

Examining issues with audit quality



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The major accounting scandals occurred worldwide has brought the focus of public to the audit profession and the audit quality. Enron and WorldCom cases in United States and Parmalat case in Europe are the example of major scandals as a result of the failure of audit services. In Malaysia, the Transmile case which involved around RM530 million of accounting fraud has also addressed the problem about the quality of audit services. These examples of corporate and accounting scandals that happened worldwide have indicated that the audit quality of the audit profession is not at an appropriate and acceptable level.

Over years, the audit quality issue has been discussed and debated globally. Several actions have been taken by international and domestic authorized agencies to address the audit quality issue. For example, the government of United States has introduced and enacted the Sarbanes-Oxley Act in 2002 as a response to the audit failure in big major corporations, such as Enron and World Com. In addition, the Center for Audit Quality has been established in United States as one of the steps to enhance the audit quality of audit profession. In Malaysia, the Malaysian Institute of Accountant (MIA) plays a vital role in addressing the audit issue and promoting and enhancing the quality of audit.

Generally, the function of auditing is to provide reasonable assurance that the financial statements are prepared and presented in a true and fair view and free from material misstatements. The audit reports and audited financial statements will be widely used by the various groups of stakeholders for decision making. Hence, audit quality is an important factor that affects the credibility of the audited financial statements as perceived

by the stakeholders. In other words, high audit quality is necessary criteria to build up stakeholder's confidence on the audit profession.

According to Gaurav Shah, there are five important steps that should be followed to produce a quality audit. Firstly, auditors should plan the audit thoroughly after clearly understanding the objectives and directions of auditing and clearly define the agenda of audit. Next, auditors should perform the audit procedures according to the scope and goal set in the earlier step and continuously measure the performance of the audit works in order to avoid any unnecessary variances happened during audit process. The third step is to record the result of performance, including any errors and problems and report appropriately the result to the management level. Subsequently, improvements should be made on the audit process by solving any detected problems. Lastly, follow up audit should be conducted for the control purpose to avoid any recurring of problems.

2.0 AUDIT QUALITY

In order to understand clearer the concept and evolution of audit quality, we will discuss the definition and dimension of audit quality, the audit quality gaps, the factors that affect the audit quality and the relationship between audit fees and audit quality in this section.

2.1 Definition of Audit Quality

There is no specific definition for audit quality in the auditing standards. Generally, people focus on the reliability of the audited financial statements when referring to audit quality. When an audit is said to have high quality,

the financial statements are usually free from material misstatements and able to provide reliable information for decision making.

Traditionally, audit quality has been defined by DeAngelo (1981) as the “market-assessed joint probability that a given auditor will both discover (a) a breach in the client’s accounting system and (b) report the breach”. Under such definition, there are two main features in audit quality, which are the competence of auditors by possessing necessary knowledge to make correct judgment or discover problems on client’s accounting system and the independence of auditors to disclose these problems.

On the other hand, the Audit Quality publication by ICAEW in 2002 indicated that audit quality is related to the professional opinion given by auditors based on essential evidences and objective judgments. Hence, it is important to understand clearly what is expected on auditors’ works to provide an appropriate professional opinion on financial statements in order to achieve high audit quality.

2. 2 Dimensions of Audit Quality

The AUDITQUAL model

According to the AUDITQUAL model by Angus Duff (2004), there were nine different dimensions in assessing audit quality, which were reputation, capability, independence, expertise, experience, responsiveness, empathy, client service and non-audit services. These nine dimensions were closely interrelated to represent the whole picture of audit quality. Besides, these nine dimensions can be grouped into two distinct factors that relating to technical quality and service quality.

Technical quality is mainly related to the competence and independence of auditors, such as their technical skills, integrity and ability to express objective judgment and opinion. Hence, the dimensions related to technical quality are reputation, capability, independence, expertise and experience.

On the other hand, service quality focuses on issues related to audit clients, such as the additional value-added services provided and the responsiveness to the needs of clients. The dimensions of audit quality under this service quality are responsiveness, client service, non-audit services and empathy.

2.3 Audit Quality Gaps

Audit quality and failure had become one of the key issues in the audit profession mainly due to the perception gaps of audit quality. According to Angus Duff (2004), there are totally eight gaps being identified in the audit quality model. These gaps are mainly the different perception of audit quality between different parties, such as the auditors, clients and stakeholders, and regulators.

With referring to the diagram above, Gap 1 is the discrepancy between the client expectations and the perception of audit firm on client expectations. Gap 2 represents the difference between client expectations and the quality standards of audit firm. Gap 3 refers to the difference between the quality standards of audit firm and the observed quality on audit. The difference between the promises made about audit quality through external communication and the quality of audit forms Gap 4. All Gap 1 to Gap 4 actually represent the quality differences which happen within the audit firm.

