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**Implementation of Audit Quality Control System:  
Preliminary Evidence from Small and Medium Audit  
Practices in Malaysia**

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# **Implementation of Audit Quality Control System: Preliminary Evidence from Small and Medium Audit Practices in Malaysia**

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## **Abstract**

This paper studies the implementation of International Standards on Quality Control 1 (ISQC 1) among the small and medium audit firms in Malaysia. Since July 2006, the Malaysian Institute of Accountant (MIA) has adopted the ISQC 1 as part of the approved standard of auditing in Malaysia. However, the implementation of ISQC 1 among small and medium audit firms in Malaysia is not encouraging. A focus group interview has been conducted to gain the perceptions of the practitioners from small and medium audit firms on the implementation of ISQC 1 in their firms. Results show that most of them are lack of exposure and knowledge on the ISQC 1 standards. Therefore, due to this matter, most of the respondents have pessimistic perceptions regarding the implementation of ISQC 1.

*Keywords:* audit quality, quality control system, ISQC 1, small and medium audit practices.

## **1. Introduction**

Assessment on audit quality of audit firms ensure that an audit firm's processes are systematic and disciplined, and work to improve the effectiveness of the firm's practices (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 exceed client expectations and maximize client satisfaction. The challenges for all the audit firms are to understand the determinants of client satisfaction and to maintain audit quality (Ismail et. al., 2006).

Whilst previous corporate collapses, resulted in the media and regulators focusing on the adequacy of audit quality in audit firms in general, it is useful to specifically consider the quality assessments among the small and medium audit firms as small and medium audit firms are commonly associated with lower audit quality (Beatty, 1989). Larger audit firms are more likely to be associated with superior ability to perform more powerful test, thus resulting in more precise information which eventually lead to higher audit quality, all else being equal (Beatty, 1989).

Malaysian Institute of Accountant (MIA) has, in July 2006, adopted the International Standards on Quality Control 1 (ISQC 1) as part of the approved standard of auditing in Malaysia. In essence, ISQC 1 focuses on the quality of audit performed by all members of MIA and they are expected to comply with the standard. Nevertheless, evidence showed that the implementation of ISQC 1 is rather limited in Malaysian small and medium audit firms (Normah & Johari, 2007).

Small and medium audit firms tend to operate based on nonstandard operating procedures, which essentially does not reflect total compliance to the ISQC 1. In addition, to the small and medium audit practitioners, complying with ISQC 1 implementation is a major hurdle to them (Normah & Johari, 2007). Hence, this study explores the issue to ascertain the perceptions of audit practitioners on the implementation of ISQC 1 among small and medium audit firms in Malaysia. This research is in conjunction with what has been suggested by Pflugrath et. al. (2007) that since complying with the ISQC 1 mandatory changes is such a burden to the auditors, hence he suggested that there is a need for timely research on this standard.

## **2. Literature Review**

### **2.1 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). Sutton (1993) argued that there is a need for accounting researchers to developed objective measure in evaluating process quality. Audit process comprised of engagement planning, interim fieldwork, year-end fieldwork and final administration. He has developed and validated a set of key factors influencing the quality of audit process in the large international audit firms. 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.

There are numerous of previous researches done on studying multi-aspects of audit quality and have found evidence that large audit firms serve those clients that demand greater quality as a result of audits performed by large audit firms are perceived to be of higher expected quality than audits by small firms. For example, DeAngelo (1981) provides a theoretical argument suggesting that audit quality increases with audit firm size because of differences in the loss functions faced by big versus small audit firms. In addition, Palmrose (1988) finds that large firms' 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. This is also consistent with Moore and Scott (1989) that demonstrates audit firm size is positively related with the extent of audit work undertaken.

Although many studies have examined the influence of audit size in measuring audit quality, some studies measured audit quality using a direct approach. 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). Furthermore, among the three groups, there were significant differences in the importance assigned to each factor.

Both preparers and users placed significantly more importance on adherence to the general standards of GAAS than did audit partners. Auditor responsiveness to client needs was seen as more important by preparers than by partners. On the other hand, audit partners placed more emphasis on a skeptical attitude than did preparers. Finally, users also placed significantly less emphasis on involvement of high-ranking members of the audit team than did partners. The attributes of audit quality should provide insight into the determinants of client satisfaction however, the relationship between satisfaction and audit quality is diverse (Cronin and Taylor, 1994). The factors associated with high quality audits may not be exactly the same factors that drive client satisfactions. However, it is important to determine which of the identified audit quality attributes are associated with client satisfaction (Behn K et al., 1997). In addition, a lot of prior research is related to audit quality, financial information risk and value relevance of audits relies on the assumption that there is a time invariant audit quality difference between “big” and “small” auditor (Tilis, 2005).

