Auditing the Auditors: Has the Establishment of the Audit Oversight Board Affected Audit Quality?

Hashanah Ismail¹*, Ung Chui Theng²

¹Faculty of Economics and Management, Universiti Putra Malaysia, 43400 Serdang, Malaysia, ²Faculty of Economics and Management, Universiti Putra Malaysia, 43400 Serdang, Malaysia. *Email: hashanah@upm.edu.my

ABSTRACT

This paper reports on the results of a research into the relationship between audit quality during the years before and after the incorporation of the Audit Oversight Board (AOB) in Malaysia in 2010. As the AOB only audits auditors of listed companies this study is based on 50 companies’ audited financial statements 2 years before and after AOB was established. A total of 200 firm years were observed. Using reported companies’ earnings to proxy for earnings and audit quality the data collected were analyzed using the modified Jones model for discretionary accruals. The study does find the discretionary accruals to be lower after AOB was established although the change is not significant. Although not significant statistically it evidences that having an independent auditor of the auditors with sanctioning powers does contribute towards greater assurance of audit quality being delivered and that regulation of audit complements the self-regulating regime by the profession for auditors of listed companies in Malaysia.

Keywords: Audit Regulation, Audit Oversight Board, Audit Quality, Discretionary Accruals, Self-Regulating

JEL Classification: M42

1. INTRODUCTION

External auditors ensure integrity in the financial reporting process through independent audits of financial statements. Thus audited financial statements are deemed more credible than unaudited ones by virtue of the assurance given by an independent expert, the external auditor. In Malaysia audits must be performed according to a prescribed minimum quality level found in the auditing standards approved by the Malaysian Institute of Accountants (MIA) and any departure or non-compliance with approved auditing standards may result in a sub-standard audit and non-compliance with approved auditing standards must be justified. Whilst external auditors monitor the quality of financial reports prepared by companies, who monitors the quality of the work performed by auditors? The quality of the external audit is monitored by the profession such as a peer review, which makes the audit profession a self-regulating profession. However, in 2010 an additional layer of regulation of the external audit was created when the Audit Oversight Board (AOB) came into being on April 1, 2010 under the Securities Commission Amendment Act, 2010. The AOB is an oversight mechanism to regulate and oversee the proper financial reporting of public interest entities (PIE). Although the AOB is a recent institution, similar independent AOBs have been established in several jurisdictions such as Australia, Holland, Japan, Canada and the US, all of which have the same function: To monitor the processes used by participating audit firms in respect of compliance with auditing standards and legal obligations relating to audit and audit quality. Given that the AOB is now another layer of regulation to the existing regulatory framework of audit in Malaysia, have the quality level of audit performed on the financial reports of Malaysian companies improved?

An earlier study by Hashanah et al. (2012) examined the responses and expectations of external auditors to the prospect of being audited by a regulatory body, the AOB. The study reports a consensus among practitioners that audit quality will be raised in anticipation of the potential visit by the AOB to audit firms.
The quality of audit is invisible and therefore proxies have to be selected as a measure of audit quality rendered. This paper examines the dimension of audit quality from the perspective of the end result of audit: The quality of audited financial statements to answer the research question as to whether audit quality has been affected by the establishment of the AOB or not. The rest of the paper is organized as follows: The next section reviews some of the literature on audit quality and the regulatory framework of auditing. This is followed by a description of the methodology of the study. The paper then discusses the results and finally concludes.

2. LITERATURE REVIEW

2.1. Audit Quality
Audit quality is viewed as one of the important factors affecting the credibility of financial statements (Arrunada, 2004). If a quality work is performed then the audited financial statements would be given an appropriate report rendering the financial statements useful to users for decision making. De Angelo (1981) defines audit quality as having twin dimensions of the probability that the auditors are competent to be able to detect material misstatements and having detected the misstatements are willing to report it, that is upholding auditor independence. According to De Angelo (1981) big four audit firms provide better quality audit than the non-big four as the former have a reputation to protect and clients pay bigger fees to big four firms because the audited financial statements have a higher credibility.

