

# **Benefitting from the International Standards on Quality Control (ISQC) 1 : A Tool for Assessing Audit Firms**

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## **Abstract**

This paper provides an overview on the International Standards on Quality Control 1 (ISQC 1) self-assessment checklist for audit firms in Malaysia. The checklist is developed by a Universiti Teknologi MARA research team with a collaboration of Malaysian Institute of Accountants (MIA) and Malaysian Accountancy Research and Education Foundation (MAREF). The checklist items are based on the ISQC1 requirements, ISQC 1 manual and MIA By-Laws. This checklist has been validated by a group of practitioners from various audit firms. It is hoped that this checklist would assist audit firms to assess themselves and hence, could improve their audit service quality. Although the implementation of ISQC 1 in audit firms imposes additional responsibilities, audit firms should realize the importance in finding the right balance between governance, oversight and business growth.

*Keywords: audit quality, quality control system, ISQC 1, self-assessment, audit practices*

## **Introduction**

*“We have policies and procedures, backed by rules and bye-laws, that require member firms conducting transnational audits to: maintain appropriate quality control standards in accordance with International Standards on Quality Control (ISQC 1), issued by the International Auditing and Assurance Standards Board (IAASB), in addition to relevant national quality control standards; participate in the network’s audit quality control review programme; have policies and methodologies for the conduct of audits that are based, to the extent practicable, on International Standards on Auditing; and have policies and methodologies in place that, as a minimum, conform to the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants and national codes of ethics” - Russell Bedford, an approved transnational audit firm & a member of the IFAC forum firms, 2008.*

Recent development concerning audit quality control has required audit firms to comply with the International Standards on Quality Control (ISQC 1) issued by International Auditing and Assurance Standards Board (IAASB). Malaysian Institute of Accountant (MIA) has, in July 2006, adopted ISQC 1 as part of the approved standards of auditing in Malaysia. In essence, ISQC 1 focuses on the quality of audit performed by the audit firms and they are expected to comply with the standards. As such, audit firms are faced with additional responsibilities in respect of implementing new quality control safeguards and procedures. A recent study conducted by MIA and Universiti Teknologi MARA (UiTM) (2007) indicates that the implementation of ISQC 1 is rather limited in Malaysian small and medium audit firms. Small and medium audit firms tend to operate based on non-standards operating procedures, which essentially does not reflect total compliance with ISQC 1.

In order to gauge the quality of audit firms, it is important to have a guideline for audit firms to rely on. Based on the ISQC 1 framework, a self-assessment questionnaire has been developed by a team of researchers from UiTM with the collaboration of MIA and Malaysian Accountancy Research and Education Foundation (MAREF). This project is hoped to contribute to the improvement in the quality control of small and medium audit practices in Malaysia. It is also to provide a more objective appraisal of audit quality in small and medium audit firms. The checklist would enable audit firms to self-assess their service and to recognize any deficiency that could have compromised audit quality.

### **The Search for Audit Quality**

The strong interest in understanding audit quality is partly due to the concern of issues such corporate collapse, expectation gaps and corporate governance. Although many people 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. Audit quality is determined from a number of components such as good audit team, long firm experience, full complying with generally accepted auditing standards and sufficient customer service. This also covers all stages of audit process: engagement planning, interim fieldwork, year-end fieldwork and final administration. The extant of good quality audit services should not be limited to the audit engagement only. Audit quality involves quality assurance in all aspects of business such as managing human resources and relation with clients.

## Understanding the International Standards on Quality Control 1

In 2004, IAASB under the supervision of International Federation of Accountants (IFAC), has approved the ISQC 1 that concerns 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, MIA has imposed that all registered accountants and auditors (practitioners) in Malaysia to comply with the ISQC 1 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.

The 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, the ISQC 1 deals with firms and its personnel to comply with professional standards and regulatory and legal requirements. As shown in Figure 1, the ISQC 1 sets out seven quality control elements that must be rigorously and comprehensively addressed.

