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Procedia Economics and Finance 31 (2015) 632 – 639

Procedia
Economics and Finance

www.elsevier.com/locate/procedia

INTERNATIONAL ACCOUNTING AND BUSINESS CONFERENCE 2015, IABC 2015

Audit Firm Governance: An Overview From Malaysia

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Abstract

This paper presents a preliminary analysis of survey data in a study to examine the governance of Malaysian audit firms. Data on 30 audit firms including big four and non-big four audit firms is used to describe four dimensions of the audit firm governance, namely, leadership, values and ethical requirement, independent non-executive, and operation. The survey study is still in progress, hence the presentation of the current analysis to highlight the level of awareness and compliance to the global standard of Code of Audit Firm Governance (CAFG) issued by the Financial Reporting Council (FRC) of United Kingdom. However, descriptive statistics thus far are found to provide useful insights into the governance of Malaysian audit firms. The preliminary analysis suggests that Malaysian audit firms are aware on the issuance of the CAFG, and have been in compliance to the CAFG except for matter in relation to transparency report and designation of independent non-executive directors. The establishment of Audit Oversight Board (AOB) in Malaysia does influence the level of compliance to the CAFG amongst Malaysian audit firms.

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Peer-review under responsibility of Universiti Teknologi MARA Johor

Keywords: Audit Firm Governance; Code of Audit Firm Governance (CAFG); Financial Reporting Council of UK; Audit Oversight Board (AOB); Malaysia.

1. Introduction

Corporate governance is defined as a system by which companies are directed and controlled (The Cadbury Committee, 1992). On the part of definition of corporate governance as defined by the Malaysian Code of Corporate Governance (MCCG), is that “corporate governance is a process and structure used to direct and manage the business”. Corporate governance has become an important factor in financial market development and firm value, particularly in emerging markets (La Porta et al, 2000). Further definition is given by Abidin et al (2009), where corporate governance is about the organization of a company by taking into account responsibilities towards shareholders and stakeholders.

Auditing industry has also addressed the importance of installing sound governance not only on the part of publicly listed entities, but also within the audit firms. In the year 2010, the Financial Reporting Council (FRC) and the Institute of Chartered Accountant of England Wales (ICAEW) have published the Code of Audit Firm Governance (CAFG). The CAFG structure is similar to the UK Corporate Governance Code, where it comprises of 20 principles and 31 provisions.

This paper examines the awareness and the level of compliance of Malaysian audit firms to the CAFG. survey responses from 30 Malaysian audit firms, comprises of four (4) big audit firms and twenty-six (26) small and medium audit firms, which also known as non-big four audit firms were analysed. Section two of this study presents background and literature review , while section three discusses the descriptive statistics in . Section four provides a discussion of findings, while section five presents the conclusion.

2. Background and Literature Review

The Malaysian Institute of Accountant (MIA) has shown its appreciation on the importance of audit firm governance through the establishment of the Audit Oversight Board (AOB) in the year 2010. This AOB is responsible to oversee the performance as well as promoting good governance structure among Malaysian audit firms. The AOB works together with other relevant regulatory agencies such as the Companies Commission of Malaysia, and the Central Bank of Malaysia, to ensure there is a holistic regulatory framework for auditors in place which consequently promotes the growth of auditing profession through good governance.

Basically, AOB relies on the International Standard on Quality Control (ISQC) as a basis for measurement of the performance of Malaysian audit firms. The Council of the Malaysian Institute of Accountants (MIA) has approved this ISQC since July 2005 for publication. The status of ISQC is set out in the Council's statement Preface to Malaysian Approved Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.

This effort is seen in line with the issuance of the Code of Audit Firm Governance (CAFG) by the Financial Reporting Council (FRC) of the UK in the year 2010. The guidelines provide the details to enhance audit quality or efficiency such as the suitable audit technology, process and procedures, continuous professional development, and resource allocation of the audit team. Thus, it is expected that an audit firm with good governance will always want to maintain its good reputation by providing efficient audit works. As stated by the FRC of UK (2010), good audit firm governance is a way in which the audit firms maintain the public trust in their brands by being seen as exemplars of best practice governance.