2.2. Regulatory Framework of Audit
The quality of audit is regulated at many levels through a number of rules, regulations and the law and for specialized sectors such as the financial institutions an additional layer of regulation is imposed by the Central Bank. Several provisions in The Companies Act 1965 mandate that auditors must have competence and the necessary skills before accepting nominations to be appointed as auditors. In addition the law also upholds the auditors’ independence by giving auditors certain rights such as the right to seek information, to attend general meetings concerning the audit and the right to be heard if dismissed. The law empowers the MIA to prescribe the competence criteria. At the professional level MIA regulates its members as to the qualifications and continuous training that auditors must have and attained in order to be a fit and proper person to be appointed as auditors. MIA also prescribes as minimum quality standards, the International Auditing Standards issued by International Federation of Accountants when carrying out the audit and any departure or non-compliance with extant standards will have to be justified. “Auditors are required to declare positively in the auditors” report that the audit was carried out in accordance with approved auditing standards in Malaysia. In July 2006 MIA adopted the International Standards on Quality Control which audit firms must use. This standard prescribes quality elements of the audit at firm level. In addition the members of the profession are also bound by the Code of Ethics under the MIA by-Laws to uphold auditor independence and integrity. Hence regulation relating to audit quality before the AOB was established spanned both the individual and firm levels and the profession was largely a self-regulating profession where the profession itself was not only the standard setter but was also the monitoring body for compliance with the profession’s rules and Code of Ethics and the profession would impose sanctions on members for failure to perform quality audit work as prescribed by auditing standards.

In April 2010 the AOB commenced operations. It was set up under Section IIIA of the Securities Commission Act 1993 to oversee the auditors of PIE and to promote confidence in the quality and reliability of PIEs’ audited financial statements. In 2010 too AOB was admitted as a member of the International Forum of Independent Audit Regulators (IFIAR). It would have the power to reprimand auditors that had done wrong including issuing penalty and deregistering auditors from practice. AOB is therefore the auditor which audits the auditors and its incorporation added another layer to the regulatory framework making audit regulation no longer entirely one of self-regulation but co-regulated between the profession and the law.

3. METHODOLOGY

As there is no specific measurement of audit quality, it has been defined in various ways from the compliance to the applicable auditing standards, the competence of auditors to report the breach of financial statements containing material errors and report it, the accuracy and reliability of information reported and also the measure of the audit’s ability to improve the fineness in accounting data. However, there is no one perfect metric to capture the many facets of audit quality, many of which are not directly visible to the public. For most cases, the proxy for audit quality can only be accessed and assessed through the publicly available information but not the private information known to the auditors. The real audit quality is that the audit does not result in both the Type I error: Issuing an unqualified opinion to a failing company and Type II error: Issuing a qualified opinion to a non-failing company (Jackson et al., 2008). Various methodologies have been used in prior research and one of the most highly used is the discretionary accruals computed from figures reported in the audited financial statements. Among these, the use of discretionary accruals is the most popular. A higher level of accruals shows that there is a higher probability for management to exert influence over the auditor to report on terms favorable to management (Jackson et al., 2008). Healy (1985) used total accruals and McNicholas and Wilson (1988) used the discretionary portion of an individual account, bad-debt provisions. There are, however, some deficiencies on both methods as Healy’s model does not split non-discretionary accruals from discretionary accruals and McNicholas and Wilson’s method does not study the behavior of total discretionary accruals. Jones (1991) had successfully developed a model to capture the net effect of all accounting choices on reported income. The model regresses total accruals against the change in revenue and property, plant and equipment. After that, the Jones model was widely adopted by many studies. To report better performance of their model in estimating discretionary accruals, Dechow et al., (1995) had added the change in accounts receivable as an explanatory variable in the estimation regression of the Jones model. Moreover, it was claimed that the cross-sectional Jones models are better specified than their time-series counterparts (Subramanyam, 1996). For this paper, the discretionary accruals are measured using the cross-sectional variation of the modified Jones model.
3.1. Sample Selection
The sample consists of 50 public listed companies on the Kuala Lumpur Stock Exchange (KLSE) or Bursa Malaysia for the period from year 2008 to 2012. The pre-inspection period is represented by the period from year 2008 to 2009 while the post-inspection period is represented by the period from year 2011 to 2012. The data on year 2007 is also collected to be used to measure the discretionary accruals for year 2008. The year 2010 is referred as the basis year as it is the year where the AOB is established. The sample only includes companies under the category of industrial and consumer products (manufacturing industry) to adjust for the effects on the discretionary accruals calculated arising from the difference of industry. Besides that, as 90% of the public listed companies on the KLSE are audited the big-four companies, the sample includes only the companies audited by the big-four audit firms and exclude firms audited by the non-big-four companies. As a result, the sample contains 200 firm year observations over the period 2008-2012. Details of the companies, auditors and sectors if provided in Table 1.