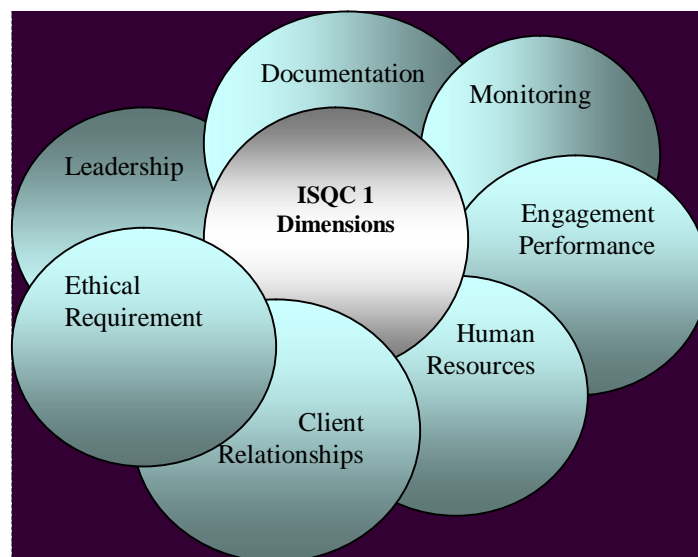


Figure 1: Dimensions of ISQC1 Audit Quality Control Dimensions

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; (6) Monitoring; and (7) Documentation. The standards requires audit firms to document the evidence of the operation of each of the seven elements of

its quality control system and retain that documentation for an appropriate period. Details explanation on each dimensions are shown in Table 1.

Table 1: Definition of 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

No.	Element	Definition
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)

### **The Development of Self-Assessment ISQC 1 Checklist**

The development of the checklist involved three different stages. First, the researchers formed common themes of the 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 the 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. 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. 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.

### **Components of Self-Assessment ISQC 1 Checklist**

The structure of the checklist consists of two parts (refer Table 2). The first part presents questions on the policy and procedures and the second part presents questions regarding the practices. Questions on the policies and procedures shall be answered either yes or no whilst questions on practices shall be answered using four different indicators. The indicators enable 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. The firm should use the indicators as an opportunity to ask itself challenging questions and to respond with accurate answers geared toward self-improvement.

Table 2: ISQC1 Self-Assessment Checklist - Format

<b>Part</b>	<b>Explanation</b>										
<b>Policy and Procedures</b>	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.										
<b>Practices</b>	<p>The part comprises of questions on the practices of each elements of ISQC 1. Each indicator shall be answered using four-scale options.</p> <table> <tr> <th><i><b>Indicator</b></i></th><th><b>Explanation</b></th></tr> <tr> <td><i>Not evident</i></td><td>No evidence/ documentation exists</td></tr> <tr> <td><i>Emerging</i></td><td>Evidence indicates early or preliminary stages of implementation of practice</td></tr> <tr> <td><i>Operational</i></td><td>Evidence indicates practices and procedures are actively implemented</td></tr> <tr> <td><i>Highly functional</i></td><td>Evidence indicates practices and procedures are effectively and consistently implemented</td></tr> </table>	<i><b>Indicator</b></i>	<b>Explanation</b>	<i>Not evident</i>	No evidence/ documentation exists	<i>Emerging</i>	Evidence indicates early or preliminary stages of implementation of practice	<i>Operational</i>	Evidence indicates practices and procedures are actively implemented	<i>Highly functional</i>	Evidence indicates practices and procedures are effectively and consistently implemented
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The self-assessment checklist is then formatted into the 7 different dimensions where each dimension contains both the policy and procedures and practices parts as shown in Table 2. The finalized question items for each dimension of the self-assessment checklist are shown in Table 3.

Table 3: Question items for each element of quality control checklist

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**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, standardsized documentation, specific guidance materials and software tools
  - Undertakes appropriate consultation with experts within or outside the firm to
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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
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## Rating the Score

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 2. The cobweb concept represents degree of compliance with the ISQC 1. In the best scenario, total compliance with the ISQC 1 will depict a complete cobweb. The score represents the level of compliance for each of the 7 element of the ISQC 1.