On the other hand, Gap 5 represents the client expectations and the client's perception of the audit quality delivered. Gap 6 is the discrepancy between the client expectations on what auditor should attain and what auditor can reasonably be expected to attain. The difference between what auditor can reasonably be expected to attain and the auditor's responsibilities as stated in laws and regulations creates Gap 7. Gap 8 is the difference between auditor's responsibilities as stated in laws and regulations and the actual performance of auditor. The usually said of audit expectations gap in audit profession is collectively represented by Gap 6 to Gap 8.

2. 4 Factors Influencing Audit Quality

According to the Audit Quality framework developed by Financial Reporting Council (FRC) of UK in 2008, there are five key drivers that affect the audit quality. These five key drivers are the culture within an audit firm, the personal qualities and skills of audit partners and staff, the effectiveness of audit process, the audit reporting's reliability and usefulness, and the factors outside the control of auditors.

An audit firm's culture is significantly affects the ways of how audit works and processes being performed. A strong and positive culture will directly increase the audit quality of an audit firm. The top management of audit firm should create a positive environment that encourages the audit staff to achieve high quality in audit works. In addition, proper time and resources should be available for every audit works to enhance and maintain the audit quality. Financial considerations should not be the main focus or factor that affects the allocation of time and resources. An appropriate control and

monitoring system should be designed and put in place to safeguard the quality of audit too.

Audit is a service rather than a product. The quality of audit service may vary when the audit is performed by different people. Hence, human factor is important in determining audit quality. Audit partners and staff should equip with necessary skills, knowledge and professional skepticism in order to provide high quality audit works. It is important for auditors to understand well the environment of the client's business and adhere to the relevant auditing principles and ethical standards. Proper training should be given to auditors to develop their competency and capabilities. The works of junior auditors should always be monitored and reviewed by senior auditors or partners to ensure the quality of audit.

The audit process is one of the key drivers to audit quality too. Appropriate audit methodology and tools should be applied in audit according to situation. Audit partners and senior auditors should be always involve in the audit process to provide adequate support and monitor on audit process. In addition, auditors should gather sufficient and relevant audit evidence to support the judgment and conclusion reach throughout the audit process. Proper audit documentation should be put in place too. Furthermore, it is important to consider and maintain the level of independence, objectivity and integrity of auditors in the audit process to ensure the audit quality.

The way how an audit being reported will affect the quality of an audit too. Audit reports should be prepared in an appropriate form that follow the guidance of relevant standards. Audit reports should be written by using

clear language without ambiguous words. Proper opinion and conclusion should be provided in audit reports regarding the true and fair views of the financial statements. In addition, proper and clear communication with audit committee is necessary and such action will provide a positive impact on the audit quality.

Factors that outside the control of auditors also play an important role in the quality of audit. For example, the corporate governance of an organization is important to enhance the audit quality. An adequate and good corporate governance within an organization directly assists the auditors in performing audit and hence increase the audit quality. The another example of factors outside the auditors' control is the role and behaviour of audit committee. An audit committee should always actively address the issues identified throughout the audit process. Other examples of factors outside the control of auditors include the role of shareholders and the audit regulatory environment.

2. 5 Audit Quality and Audit Fees

Audit quality is something that is intangible and unobservable. Hence, the audit fees are usually used as a proxy for audit quality in many research studies. Generally, there is strong positive relationship between audit fees and audit quality.

In order to achieve higher audit quality, it is necessary to conduct more investigation and audit procedures on the financial statements. This resulted in more audit hours and higher audit fees. In addition, the use of more senior auditors and specialized auditors also is required to achieve higher audit

quality. This resulted in higher audit fees too. Hence, it can be concluded that higher audit fees should be an indirect evidence to reflect higher audit quality because more resources and efforts has been put in to provide reasonable assurance that financial statements are free from material misstatement.

In 2002, the Malaysian Institute of Accountants (MIA) had issued the MIA-By Laws (On Professional Conduct and Ethics) and the laws have provided guidance and recommendation for setting appropriate audit fees. The audit fees should be charged based on the total time spent for particular audit works and the charge-out rate of the related auditors. Therefore, the longer the time spent and the more the number of auditors involved, the higher the audit fees. This should later reflect in higher audit quality.

3.0 AUDIT QUALITY ISSUES

Due to the limitation of pages, we will only discuss five audit quality issues in this section, which are inconsistency of audit quality across countries, reduced audit quality practices (RAQP), single audit quality issue, International Standard on Quality Control (ISQC) and the corporate governance issue.