3.2. Specifications and Explanation of the Model
Discretionary accruals are used as the proxy for audit quality. It is concluded that the audit quality from reduced managerial discretion results in less abnormal accruals, all other things being equal. The abnormal accruals are measured by way of the performance-adjusted cross-sectional modified Jones model which was largely used in various auditing literature to measure audit quality (Jones, 1991; Dechow et al., 1995; Kothari et al., 2005).

\[ TA_{i,t} = \beta_0 + \beta_1 \left( \frac{1}{\text{Assets}_{i,t-1}} \right) + \beta_2 (\Delta \text{REV}_{i,t} - \Delta \text{AR}_{i,t}) + \beta_3 \text{PPE}_{i,t} + \beta_4 \text{ROA}_{i,t} + \epsilon \]

Where, \( TA_{i,t} \) is total accruals in year \( t \) (defined as the change in non-cash current assets minus change in current liabilities excluding current portion of long-term debt, minus depreciation and amortization) scaled by lagged total assets; \( \text{Assets}_{i,t-1} \) is a firm’s total assets in year \( t-1; \Delta \text{REV}_{i,t} \) is sales in year \( t \) less sales in year \( t-1; \Delta \text{AR}_{i,t} \) is accounts receivable in year \( t \) less accounts receivable in year \( t-1; \text{PPE}_{i,t} \) is net property, plant and equipment in year \( t; \text{ROA}_{i,t} \) is return on assets in year \( t \). A company’s unadjusted abnormal accruals are set equal to the firm-specific residuals estimated from the above model of expected (normal) accruals.

To test for the hypotheses, model below is used:

\[ |TA_{i,t}| = \beta_0 + \beta_1 \text{Size}_{i,t} + \beta_2 \text{Performance}_{i,t} + \beta_3 \text{Growth}_{i,t} + \beta_4 \text{Post Inspect} + \epsilon \]

Where,

\[ |TA_{i,t}| \] is the absolute value of performance-adjusted abnormal total accruals measured by modified Jones model; \( \text{Size}_{i,t} \) is the natural logarithm of total assets; \( \text{Performance}_{i,t} \) is the operating cash flow scaled by total assets; \( \text{Growth}_{i,t} \) is the percentage of year-to-year growth in sales; \( \text{Post Inspect} \) is the variable of interest to be tested, where it takes value of 1 when the observation relates to post period inspection, else 0.

For this model to test for the hypothesis, three control variables have been used: \( \text{Size}, \text{Performance} \) and \( \text{Growth} \). The variable \( \text{Size} \) is included to control the effect of the political cost hypothesis which suggests that larger firms (firms with more political visibility) prefer income-decreasing accounting choices (Bauwhede et al., 2000). The coefficient on this variable is predicted to be negative. The next control variable is the \( \text{Performance} \). Dechow et al. (1995) and Young (1999) propose that the existing accrual expectation models may yield measurement error in the discretionary accruals proxy, and hence misspecified tests for earnings management for firms with extreme financial performance. The absolute value of the cash flow operation is used in this model, so the coefficient is suggested to be positive or negative. For the \( \text{Growth} \) control variable, it is used in this study as the support from previous studies from Becker et al. (1998) for the relationship between it and the accruals.

4. RESULTS AND DISCUSSIONS

4.1. Descriptive Analysis
The final sample includes 50 companies from Bursa Malaysia for 4 years of 2008, 2009, 2011 and 2012. Therefore, there is a total of 200 firm-year observation. The industry chosen was from consumer and industrial product industry to make adjustments for the differences brought by the different industries. The sample includes 19 companies (38%) manufacturing of consumer products and 31 companies (62%) manufacturing of industrial products. The companies selected were that only audited by the big four audit firms to adjust for the different of audit quality between big firms and small firms as being mentioned and proposed by prior literature. As being found out, most of the listed companies of manufacturing sector producing consumer and industrial products are being audited by KPMG and Ernst and Young. Out of 50 companies, 18 companies are audited by KPMG and Ernst and Young which represent 36% respectively. The remaining 14 companies (28%) are audited by Pricewaterhouse Cooper and Deloitte Kassimchan, where 8 companies (16%) are audited by Deloitte Kassimchan and the other 6 companies (12%) are audited by Pricewaterhouse Cooper. The companies chosen as sample are all with the same financial year end (31 December). This is to ensure that the information for the sample is to be consistent within a particular range.

The Table 2 presents the descriptive statistic of the dependent and control variables, and the variable of interest. The Table 1 shows that the mean (median) abnormal total accruals in absolute value are 0.0695 (0.436). The mean (median) total assets is RM875,472,700 (RM286,806,500), while the mean (median) absolute value of operating cash flow scaled by total assets is 0.0808 (0.0594). The mean (median) growth rate measured as the percentage change in sales is 6.24% (5.55%). The mean and median for the post-inspection variables is 0.5 as the firm year observation for both pre and post of the establishment of AOB is same: 100 firm year observation.

4.1.1. Empirical analysis for the testing of hypothesis
The Table 3 relates to the result of the analysis of the hypothesis relating to audit quality pre- and post-AOB is established
Ismail and Theng: Auditing the Auditors: Has the Establishment of the Audit Oversight Board Affected Audit Quality?