In the context of this study, audit firms' governance is assessed based on both of the CAFG and the ISQC. The elements of the assessment are adopted from the ISQC questionnaire developed by the UiTM research institute in collaboration with the MIA, which is used as a tool to evaluate the system and quality of the audit firms (Zuraida 2010). The questionnaire has later been modified so as to include relevant codes of CAFG that in accordance with the ISQC. Since there are not much prior literatures found on the audit firm governance, this study is the first which attempts to provide an overview on the audit firms' governance in Malaysia. Thus, the following provides further discussion on the elements of the assessment for the audit firm governance based on both ISQC and CAFG.

1.1. Leadership

This element covers matters on owner accountability and management principles. It is stipulated that the management of a firm should be accountable to the firm's owners and no individual should have unfettered powers of decision. Under management principles, an audit firm should have effective management which has the responsibility and clear authority for running the firm. Besides that, ISQC has highlighted the responsibilities of the leader and also the monitoring role.

1.2. Values and Ethical Requirement

The CAFG states that an audit firm should perform quality work by exercising judgment and upholding values of integrity, objectivity, professional competence and due care, confidentiality and professional behavior in a way that properly takes the public interest into consideration. This is in line with the ISQC element on Ethical Requirement.

1.3. Independent non- executives

According to the CAFG, an audit firm should appoint independent non-executives. These independent non-executives are the one who through their involvement is responsible to collectively enhance shareholder confidence in the public interest aspects of the firm's decision making, stakeholder dialogue and management of reputations risks including those in the firm's businesses that are not otherwise effectively addressed by regulation.

1.4. Operations

CAFG has highlighted a compliance principle, risk management principles, and people management principle. These matters are covered under the ISQC which are stipulated under acceptance and continuation of client relationships and specific engagement, human resource, as well as engagement performance.

3. Descriptive findings

Since the current study is still in progress and thus has not yet attained a sufficiently large sample to allow for an estimation analysis, the descriptive statistics of the survey data thus far provide a preliminary insight into the governance of Malaysian audit firms. The survey examined four dimensions of CAFG aspects of 30 audit firms in the study sample. In this section, the descriptive statistics along with the lines of the aforementioned dimensions were discussed.

3.1 Leadership

Table 1 describes the results of our descriptive analysis on the first dimension of CAFG that is *Leadership*. The first part relates to background of audit firms and from the Table 1, it can be seen that 26.7 percent of audit firms represent audit firms that have link to global parent, which are categorized as big eight audit firms globally. This includes the big-four audit firms. When the firms are asked whether they know or aware on the issuance of code for audit firm governance, mostly, 80 percent, of the audit firms indicate their awareness and acknowledge the code issued by the FRC of UK

Second part covers matter on governance structure of audit firm which oversees the management activities, duties, types of decisions they make, appointment, re-election, staff assessments, quality control, and operational responsibility assignment to the managing directors, partners and any other matters that relate to leadership. Table 1 shows that 100 percent of the 30 audit firms surveyed established a board or other governance structures which responsible for decision and overseeing the activities of management team. The board can be regarded as partners or managing partners that have responsibility to oversee the activities of management team under their supervision.

When audit firms are asked whether they provide transparency report of (disclosure on management teams' operation, duties and type of decisions they made, the names and job titles of all members, election or appointment of team members, terms, length of service, meeting attendance in the year, and relevant biographical detail) it is found that most of the audit firms, 73.3 percent, do not provide this transparency reporting. Nevertheless, 26.7% of the audit firms provide transparency report about the above said matters. Basically, these are the 8 audit firms which are actually regarded as big eight audit firm globally, hence the transparency report is provided by their global parents. Meanwhile, 100 percent having their governance structures and management team together with their members subject to a formal, rigorous and on-going performance evaluation and, at regular intervals, the members are subjected to re-election or re-selection. In regard to quality control, the statistics show that all 30 audit firms have

sufficient allocation of resources for development, documentation and support for quality control policies, and they also have mechanism in place to ensure operational responsibility for the firm's quality control system has been properly assigned by the firm's chief executive officer or managing board of partners. Additionally, quality control manual of all firms also up to date in accordance to the ISQC guideline by the Malaysian AOB, parallel with the CAFG.