## **2.2 The development of ISQC 1**

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.

As the adoption of ISQC 1 is still in the early stage of implementation, therefore, number of prior research concerning the ISQC 1 is limited. Pflugrath et. al. (2007) support the requirements of ISQC 1 as relevant to the quality control of accounting firms and have potential to positively impact the quality of the audit performance. However, this study concerns the interactive effects of the code of ethics and technical competency, which form an integral part of standard-setters' quality control standards, upon the quality of auditor judgments. Another relevant

study to date (Booth and Schulz, 2004) appears to provide support for ISQC 1's recommendations by finding that an overall strong ethical environment can significantly reduce the tendency of managers to continue failing investments. However, this study is a management accounting field and therefore the applicability of this study to the auditing field is limited.

A survey done on the quality control of audit firms in South Africa (Research Report 2005) indicates that small and medium audit firms were quite pessimistic on the implementation of ISQC 1. The survey reported that there were differences in opinion (in respect of the size of audit firm) as to which partner should be given the responsibility of monitoring and implementing quality control systems. Other than the sole practitioners and firms with two-three partners, respondents did not support systems of quality control comprised of informal structures. They were seriously concerned on the issue of the "excessive time" that partners will be spending on quality control reviews.

### **3. Research Methodology**

#### **3.1 Data collection**

In obtaining the information from practitioners, the researcher team has collaborated with MIA to conduct a focus group interview with small and medium audit firms around Klang Valley area. The respondents comprise of experienced practitioners who are either senior partners or sole practitioners. These are the right respondents as they are regarded as responsible for the implementation of quality control policies and procedures in their firms. As such, they are regarded as the informed respondents and



capable of providing objective and views that are representative of both their personal views and their firm's positions on quality control policies and procedure. The respondents are drawn from cross section, comprising of small and medium firms, sole practitioners and administrator.

As such, the information gathered from the focus group meetings with the informed respondents will enable the assessment of the perceptions from the practitioners' point of views on the implementation of ISQC 1 in their own respective firms. In addition, the problems and challenges that the practitioners anticipate in implementing ISQC 1 were identified. Besides that, the respondents are also asked to provide suggestions regarding ISQC 1. Their suggestions could be used as guidance for MIA to enhance the awareness and positive impact on the implementation of ISQC 1 in Malaysia especially for the small and medium audit firms.

### **3.2 Structure of the interview**

The objectives of the focus group interview are mainly two fold which are to gain information for the research analysis and also as an education platform for the practitioners to know more about the ISQC 1 standards. Hence, a short briefing has been conducted by one of the research team members on the basic knowledge of ISQC 1 before the interview session started. The content of the briefing is mainly on the Introduction of ISQC 1, definitions and elements of ISQC 1 which are the Leadership responsibilities for Quality within the firm, Ethical requirements, Acceptance and Continuance of client relationships and specific engagements, Human resources, engagement performance, monitoring and documentation.

The interview was a semi structured interview which according to Bruce L. Berg (1988, p.17), located somewhere between the extremes of completely standardized and completely non standardized interviewing structures. To facilitate the interview sessions and to be more productive, a list of questions that would be discussed during the interview has been prepared in advance prior to the interview.

#### **4. Data Analysis and Interpretation**

In this section, the results from the interview focus group are analyzed and interpreted. The interview was conducted in two parts where by the first part was before the briefing session on ISQC 1. The briefing was presented by one of the research team member and the second part was conducted after the briefing session. This is done in order to obtain their perceptions of the respondents before and after the briefing session on ISQC 1 in Malaysia.

##### **4.1 Respondent profile**

The Malaysian Institute of Accountants (MIA) has helped to select and invite the participants for the interview session. However, the selection was limited to only 10 practitioners as this is just to get the preliminary feedback on the implementation of ISQC 1 in Malaysia from the small and medium size audit firms. The majority of the respondents attending the interview were experienced partners, senior administration executive as well audit as senior of small and medium size audit firms. These levels of respondents are the most suitable candidate as the target group for the interview because they are responsible for the firm's system of quality control.

Majority of the partners are senior partners with number of practicing years ranging from 10 to 30 years of experienced. General profile on number of staff for the small audit firms are 1 to 3 partners, 1 to 5 managers and 5 to 30 numbers of staff currently working with the firm. However for the medium size audit firm the profile on number of staff are approximately 20 partners, 40 managers and 250 numbers of staff. Nevertheless, most of the small firms are recently incorporated between 5 to 30 years of incorporation. Therefore, that is a strong reason why the firms are currently low in total number of staff working in the firms as compared to medium size firm.