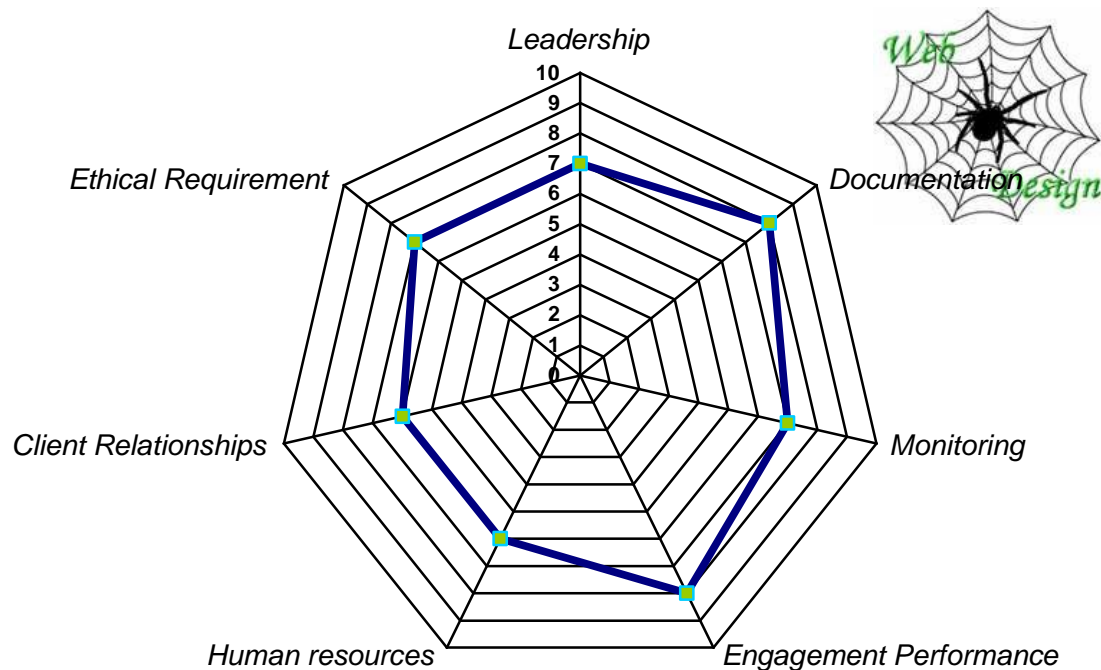


Figure 2: ISQC1 Self-assessment Score

Once the determination of the scores of each dimension has been calculated, audit firms will receive the overall score. As shown in Table 4, this score is ranked into five different scales. The overall assessment score indicates the firm's overall assessment in complying with the

ISQC 1 and the score is represented by the number of stars being the 5 stars indicates the best level of compliance to the ISQC 1.

Table 4: Overall Score Assessment

Level of achievement	Score	Rating
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%	*

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. Although the implementation of the ISQC 1 for small and medium audit firms might be a burden to them especially in terms of lacking number of staff in-charged the quality control system and understanding the standards itself, the standards is an effective method towards the improvement of quality control systems. The audit quality control assessment provides a practical implication such that this is to enhance professionalism and credibility of audit profession as well as to improve the effectiveness of small and medium audit firms.

Audit firms should have the initiative to provide the right tone that can influence audit quality. According to a recent paper issued by the Transnational Auditors Committee, the Executive Committee of the Forum of Firms, IFAC, entitled *Tone at the Top and Audit Quality* (2007)<sup>1</sup>,

<sup>1</sup> *Tone at the Top and Audit Quality* can be downloaded free-of-charge from the IFAC online bookstore at <http://www.ifac.org/store>. The paper describes five areas in which management can address tone

audit firms should realize the importance of the tone at the top in finding the right balance between governance, oversight and business growth. As a result, a well-recognized audit quality of the organization would make customers' choices easier and lowers their expectation of risk.

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at the top issues: strategy, communication, job descriptions, performance appraisals, and monitoring.