3.1 Inconsistency of Audit Quality across Countries

The key element of audit quality is its consistency. The nature and process of an audit should be the same regardless the size of the organizations and the countries where the audit is performed. However, it is a global challenge to maintain the international consistency on audit quality when across countries.

The inconsistency of audit quality across countries is mainly due to the national differences in the following aspects (ICAEW, 2010).

Political, economic and business environment

The characteristics of political, economic and business environment play a significant role on the audit quality of financial statements. The national differences included the corruption and bribery level, the business ethics level, the number and rights of foreign investors and the quality of governance in economic activities.

Legal framework

Without a formal and complete legal framework, it is difficult to achieve high audit quality. According to the Fundamentals – Third Parties published by Audit Quality Forum of ICAEW, it is important to have supportive legal framework for auditors to obtain relevant and reliable information from third parties.

The excessive threat of litigation and legal liability can adversely affected the audit quality. Excessive litigation may cause auditors to view standards as rigid rules without proper judgment in their application. In addition, excessive litigation may also prevent the further evolution and innovation in standards and practice.

Education

Inconsistency of audit quality in different countries may be due to the countries' education system and their global connectivity level, such as the degree of international communications and relationships.

The financial operations and preparation of financial statements should be overseen by a financially literate person with relevant knowledge, skills and experience so that relevant accounting standards can be applied accurately. On the other hand, auditors should possess adequate and necessary knowledge, skills and experience to carry out works with proper professional judgment and skepticism.

Culture

According to Hofstede (1980), there were four main dimensions of national culture, which were individualism versus collectivism, strong versus weak uncertainty avoidance, large versus small power distance, and masculinity versus femininity. Different culture between different countries may affect the way a business is operated and certain behaviour to be acceptable or not.

For example, Malaysia is a multicultural society where directors of organizations may come from different ethnic backgrounds. The difference in ethnic background caused different holds in cultural values. Hence, the directors of organizations may perceive audit quality differently.

Perceptions of audit

The auditors in different countries may perceive audit quality differently due to the length of time over which regulations and systems about accounting and

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auditing had been developed, and the origins and development of audit service. The motivations of auditors also influence the perceived audit quality too.

Several initiatives had been taken to promote the international consistency of audit quality. One of these initiatives is strengthening the adoption of International Standards on Auditing (ISAs) and International Standards on Quality Control (ISQCs) issued by the International Auditing and Assurance Standards Board (IAASB). In addition, national independent audit oversight bodies are established, such as Public Companies Accounting Oversight Board (PCAOB). Besides, national regulators had arranged agreements between countries to rely on each others' works.

To further encourage the consistency of audit quality across countries, the following four areas of potential action can be considered (ICAEW, 2010).

Share experience

In order to improving communication and building up necessary skills to achieve consistency and audit quality, it is crucial to share information and experience between auditors on how to build on current practices and potential new use of information technology (IT). This can be done through international exchange and education programmes that expose auditors to new and different environments.

Sharing experience and practice is not only limited to audit firms and audit firms networks, it also can happen between national professional

accountancy bodies and national regulators and between national and global organizations.

Acknowledge national differences

International standards should focus more on how national differences may affect audit risk. In addition, standards should have adequate flexibility for auditors to exercise professional judgment to deal with misstatement risks in order to suit with the related national environment.

Promote the role of audit

The role of audit can be promoted to identify the issues of economic development. When a country facing problems to issue clean audit reports and such problems could not be solved by acknowledging national differences or sharing experience, it gives a sign that there are certain issues need to be resolved, normally related to the political, economic, and business environment or the legal framework.

The IAASB standards should be implemented internationally in order to help highlight the national differences and support economic development.

Support research

Academic research and studies are important in contributing to the consistency in audit quality across countries. Various issues and information are explained clearly in the research papers for better and thorough understanding by others. These issues include the effective ways of sharing experience globally, the acknowledgment of national differences within

international standards and the connection between the audit practice and issues of economic development.

3. 2 Reduced Audit Quality Practices (RAQP)

In the “ post-Enron era”, auditors are said to be working under high pressure condition in the competitive audit market because they are required to perform more audit works but no increase in their audit fees. The behaviours of auditors under such condition directly affect the audit quality and thus rise up an important issue in the auditing profession. Due to the cost-quality conflict and high working pressure, many auditors had engaged in the Reduced Audit Quality Practices (RAQP).

