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Enhancing Audit Quality through Clan Control in Malaysian Public Accounting Firms

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ABSTRACT

The aim of this paper is to explicate the ways in which auditing firms in Malaysia develop control system in human resource management to improve audit quality. This study focuses specifically on clan controls within auditing firms to enhance audit quality which is the core component of International Standard on Quality Control 1 (ISQC 1) implementation. International Federation of Accountants (IFAC) has introduced six elements of ISQC 1 including human resource that could promote audit quality within auditing firms. Six audit partners representing Big Four and Non Big Four auditing firms in Malaysia were interviewed. Data obtained through the in-depth interviews were analyzed using constant comparative method. Elements of human resource management investigated in the study are communication, recruitment, training, leadership style or involvement, review process and appraisals. Findings suggest the Big Four institute different forms of clan control than their counterpart the Non Big Four firms. The Big Four firms have more formal, systematic and structured controls as compared to the Non Big Four firms. The main contribution of this study is the emerging framework that depicts the differences in clan controls and audit quality measures between the Big Four and Non Big Four auditing firms. The framework promotes a new understanding on the diverse process of attaining audit quality among auditing firms in Malaysia.

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INTRODUCTION

The major determinant of auditor's professional status is the perceived quality of the service provided by the auditors to their clients and society McNair (1991). However, auditors face constant conflict between the cost of auditing and the pressure to perform quality audit work (Pierce & Sweeney, 2005). Recent movement by International Federation of Accountants (IFAC) in introducing the International Standard of Quality Control 1 (ISQC 1) to auditors is purported to improve quality in auditing firms. ISQC 1 comprises six elements of quality control which include leadership responsibilities for quality within the firm, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resource, engagement performance and monitoring. Auditing firms need to apply ISQC 1 in their audit work to enhance audit quality. Hence, knowledge on how auditing firms currently control their operations is essential in light of this new requirement.

Management control systems (MCS) could best be defined as all devices and system that managers use to ensure that behavior and decisions of their employees are consistent with the organization objectives and strategies (Malmi & Brown, 2008). Previous literature has revealed that management control system of auditing firms has an impact on audit quality based on the organizational structure, job continuity, informal controls such as social controls and clan controls (Otley & Pierce, 1996; Pierce & Sweeney, 2005). Therefore, it is important for the auditing firm to have an efficient management control system to boost the quality of the auditor's work. The clan control or human resource management is essential although other forms of control are in place (Pierce & Sweeney, 2005).

Clan control refers to the additional control to the formal quality controls of human resource that operate within auditing firms (Macintosh, 1985). The human resource management which involves the recruitment, socialization and acculturation, job satisfaction, organizational and professional commitment, promotion and turnover of staff is important because auditing firm rely heavily on the staff for performance and quality of the firm (Brierly & Gwilliam, 2003). The number of prior studies on the recruitment and socializing of accountants is limited (Andersen et al, 2001). In addition, concerns about the quality of auditors and criticism of the auditing profession have risen due to the high staff turnover and difficulty to attract suitable staff resulting in the recruitment of low caliber staff (Pierce & Sweeney, 2005). Hence, there is a need to investigate human resource management in the Malaysian context taking into account the Non Big Four firms to obtain a better understanding on the association of clan controls and audit quality.

The current study investigates the ways in which auditing firms in Malaysia develop control system in human resource management to improve audit quality. The study delineates the difference and similarities in clan controls between the Big Four and Non Big Four firms to come up with a new framework on clan control and audit quality in auditing firms. The rest of the paper is organized as follows; the ensuing section describes the background of the study, followed by a section on the methodological approach of the study. The paper continues with the discussion and findings section and concludes with a section on limitations and suggestion for future research.

BACKGROUND OF STUDY

International Standard on Quality Control 1 (ISQC 1)

In 2004, the International Auditing and Assurance Board (IASB) of the International Federation of Accountants (IFAC) approved the International Standards on Quality Control (ISQC 1) concerning the quality control for firms performing audit and review of historical financial information and other assurance and related service engagements. In line with this requirement by IFAC, the Malaysian Institute of Accountants (MIA) has imposed that all registered accountants and audit practitioners in Malaysia to comply with the new quality control standards by 30 June 2006. As a result, audit practitioners face additional responsibilities to implement new quality control safeguards and procedures.

ISQC 1 deals with firm-wide quality control which provides reasonable assurance that auditing firms and its personnel comply with professional standards, regulatory and legal requirements. In addition, the standards also require auditing firms to document the operation of each of the six elements in its quality control system and retain that documentation for an appropriate period. 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. As the adoption of ISQC 1 is still in the early stage, hence, review of the literature has revealed there is limited study conducted in the ISQC 1 and the impact on audit quality particularly for the Non Big Four firms.