Table 1: Leadership

	YES	NO	N/A
The firm is link to the global parents categorized as the big eight audit firms.	26.7	73.3	0.0
The firm aware/know on the issuance of Code of Audit Firm Governance by FRC of UK.	80.0	20.0	0.0
Establish a board or other governance structures, with matters specifically reserved for decision, to oversee the activities of the management team.	100.0	0.0	0.0
Statement in transparency report			
how its governance structures and management team operate, their duties and the types of decisions they take.	26.7	60.0	13.33
the names and job titles of all members of the firm's governance structures and its management team	26.7	60.0	13.33
how management teams are elected or appointed, their terms, length of service, meeting attendance in the year, and relevant biographical detail.	26.7	60.0	13.33
Firm's governance structures and management team and their members subject to a formal, rigorous and on-going performance evaluation and, at regular intervals, members are subject to re-election or re-selection.	100.0	0.0	0.0
Designated person to assume responsibility for the firm's system of quality control.	26.7	0.0	73.3
Firm have an up-to-date Quality Control Manual appropriate to the size and operating characteristics of practice.	100.0	0.0	0.0
Sufficient allocation of resources for the development, documentation and support for quality control policies	100.0	0.0	0.0
A mechanism in place to ensure that operational responsibility for the firm's quality control system has been properly assigned by the firm's chief executive officer or managing board of partners.	100.0	0.0	0.0

3.2 Values and Ethical Requirement

In this section, the audit firms are asked about values and ethical requirements practices of the audit firms. This includes policies and procedures on professional ethics, independence, competence and due cares, and cultures. Table 2 shows that, 100 percent of the audit firms do have documentation on their policies and procedures which designed to provide the firm with reasonable assurance that the practice and its personnel comply with the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care. All the 30 audit firms also ensure that members of the engagement team have complied with major ethical requirements; and there are procedures in place to identify threats to professional independence under the Institute's code of ethics. Moreover 100 percent of the audit firms do monitor the compliance of all engagement members with policies and procedures relating to independence. Statistics further indicate that 76.7 percent of all audits firms practice a rotation of the engagement partner and the engagement quality control reviewer for audits involving public listed entities.

Looking into cultural perspectives, 100 percent of audit firms maintain a culture of openness which encourages people to consult and share problems, knowledge and experience in order to achieve quality work in a way that properly takes the public interest into consideration.

Table 2: Values and Ethical Requirement

	YES	NO	N/A
Documentation of policies and procedures that are designed to provide the firm with reasonable assurance that the practice and its personnel comply with the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care.	100.0	0.0	0.0
Consideration (including documentation) whether members of the engagement team have complied with major ethical requirements.	100.0	0.0	0.0
Procedures in place to identify threats to professional independence under the Institute's code of ethics.	100.0	0.0	0.0
Monitor compliance with policies and procedures relating to independence of all staffs.	100.0	0.0	0.0
Rotation of the engagement partner and the engagement quality control reviewer after a specified period for auditing public listed entities.	76.7	23.3	0.0
Maintain a culture of openness which encourages people to consult and share problems, knowledge and experience in order to achieve quality work in a way that properly takes the public interest into consideration	100.0	0.0	0.0

3.3 Independent Non- Executives

This part relates to independent non-executive directors of audit firms which has responsibilities to enhance shareholders and stakeholders confidence in public interest aspects. It covers matters on appointment, duties, retirement and resignation. Table 3 provides insight that only 26.7 percent of total audit firms have independent non-executive director, while the remaining of 40 percent do not have designation of independent non-executive director, and 33.3 percent state not applicable to their audit firms. As such, only the same percentage, 26.7 percent that have provide information through their website about the appointment, retirement and resignation of independent non-executives; disclosure by which their independent non-executive director discharge duties and obligations that support the audit firms as well as disclosure on the terms of reference and composition of any governance structures whose membership includes independent non-executives. The 26.7 percent represents the eight audit firms that have global parents.