According to Herrbach (2001), RAQP can be defined as the “ poor execution of an audit procedure that reduces the level of evidence gathered for the audit, so that the collected evidence is unreliable, false or inadequate quantitatively or qualitatively”. The occurrence of RAQP is considered as normal phenomena in the current audit profession and it does occur in various countries across the world, such as Australia, United States, New Zealand, United Kingdom and Malaysia. Generally, it is important for auditors to identify the factors that lead to RAQP, such as the time budget pressure, in order to understand well the adverse effects of the factors on auditors and audit quality, and hence manage such factors better.

In fact, the RAQP has affected the audit quality directly as well as indirectly. Underreporting of time is an example of auditors’ behaviour that indirectly affects the audit quality. Due to underreporting of time, several problems, such as lack of budget revision and unrecognized time pressure on future

audit, arose that will give impact on the audit quality. The RAQP that normally has direct impact on the audit quality are the incomplete implementation of necessary audit programs and procedures in order to complete audit tasks. Such practices include accept weak client explanations or doubtful evidence, premature signing-off, fail to research an accounting principle, reduce the amount of work performed on audit step and so on. (Mohd Nazli et al., 2010)

The RAQP is an issue in the audit profession of Malaysia too. It seen that there is an increasing number of auditors engaged in such unprofessional and unethical behaviours and thus giving a negative effect on the audit opinion and audit quality. The weak enforcement by relevant bodies in addressing the RAQP issue is said to be the significant factor that caused the high occurrence of such practices in Malaysia. For example, the Malaysian Institute of Accountant (MIA) is said to be failed in taking appropriate disciplinary actions against delinquent auditors. Furthermore, there were only a little litigation cases against auditors in Malaysia. (Mohd Nazli et al., 2010)

3. 3 Single Audit Quality Issue

The grants received by state and local governments from the federal government have been increased significantly over years. For example, the grants given by the federal government of United States to its state and local governments had increased from \$7 billion in 1960 to around \$450 billion in 2007. Hence, it is very important to adopt a single and uniformly structured audit to oversight the activities. This single audit concept is mainly used to

provide reasonable assurance to the federal government about the use and management of the grants. (GAO, 2007)

Hence, the single audit is clearly a significant mechanism to examine the accountability of the governments on the use and management of its funds. However, many countries, such as United States, Indonesia, Thailand and Malaysia, are facing problems about the sufficiency and quality of the single audit. For example, the President's Council on Integrity and Efficiency (PCIE) of United States had identified serious single audit quality in its report with title " Report on National Single Audit Sampling Project" in 2007. More than half of the single audits performed had been identified with deficiencies and therefore such single audits were being classified as unreliable or unacceptable audits.

In order to address the single audit issue, the PCIE with support from the Government Accountability Office (GAO) has made some recommendations to address this issue in the same report. These recommendations include:

The single audit standards, criteria and guidance should be revised and improved.

In order to conduct and perform single audits continuously, auditors are required to establish and maintain the minimum continuing professional education (CPE).

The disciplinary processes should be reviewed and enhanced to deal with unacceptable audits and auditors that not meet the basic training and CPE requirements.

3. 4 International Standard on Quality Control (ISQC 1)

The International Auditing and Assurance Board (IAASB) of the International Federation of Accountants (IFAC) has approved and implemented the International Standard on Quality Control (ISQC 1) in 2004. Later in June 2006, the MIA has adopted the ISQC 1 as the approved auditing standard in Malaysia. All registered practitioners in Malaysia are required to comply with this new quality control standard and additional responsibilities have been imposed on them.

Generally, the ISQC 1 is able to enhance the audit quality by focusing on the quality control within the firms. There are six quality control elements stated in the ISQC 1 that must be addressed in a comprehensive way. These six quality control elements are the leadership responsibilities for quality, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resource, engagement performance and monitoring. As stated in ISQC 1, audit firms are required to document all evidences of the operation of all the six elements in their quality control systems and retain the documentation for an adequate period.

The adoption and implementation of ISQC 1 could generally improve the quality of the audit practices by auditors besides increasing the quality control within audit firms. However, many small and medium audit firms in Malaysia had pessimistic perceptions on the adoption and implementation of ISQC 1. Similar result has been shown on the survey conducted in South Africa (Research Project, 2005). Most of them opined that such standards just burden their works and responsibilities because there are insufficient partners or staff to guide the quality control team due to the size of the audit

firms. Furthermore, the ISQC 1 is said to be not user friendly because many partners and staff felt difficult to understand the standards and implement the standards in normal practice. This may due to the lack of exposures and training on the ISQC 1. (Aida Hazlin Ismail et al., 2008)

3. 5 Corporate Governance Issue

One of the initiatives that had been taken by many countries to promote high audit quality is enhancing the corporate governance of an organization. For example, in Malaysia, the Malaysian Institute of Corporate Governance (MICG) had introduced the Malaysian Code on Corporate Governance (MCCG) after the economic turmoil in 1997.