Audit Quality Literature

Audit quality is inversely related to audit failure, where higher audit failure rate is associated with lower quality of auditing work (Francis, 2004). The collapse of a Big Four Firm Arthur Andersen and proliferation of corporate scandals such as Enron and WorldCom in the United States (US) have brought a big impact to the auditing profession. Similarly in Malaysia, in 2006, the public were taken aback by the 'Mini Enron' case of Transmile Corporation scandal. It is the job of auditors to provide assurance on the credibility and reliability of the information. Therefore, the vital issue is on how effective are the auditors in ensuring the credibility of accounting information in the audited financial statements (Carlin & Laili, 2009).

Prior research on audit quality that relates to management control systems in auditing firms concerns the controlling of cost and quality of audit work performed by auditors (Pierce & Sweeney, 2005; McGarry & Sweeney, 2008; Parkey & Roffey, 1997). The greatest difficulty in controlling audit quality is the ambiguity of outputs and the uncertainty for the auditors to conduct a 'good audit' [19]. In addition, auditing firms are not able to objectively measure output and have imperfect knowledge of the transformation systems (Pierce & Sweeney, 2005). In this situation, the informal controls such as the clan controls characterized by ritual and ceremonies could be useful and it requires stability of membership and strong social memory (McGarry & Sweeney, 2008). Hence, the role of management control system in the auditing firm is important in mitigating the issue of cost and quality conflict (McNair, 1991).

Management Control System in Auditing Firms

The two main types of controls in management control system literature are formal control and informal control. Consequently it has been argued that the characteristics of the audit environment render formal behavioral and output controls less effective in the control of audit quality (Brierley & Gwilliam, 2003). As a result, audit firms may employ formal controls to the extent that it is possible but may also rely on the informal mechanisms of control such as the clan control (Deis & Girous, 1992). Ouchi (1980) supports that clan control is one of the most important forms of control in the management control system. Empirical study conducted by McGarry and Sweeney (2008) examine the clan controls over the audit quality issue from the perspective of senior auditors. Findings reveal that two forms of clan type controls which are the informal communication and role of modally aspect of mentoring.

METHODOLOGY

This study adopts the constant comparative method of analysis which was originally developed for grounded theory methodology (Glaser 1978; Strauss and Corbin 1990). The method falls under an interpretive paradigm with the intention to build theory rather than to test theory. The method requires the researcher to take one piece of data and compare it to other pieces of data that to identify similarities or differences. During this process, the researcher begins to look at what makes this piece of data different and/or similar to other pieces of data. The steps start with a problem statement of what you want to study and tentative research questions. However, this methodology is fairly new in the accounting research as compared to other field of research (Parker & Roffey 1997). In recent years, the acceptance of the method is more prevalent amongst the management and auditing research (Pierce & Sweeney, 2005).

The constant comparative method is a more appropriate approach for this study because most prior studies on controls in auditing firms used the quantitative methodology by either using a survey or an experimental study as the research design. Some of the variables examined using these methods have been studied for more than two decades. In addition, with the constant comparative approach, researchers are able to investigate more in-depth of the phenomenon and uncover new variables relating to the phenomenon. Since there are changes in the auditing environment globally and also the management and structure of the auditing firms resulting from the fall of Arthur Andersen (Pierce & Sweeney, 2005), it is befitting to conduct new studies that could offer new insights on control systems in auditing firms particularly from the partners' perspectives. Using in depth interviews to collect data can reveal that actual variables that currently impact control systems in auditing firms.

Interviewees were selected based on purposive sampling and six audit partners were chosen representing the Big Four and Non Big Four auditing firms around Kelang Valley area which represents the main business center in Malaysia. Prior studies suggest that size of the auditing firms have an influence on audit quality (O'Keefe & Westort, 1992; Mansi et al, 2004; Malmi & Brown, 2008) and therefore respondents were selected based on the auditing firms they represent. The appropriate sample size for qualitative research depends on 'theoretical saturation' is achieved that is when no new or relevant information regarding a category emerged from new data collected. The main category or theme is considered to have been well developed in terms of its properties and dimension (Otley & Pierce, 1996). Semi-structured interview was used in the study to collect the data. The questions are mainly open-ended and this allows the researcher the opportunity to probe more questions during the interview [3]. In addition, the interviewer usually has some latitude to ask further questions in response to what are seen as significant replies. In order to ensure all relevant information is captured during the interview, a tape recorder is used to record the conversation throughout the interview sessions. In addition, notes were also taken by the researcher during the interview as a backup if the tape recorder is not functioning well.