#### **4.2 Feedbacks and suggestions**

Questions were asked regarding the perceptions of the respondents towards ISQC 1 implementation in Malaysia. Majority of the respondents are not in favor of the implementation of ISQC 1 in Malaysia as they are of the opinion that it is a burden and responsibility for the small and medium audit firms. The main reason is because most of the audit firms do not have sufficient partners to lead the quality team, and therefore their main constraint is lack of staff to be in-charged of the quality matters. There is also feedback from respondent with the opinion that this ISQC 1 is not a user friendly standard. Therefore, the respondent feels that it is difficult to understand the standard and to implement them in their practice.

However, despite all the negative perceptions on ISQC 1 implementation for the small and medium audit firms, there are a few respondents whom agree and support the implementation of this standard. One of the feedback was the implementation of ISQC 1 among audit firms could help the professions to be able to improve their quality of their audit practices. In addition, another respondents support

the idea of implementation of ISQC 1 because this is one way to enhance the quality control of the audit firm. Besides that, the implementation of ISQC 1 could be an excellent step to enhanced professionalism and standards among small and medium audit firms in Malaysia.

The respondents were asked on suggestions to enhance the implementation of ISQC 1 among small and medium audit firms in Malaysia. Majority of the respondents agreed that training and workshop are the most important ways to enhance awareness and implement ISQC 1 among audit firms. As this is a newly introduced standard, therefore most of the small and medium audit firms are not familiar with this standard. Therefore, it is important for them to get the basic knowledge and information on what is ISQC 1 all about before they could implement in their daily work practices. Another suggestion is to educate the students from higher learning institute on the importance of ISQC 1. This is to ensure that the students whom will the future employees of the audit firms understand and know the importance of this standard to be used in their work.

#### **4.3 Problems arises**

The respondents were asked question on any problems arises during the implementation of ISQC 1 in their firm. One of the respondents encounters the problem of delegation of responsibility in the implementation of ISQC 1. This is because due to small number of staff in small and medium audit firm. Therefore, delegation of responsibility for the quality controls is limited. Another interesting problem arises is the respondent feels that it is such a waste of their precious time to fill up all the forms and checklist required in the ISQC 1 especially during the peak

period of audit month. Hence, this might result a misleading opinion of quality controls practiced in the firm because the checklist might not be answered correctly.

Other than the above problems, another issue arises in the development of ISQC 1 and creating awareness of ISQC 1 among the staff members of the firm. The respondent also highlighted that it is difficult to get the staff members to understand the concept of ISQC 1 to be implemented in the firm. This might be due to less exposures and training has been conducted on the ISQC 1 to the audit staff. In addition, another issue is concerning lack of staff to be responsible on the quality control management and training that needs to be conducted for the staff members on ISQC 1. This problem arises in the small audit firms where the total numbers of staff are limited to less than 10 people inclusive of the partners and administrators.

## **5. Conclusion**

This study provides insights into the recent implementation of ISQC 1 on small and medium audit practitioners in Malaysia. Furthermore, this study also analyzes the perceptions of audit practitioners on the problems in implementing ISQC 1. Using a focus-group interview, ten audit practitioners has volunteered to participate in the study. Most of the respondents agreed that the implementation of ISQC 1 for the small and medium audit firms a burden to them especially on internal matters such as lacking number of staff in-charged the quality control system and understanding the standard itself. This evidence is consistent with the survey conducted in South Africa (Research Report, 2005) which also found that small and medium audit firms were quite pessimistic on the implementation of ISQC 1. Audit firms with single or few partner(s) were concerned on the time spent in monitoring and implementing quality

control systems. However, some of the respondents did agree that ISQC 1 is an effective method towards the improvement of quality control system for small and medium audit firms. In fact, they also agree that ISQC 1 could enhance their professionalism and credibility. The findings also indicate that they suggest a further training on ISQC 1 is still needed in enhancing the implementation of ISQC 1.

This preliminary finding on the implementation of ISQC 1 could assist the profession in monitoring the quality of the audit process as well as the audit firms. In conjunction with this current study, a further study is done to develop a quality assurance on the audit firms using a self-assessment checklist in Malaysia. This approach is hoped to help the small and medium audit firms to assess their efficiency and effectiveness of their audit firms based on standards and benchmark information given in the ISQC 1 Standard (MASA, 2007). In doing so, MIA has supported this project and closely worked with the model provided in other countries such as Australia and Pakistan. Audit quality is an increasingly important issue and should be a useful area of exchange of national experiences (Mazur et al., 2005).

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