When referring to corporate governance, people normally focus on the board of directors of organizations. The two main and observable characteristics of board of directors are the board composition and the separation of roles of Chairperson of the board and the Chief Executive Officer (CEO). The MCCG has provided guidance and recommendation on these matters.

According to MCCG, an effective and well-balanced board of directors should have a certain proportion of independent directors. The MCCG has recommended the organizations in Malaysia should have a minimum of one-third independent directors on the board. This action can improve the oversight and control of board on entities' operation and avoid too much power being placed on the CEO and top management. According to the governance theory, the independent directors should always protect the interests of shareholders by using higher audit quality services because

auditing is a good monitoring activity to control the behaviour of management. (Zalailah Salleh et al., 2006)

In addition, the MCCG also recommends the organizations of Malaysia to separate the role and function of the CEO and the Chairperson of the board. This recommendation is to avoid the unnecessary conflict of interest and the domination of power and authority by a single person in decision making. By separating the power and authority, the independent Chairperson of board is expected to have a higher demand on higher audit quality. (Zalailah Salleh et al., 2006)

Furthermore, the MCCG also provides guidance and recommendation on audit and accountability. According to the MCCG, the board of directors has the responsibility to maintain an appropriate relationship with the external auditors of the organization by establishing transparent and formal arrangements. (Zalailah Salleh et al., 2006)

As a conclusion, it is important to maintain the independent of the board of directors and separate the role of the CEO and the Chairperson in order to maintain the high audit quality of organizations.

4. 0 RECOMMENDATION

The audit quality issues have been debated around the world for a long time periods. Different research papers and studies have investigated and discussed the importance and shortfall of audit quality in recent years. In order to improve the audit quality, several recommendations has been proposed. Hence, in this section, we will discuss and elaborate some recommendations for improvement of audit quality.

Understanding the nature of audit quality

Audit quality should be recognized as a multi-dimensional construct.

Researchers, educators, auditors and other relevant parties should always view audit quality in broader aspects, which should include both the service quality, such as responsiveness and empathy, and the technical quality, such as the reputation, capability and independence. Undeniably, there are empirical relationships occurred between the factors which explain the service quality and technical quality even though these two facets of audit quality have been viewed as distinct constructs. Hence, it is difficult to improve the audit quality by focusing on only single aspect and missing out the other relevant variables and aspects.

Emphasizing on the perception of audit quality by clients and stakeholders

In order to improve the audit quality of the services provided by audit firms and auditors, it is essential to understand clearly what audit quality is perceived by the clients and stakeholders, who are mainly the key users of the audit reports and audited financial statements. According to the survey conducted in the “ Auditqual: Dimension of Audit Quality” by Angus Duff in 2004, both auditors, clients and stakeholders rated the reputation and capability dimensions of technical quality as the highest in their perception of audit quality. Hence, the reputation of firms and the capabilities of audit staff and partners seen to be the key factors when promoting the audit services to clients. This clearly show that clients and stakeholders are valuing much more on the firms’ reputation and auditors’ capabilities rather than other factors, such as the non-audit services provided.

Proper systems to monitor and improve audit quality

The audit firms provide services rather than products to their clients.

Therefore, it is important for audit firms and auditors to provide the highest level of audit quality for their clients in order to gain sustainable competitive advantage and a leading position in the audit market. An adequate understanding of the clients' perception on audit quality should be used as a basis to monitor and improve the audit quality. In addition, the audit firms should understand and minimize the audit quality expectation gaps which occur both within the audit firms and between the perception of clients, stakeholders and auditors. Hence, proper systems should be developed and put in place to continuously monitor the perception of audit quality by clients, identify the reasons for the shortfalls of audit quality and design appropriate actions to improve the audit quality.

Employ, retain and develop competence staff

As noted before, audit is a service provided by individual rather than a product. Hence, the audit quality is significantly dependent on the quality of the individual. Every audit firms should then employ, retain and develop high-caliber staff in order to provide high quality audit services that add values to the clients. The good quality staff should be equipped with adequate and necessary technical and interpersonal skills to deliver high level of technical quality and service quality to the clients and stakeholders in their audit works. Therefore, it is important for audit firms to properly screen individuals before employment being made through appropriate tests and assessments. After employment, continuous effective communication with staff should be established to retain and develop high quality staff.

Examples of effective communication include open meetings, feedback via intranet and independent