DISCUSSION OF FINDINGS

Definition of Audit Quality

Two partners from the Non Big Four are of the opinion that audit quality is a 'very subjective matter' (P4 and P6), with one partner defining it as 'doing what is right' (P5). Being in the industry, doing what is right is by 'having the right people, the right documentation, right systems and audit processes in place for daily work routine' (P4). The definition of audit quality is supported further by three Big Four partners that consider audit quality as 'using the right method of process in accordance to relevant standards applicable in Malaysia' (P1). Audit quality can also be defined as 'risks that need to be addressed properly during the work of audit' (P3).

Therefore, 'having a good control in the firm' (P5) is also said to be an alternative definition of audit quality.

All of the partners agree that audit quality can best be defined as by having the right people (staff) and audit procedures in the firm. This should lead to good quality audit work and thus increase the possibility of providing the right audit opinion. Human resource management through the clan control is said to play vital role in promoting audit quality. The staff of the firms are the main asset and the 'human factors are the ultimate factors that determine whether the firm succeeds or not (P4). The human resource control is important regardless of the size of the firms.

Clan Control

Management control system (MCS) has a very broad conception of what should be considered as the components of MCS. The concept of clan control in research has been developed by Ouchi (1980) that individuals are exposed to a socialization process that instills in them a set of skills and values which relates to certain groups of professions such as doctors and accountants. Clan controls are particularly perceived to be applicable to the audit environment (Macintosh, 1985). However, not many published research provides empirical evidence on clan control and the relationship with audit quality. Prior studies in auditing examines the issue of clan control from the perspective of Big Four auditing firms partners and seniors in United Kingdom (UK) and the role modeling as a controls procedures in the firms (Pierce & Sweeney, 2005; Sweeney & Pierce, 2004).

Clan Control in Big Four Firms

Five forms of clan control will be discuss in this study which is adapted from Pierce and Sweeney (2004) findings. Please refer to **Figure 1** for details of the findings on clan control. The human resource elements are communication, recruitment, training, review process and appraisals. Formal communication could be found in the Big Four auditing firms. All forms of communications are conducted through the emails or meetings among the staff. The whole cycle of auditing process has been programmed according to the firm's audit methodology and culture. In addition, the audit review processes to maintain high quality audit work is very structured with proper audit procedures to be followed by the auditors. This formal type of controls is also a form of bureaucratic controls such as formal review of audit working papers, compliance with audit methodology and supervision of junior staff (Pierce & Sweeney, 2005).

Recruitment of new staff is according to the firm’s policies and criteria. The knowledge and skills of the candidates are the top priority for the selection of interview. The interview process will be done by the human resource department partner with the pre-selection of candidate conducted by the audit partners. Intelligence Quotient (IQ) test and English proficiency test will be conducted before the interview process. Therefore, the recruitment process for the Big Four firms is more structured and systematic with proper procedures and screening process.

Formal and informal training were also considered as important quality controls in auditing firms (Pierce & Sweeney, 2005). For the Big Four firms, the training is structured and systematic according to the firm’s procedures and policies. Trainings are conducted during the off peak period and compulsory for all the audit staff at every level. The modules for the training are just like the syllabus for the university courses. There are also soft skill trainings such as leadership skills, negotiation skills and most of the trainers are in-house trainers.

Review process for both groups of Big Four and Non Big Four are structured. However, the Big Four firms instituted more formal procedures as compared to the Non Big Four firms. This is evident from the findings that the Big Four firms have external reviewers from other offices to maintain the high quality audit work. However, the external review process is lacking in the Non Big Four firms.

The Big Four firm’s appraisal process is formal and structured in nature. The appraisals are conducted annually or in some firms twice a year. It is considered as formal as the senior in-charge will assess the junior team members and provide the feedback to the managers. Then discussion between the managers and senior in-charge will be conducted before comments and feedback is formed on the performance of each staff. The appraisal for the junior staff for the Big Four firms is conducted twice a year because the first three years in the firms are considered to be most progressive and demanding for the staff. Therefore, the appraisal will be used as guidance to promote the staff or increase the salary. Another reason is to ensure that the staff will feel appreciated and sustain in the firm for a longer period of time.

Clan Control for the Non Big Four Firms

Clan control in the Non Big Four firms is less bureaucratic as compared to the Big Four firms with the communication control being informal. Findings indicate that being in a small and medium size auditing firm; the partners are more involved in the daily operation of the firms. Meetings and discussion are conducted informally between the junior staffs and top management. The partners and managers have the time to go through all the working papers done by the staff and provide detail feedbacks on audit work. Hence, this will increase the quality of the audit work and additional on-the-job training provided for the junior staff could benefit them tremendously. Small firm conduct appraisals for the staff less formally from that conducted by Big Four firms. The partners of small firms are very much involved in assessing staff. Any information can be disseminated to the staff by either announcement in the office or emails.