4.2. Discussion on Findings

4.2.1. Inspection of AOB

The main reason for the rejection of the hypothesis may probably be due to the characteristics of the inspection of AOB. According to what is being reported from the annual report (AOB, 2012), the number of audit engagement inspected during the year 2011 was 52 and this number dropped to 37 only in year 2012, making a total number of audit engagement inspected during the year 2011 was 286.806.5 thousand as compared to that of total sample size of 200. Besides that, a univariate t-test shows that the mean value of absolute abnormal accruals is 0.0778 in the pre-inspection period (n = 100) and drops to 0.0612 in the post-inspection period (n = 100) but the change is not significant (P > 0.10). Therefore, it is concluded that the audit quality as measured by the abnormal total accruals does not change significantly as a result of the inspection of AOB. As to the control variables, only the variable Growth shows significant coefficient for the three columns (P < 0.10). The sign of the control variables are all in predicted signs.
in the annual report published by the AOB to the public. According to the report, it is found that the auditors do not challenge enough on the estimates and judgments made by the accountants in the reporting of the financial statements. This shows that the auditors do not exercise professional skepticism at a level as expected by the AOB. Other important findings and issues include the ineffectiveness of monitoring quality control, resource constraint and retention issue and lapses in documentation. The findings of AOB shows that basically the audit firms in Malaysia are still weak and insufficient in carrying out the engagement. This could explain why the audit quality does not improve even after the inspection of AOB. If there are changes or improvements in those area identified, the audit quality may improve continuously in the future under the inspection of AOB.

The audit opinions given by the auditors in all the sample companies surveyed were unqualified. The issuing of unqualified opinion shows that auditors are satisfied with the fair presentation of the financial statements audited. The result of the study though shows no difference in audit quality pre- and post-inspection of AOB, but the test does show the decrease in the discretionary accruals. Though it is not significant but it represents slight improvement in audit quality. This slight improvement in the audit quality may be due to the revised Code of Corporate Governance, 2012. Under Principle 5 of uphold integrity in financial reporting, the Audit Committee should ensure financial statements comply with applicable financial reporting standards and have policies and procedures to assess the suitability and independence of external auditors (Code of Corporate Governance, 2012). Therefore, under the new revised Code of Corporate Governance, the audit committee is expected to put in more effort in the discussion with the auditors in anticipation of being the target of AOB for inspection. It is believed that this could be the reason for the decrease in discretionary accruals though the decrease is not significant.

The result of this study is found to be inconsistent with that of Carson et al. (2013) which reported that audit quality did improve after the inspection by the Australian AOB. However, the difference of the result generated could possibly be attributed to the greater coverage of the study comprising 33 countries over the period of 2006-2010. The larger sample size including more countries suggested that probably the effectiveness of an oversight inspection programme can only be felt over a longer period as greater coverage of inspection and post-inspection remedial steps are implemented.

### 5. CONCLUSION

Moving to independent public oversight of the auditing profession and putting an end to the traditional model of self-regulation is one of the most insightful changes in audit regulation of the past decades. Though some has been supporting the public oversight, research on its effectiveness is to be explored. Currently, United States has been the main focus of the emerging literature on public oversight, as it is one of the few countries where the inspection findings of public oversight body are disclosed publicly. The independent public oversight, however, has been a world-wide trend, emphasized by the formation of IFIAR in September 2006, growing to a membership of 44 countries in early 2013. To the best knowledge, there is no study on the effectiveness of public oversight board in Malaysia as what is being examined here. It is observed that the level of abnormal accruals is lower after the inspection conducted by AOB though it is not significant. Our results contribute to the emerging literature and debate on the effectiveness of AOB on improving the audit quality in Malaysia. The findings may help the regulators in the further development, design and mutual recognition of the oversight and inspection system. It might show that the current inspection system tend to be not so useful in improving the audit quality in Malaysia.

One of the limitations of the study may be the restriction to one of the measurement of audit quality, discretionary accruals. Other commonly used measures of audit quality such as the appropriate use of going concern opinions for loss-making companies. The sample may include the firm-year observation with qualified audit opinion to make the result more comparable. Besides that, it is found out that it is difficult to find supporting article or journal regarding to the effectiveness of inspection of AOB especially research done in Malaysia. Therefore, applying some of the theories and concepts from other journal became challenging for this paper. In addition to this, the research only includes three controlling variables. However, there are still a lot of variables which can affect the result.

For future research, it is suggested that more sectors can be brought in to entail a more comprehensive study to enrich the findings and discussions. As this study only concern on the companies...
audited by big firm only, future research can focus on the study on companies audited by the medium and small audit firm. Moreover, it is suggested future research can capture the effect of fair value by including it in the model to calculate the total accruals given that the Malaysian financial Reporting Framework has now migrated to fair value accounting giving rise to the reporting of unrealized fair value gains and losses. These emerging reportable gains and losses have yet to be factored into the existing discretionary accruals model and is therefore a potentially rich area for future research.

REFERENCES