Table 3: Independent Non-Executive Director

	YES	NO	N/A
Appoint independent non-executives who through their involvement collectively enhance shareholder confidence in the public interest aspects of the firm's decision making, stakeholder dialogue and management of reputational risks including those in the firm's businesses that are not otherwise effectively addressed by regulation.	26.7	40.0	33.3
Disclose on website information about the appointment, retirement and resignation of independent non-executives.	26.7	0.0	73.3
Disclose independent non-executives discharge duties and obligations of the firm to support the firms operation.	26.7	0.0	73.3
Disclose on website the terms of reference and composition of any governance structures whose membership includes independent non-executives?	26.7	0.0	73.3

3.4 Operation

The first part of the operation question is related to compliance principles of the audit firms which basically concerns on the policies and procedures, compliance with international and national standards on auditing, audit judgments, and quality of work. Based on the statistics result presented in Table 4, it can be seen that 100 percent of audit firms do have policies and procedures for engagement team to comply with applicable legal and regulatory requirements both national and international. Additionally, 100 percent of the audit firms do comply with applicable auditing standard for individuals signing group audit. In term of whistleblowing policy, only 26.7 percent that have such policies and procedure that enable people to report, without fear, for the sake of quality of audit work and professional judgment.

Second part on the operation pertains to engagement principle. This part concerns on matters such as review responsibilities, mechanism for audit opinion, as well as engagement quality control. Table 4 indicates that all the sampled audit firms, 100 percent, do have policies and procedures in regard to reviews responsibilities on the basis that more experienced engagement team members review work performed by less experienced team members. Besides, 100 percent as well do have engagement quality control reviews (EQCR) which are performed on the audits of listed entities financial statements and such other engagements the firm may deem appropriate before reports are being issued by the firm.

Risk Management Principles is the third part of the operation question being asked to the audit firms. It relates to matters of internal control system of audit firms. Based on the results presented in Table 4, 100 percent of the audit firms have sound of internal control where the firms conduct a review of the effectiveness of the firm's system of internal control which cover all material controls, including financial, operational and compliance controls and risk management systems, at least annually. Nonetheless, only 26.7% of the audit firms convey this information through the transparency report that firms have performed a review of the effectiveness of the system of internal control, summarise the process they have applied and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review.

The last part on the operation question is related to people management principles. This part refers to the audit firms policies and procedures for human resource management, such as sufficient number of staffs to perform audit engagement, staffs' competency, and professional development. Table 4 shows the statistics result that all 30 audit firms are of the opinion that their partners have the appropriate capabilities, competence, authority and time to perform role as an engagement partner for all engagements. Furthermore, 100 percent, do agree that they have appropriate staffs with the necessary capabilities, competence and time being assigned to perform engagements to enable the firm or engagement partners to issue reports that are appropriate in the circumstance and that firms do provide continuous professional development training for all partners and staffs.

Table 4: Operation

	YES	NO	N/A
Establish policies and procedures for complying with applicable legal and regulatory requirements and international and national standards on auditing, quality control and ethics, including auditor independence.	100.0	0.0	0.0
Establish policies and procedures for individuals signing group audit reports to comply with applicable standards on auditing dealing with group audits including reliance on other auditors whether from the same network or otherwise	100.0	0.0	0.0
Establish and apply confidential whistleblowing policies and procedures across the firm which enables people to report, without fear, concerns about the firm's commitment to quality work and professional judgment and values in a way that properly takes the public interest into consideration	26.7	0.0	73.3
Reviews responsibilities determined on the basis that more experienced engagement team members review work performed by less experienced team members.	100.0	0.0	0.0
Engagement quality control reviews (EQCR) are performed on the audits of listed entities financial statements and such other engagements the firm may	100.0	0.0	0.0

deem appropriate before reports are being issued by the firm.			
Conduct a review of the effectiveness of the firm's system of internal control which cover all material controls, including financial, operational and compliance controls and risk management systems, at least annually.	100.0	0.0	0.0
Statement in transparency report that firm has performed a review of the effectiveness of the system of internal control, summarise the process it has applied and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review.	26.7	0.0	73.3
Of the opinion that partners have the appropriate capabilities, competence, authority and time to perform your role as an engagement partner for ALL engagements.	100.0	0.0	0.0
Appropriate staffs with the necessary capabilities, competence and time being assigned to perform engagements to enable the firm or engagement partners to issue reports that are appropriate in the circumstance. (Consider knowledge of the relevant industries, ability to apply professional judgment etc.)	100.0	0.0	0.0
Firm provides continuous training for the partners and the staffs.	100.0	0.0	0.0