The recruitment process is more flexible as compared to the Big Four firms. The Non Big Four firms are mostly between five to ten years of incorporation. This is supported by Otley & Pierce (1996) that in general there is an increase of informal controls in new and flatter organizational structures. The selection criteria for new staff does not emphasize on the academic results per se. The most important criteria is involvement in the co curriculum activities. Active candidates are selected because they are able to work in teams and have cultivated good interpersonal skills. Partners are also found to be directly involved in the recruitment of audit staff consistent with Pierce and Sweeney (2004) study.

For the Non Big Four firms, structured training program is not in place. Trainings are based on requests from all departments every year. Most of the trainings attended by the staff are conducted in-house or organized by MIA or other professional bodies. Informal trainings such as on the job training which involve getting feedbacks from the managers and partners involved in active review of the files for each audit job are considered to be more effective for the junior staff (Pierce & Sweeney, 2005). One of the audit partner support that if the audit manager spent time reviewing the files at the client's place, then the quality of the audit job will increase.

CONCLUSION

This paper provides an emerging framework that promotes a new understanding of audit quality and the differences in human resource elements of control for auditing firms in Malaysia. The study reveals that Non Big Four auditing firms instituted less bureaucratic control mechanisms than their counterpart the Big Four Firms. In addition, while all partners agree that audit quality is very much dependent on the quality of their staff, control systems in the Big Four auditing firms are found to be more structured and embedded in the firms' policies and procedures and require less of partners intervention. The small sample used in the study limits the generalization of the findings to the population of auditing firms. Therefore further research needs to be conducted using either a survey method or an experimental design to statistically validate the findings obtained from this study.

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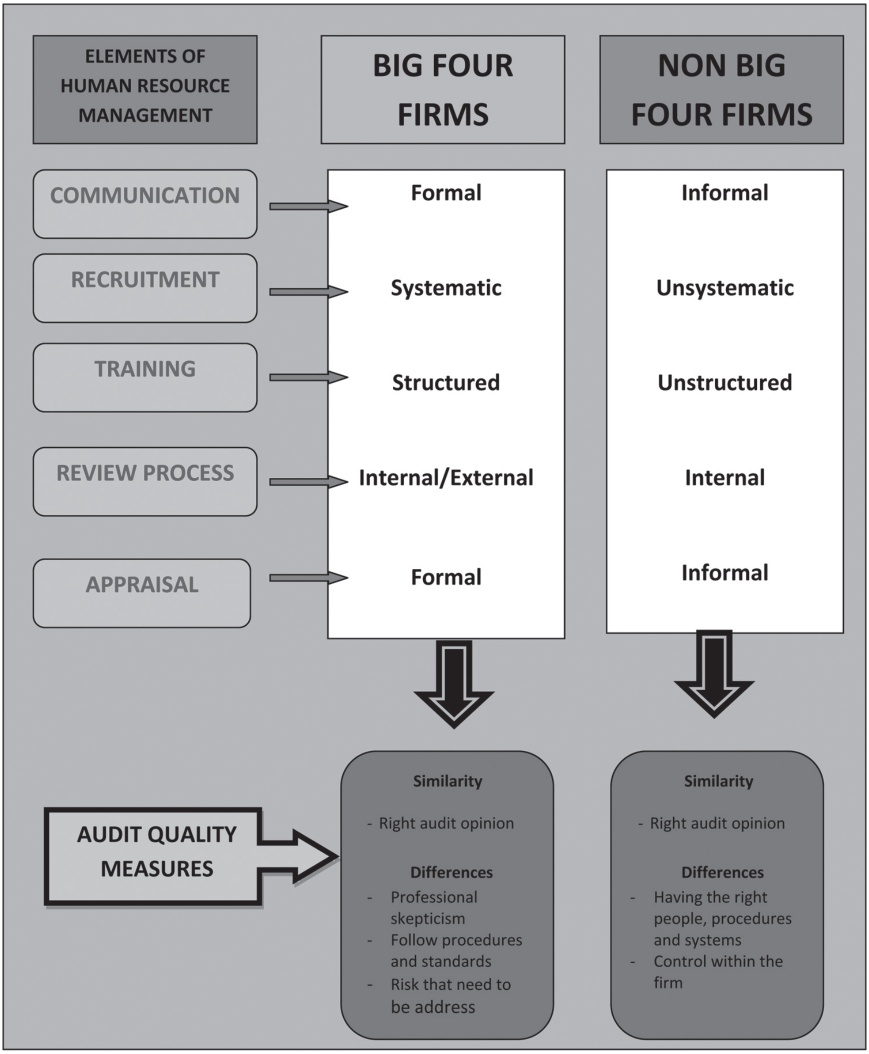

Source: Ismail, A.H. & Mohamed, Z.M. (2012)

Figure 1: Emerging Framework of Clan Control in Auditing Firms