firm’s system of quality control
2.	Ethical requirements	The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements
3.	Acceptance and continuation of client relationships and specific engagements	The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it: (a) Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity; (b) Is competent to perform the engagement and has the capabilities, time and resources to do so; and (c) Can comply with relevant ethical requirements
4.	Human resources	The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances
5.	Engagement performance	The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances
6.	Monitoring	The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements
7.	Documentation	The firm shall establish policies and procedures for the documentation to provide evidence of the operation of each element of the system of quality control

(Source: MASA 2007)

Appendix 2: Question items for each element of quality control checklist

LEADERSHIP RESPONSIBILITIES FOR QUALITY WITHIN THE FIRM

- Allocates sufficient resources
- Assigns appropriate person
- Aims in achieving quality in all engagements
- Emphasizes on firm's quality control system
- Exerts quality auditing culture

ETHICAL REQUIREMENTS

- Complies with the fundamental principles of professional ethics
- Identifies and promptly notify the threats to independence
- Requires the rotation of the engagement partner and the engagement quality control reviewer
- Takes action on non-compliance with relevant ethical requirements
- Requires partners and staff members to make independence declaration at least annually

ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND SPECIFIC ENGAGEMENTS

- Address the element of acceptance and continuance of client relationship and specific engagements
- Ensures that the personnel assigned the following matters in acceptance and continuance of client relationship and specific engagements
- Employs an assessment criteria on client's integrity
- Discusses with the appropriate level of client management and those charged with governance regarding the reasons for withdrawal and the appropriate action to be taken

HUMAN RESOURCE

- Establishes policies and procedures dealing with the personnel issues
- Communicates the above policies and procedures to the partners and staff members
- Plans future staffing needs
- Provides continuous training for partners and staff members
- Communicates the identity and role of the engagement partner to client
- Ensures the engagement partner(s) has the capabilities, competencies, authorities and time to perform their engagements
- Defines and communicates clearly to the engagement partner of his or her responsibility
- Assigns appropriate staff with the necessary capabilities, competency and time to perform engagements
- Conducts partners and staff members' appraisals on regular basis
- Offers appropriate remuneration package

ENGAGEMENT PERFORMANCE

- Designs the quality of engagement performance for example through audit manual, standardized documentation, specific guidance materials and software tools
- Undertakes appropriate consultation with experts within or outside the firm to resolve difficult and contentious matters
- Resolves differences of opinion by consulting other practitioners, professional body or regulatory body
- Completes the assembly of final engagement files on a timely basis after the engagement reports have been finalized
- Maintains the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation
- Conducts quality control review in a timely manner

MONITORING

- Establishes policies and procedures designed to provide reasonable assurance that the system of quality control is relevant and adequate
- Establishes policies and procedures on complaints and allegations relating to the system of quality control
- Ensures inspections of the engagement are conducted regularly
- Evaluates the effect of deficiencies noted as a result of the monitoring process

DOCUMENTATION OF SYSTEM OF QUALITY CONTROL

- Establishes policies and procedures requiring appropriate documentation to provide evidence on the operation of the six elements of the quality control system
-