1. Discussion

Statistics show that audit firms in this study consist of the big four audit firms and small and medium audit firms. Further, out of total 30 audit firms, there are 8 audit firms (including the big four) categorized as global audit firms specified by the Financial Reporting Council (FRC) of UK. Interestingly, these 8 audit firms have been in compliance to the CAFG as their global parents are compulsorily required to adhere to the CAFG. As such all link companies of the global parents observed the CAFG regardless of the country side they are operating.

The governance of Malaysian audit firms is observed based on the four elements of governance structure stipulated in CAFG. On the leadership part, it is found that only 26.7 percent provide transparency report that consist information on the governance structures, management team, duties and decision they made. There are possible reasons to explain the lack of transparency report by audit firms in Malaysia. One reason, there is no compulsory requirement under the ISQC for audit firms to have transparency report to convey such information; two, the audit firms do disclose this information other than in the transparency report which can be obtained through their website; three, the audit firms that are belongs to the eight global audit firms having their transparency report prepared by global parents as a whole.

On a more positive finding, all the Malaysian audit firms have been in accordance with values and ethical requirement. This is proven from the statistics result which reveal that there are policies and procedure which are designed to ensure that all staffs comply with professional requirement especially in regard to fundamental principles of professional, such as independence integrity, objectivity, due care and competency. This shows that Malaysian audit firms are comparable to global audit firms in terms of values and ethical requirements. Hence, the professionalism of Malaysian auditors is of global standard.

Nonetheless, it is roughly to find that audit firms in Malaysia have designation of independent non-executive directors, unless the firms fall under the eight global audit firms, which represent 26.7 percent of the sampled audit firms. This independent non-executive director is required under the CAFG. Since there are several matters under the CAFG not available or stipulated in the ISQC, as such this independent non-executive director is only designated by the eight global audit firms. However, the director is found not directly attached or positioned within the Malaysian audit firms but rather internationally where this director works for global parent firm as well as for the link companies.

On the operation part, it is interesting to note that all of the audit firms have been fully observed the

requirement for compliance principles, engagement principles as well as people management principles. These are fundamental aspects of audit firms in performing audit works and consistent with the objective of ISQC and CAFG to enhance the quality of audit works as well as promoting efficiencies and effectiveness in conducting audit works from planning to audit field works and concluding the audit work by providing professional audit judgment.

Overall, the audit firms in Malaysia have a sound of corporate governance. This result might due to the strict requirement imposed by AOB to audit firms in Malaysia, especially involving audit firms that responsible to provide audit judgment for public listed entities. Failed to comply any requirement may result the audit firms being disqualified to audit the public listed entities. As such the audit firms adhered to the ISQC. Notably, this in turn result in compliance with the CAFG indirectly as the code stipulated in the CAFG is more or less the same with ISQC, unless there are several matters not covered by ISQC.

2. Conclusion

Preliminary findings indicate that audit firms in Malaysia are aware on the issuance of the Code of Audit Firm Governance. Although the CAFG has not been adopted by the Audit Oversight Board, nonetheless the ISQC guideline based on the AOB intends to promote sound of corporate governance amongst audit firms in Malaysia is parallel with CAFG. It also can be concluded that, there are 8 audit firms including the big-four, which are directly, comply with the CAFG as their global parents based in the UK. The preliminary insights provided by the data thus far indicate that, there are two major parts of the CAFG that Malaysian audit firms are lacked with, which are transparency and designation of non-executive directors. It is suggested that, the AOB to look further into these matters as these are crucial code for better audit firm's governance. Nonetheless as overall, the level of corporate governance of Malaysian audit firms is in line with the global standards. While the descriptive results are preliminary findings, it may not be indicative of a more general overview of governance of Malaysian audit firms. Additional data and more rigorous analysis will be required to enable more general conclusions. The audit firm governance may later be used as proxy for the quality of 'audit firms' in future study.

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