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Reduction of Audit Quality by Auditors of Small and Medium Size Audit Firms in Malaysia: A Case of Premature Sign-Off of Audit Documents

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Abstract

Premature sign-off of audit documents (premature sign-off) is one of the behaviours of external auditors in the audit progress that will reduce quality of an audit program. The purposes of this study are to examine whether external auditors commonly practice premature sign-off and to investigate the factors contributing to these practices. In addition, the impact of premature sign-off is also evaluated. This study is based on the primary data of survey questionnaires among the external auditors as the data collection method. This study found that premature sign-off was commonly practiced by almost half of the respondents in the survey. This practices causes by rush audit work, overdependence on regular corporate clients, allocation of inadequate number of audit hours and insufficient supervision by senior auditors. Almost all respondents agree that the premature sign-off of audit documents by external auditors affect the confidence of the users in the credibility of audit report and hence, truthfulness of the financial statement.

Keywords: premature sign-off, reduction audit quality, audit, audit quality, audit evidence, Malaysia.

I. INTRODUCTION

Premature sign-off is described as the condition when auditors signing off an audit program before the auditor finishing one or more of the required audit procedures (Raghunathan,1991) in which it is not covered by an alternative audit step and without finalizing the actual work or noting the omission (Rhode 1977; Otley & Pierce, 1996). It is likely to occur in small firms as compared to bigger firms (Margheim & Pany, 1986) because of reasons such as limitation of various resources to complete the audit work. Hyatt and Taylor (2013), for example, found that audit supervisors are more likely to report false sign-off when an audit staff member is working under conditions of low time budget pressure.

The exercise of premature sign-off fall under one type of reduction audit quality program behaviour. Prior empirical research has provided evidence of the existence of reduced audit quality activities (Rhode, 1978; Alderman & Deitrick, 1982; Margheim & Pany, 1986; Kelley & Margheim, 1990; Raghunathan, 1991; Malone & Roberts, 1996; Herrbach, 2001; Barrainkua & Espinosa-Pike, 2015; Agoglia et al., 2015; and Johnson et al., 2016). Kelley and Margheim (1990), for example, found that one half of

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the auditors surveyed admitted that they had committed in dysfunctional audit behaviours on a latest audit practice. Barrainkua and Espinosa-Pike (2015) suggest that this behaviour may be caused by many factors including pressure to meet audit budget and significant reduction in audit dedicated resources. Mohammad Rezai et al. (2015) found that increased competition in the unfavourable audit market is more likely to result in unfavourable consequences encompassing price competition via decreasing audit fees, rather than quality competition through the audit quality improvement.

This study focuses on the premature sign-off because this problem is frequently surface by the external auditor particularly from the small and medium size audit firm regarding the completion process of audit report. Steps are taken in order to complete the audit report starting from setting the appointment with clients until the issuance of the audit report. However, an issue arises when external auditors approve client work without checking properly and ask the clients sufficiently about the business and financial transactions. During the audit, external auditors need to verify and ensure that an adequate level of sales invoices, purchase invoices, payment vouchers, bank statements, and other required documents are available to support the transactions. In addition, the external auditors need to have sceptical behaviour by asking the clients regarding the unusual transaction or to get detail information on the suspicious activities. Undoubtedly, the responsibility of external auditor is very high in order to maintain the professional behaviour and judgment. In addition, good quality auditors are crucial to protect the interest of stakeholders by enhancing the reliability of the financial statement (Asmuni et al., 2015) especially if the company has poor governance practices (Husnin et al., 2013). In the Malaysian context, the Audit Oversight Board was established in 2010 to monitor the quality and reliability of financial statements audited by auditors (Husnin et al., 2016).

Based on this, the current study is interested to examine whether external auditors commonly practiced premature sign-off of audit documents with their clients. In addition, this study also intent to identify the causes contributing to premature sign-off and finally, evaluate its impacts on the users of audit report. The issue like insufficient time and budget required to complete the audit report always leads to the premature sign-off of audit documents from external auditor (Cook & Kelly, 1998; Shapeero et al., 2003; Gundry & Liyanarachchi, 2007; McNamara & Liyanarachchi, 2008; Barrainkua & Espinosa-Pike, 2015; and Mohammad Rezaei et al., 2015). This behaviour will affect the professional accountability of an external auditor and negative impacts will arise if bad consequences occur after the issuance of the audit report.

There are several contributions of this study. First, it will highlight to external auditors, particularly auditors of the small and medium audit firms, concerns about the impact of their practice of premature sign-off of audit documents in order to complete an audit report. The most significant is the impact on the decision making of stakeholders such as financial institutions, potential investors, lenders, and other related parties.

Second, it will assist the regulatory bodies like the Malaysia Institute of Accountants (MIA) and Companies Commission of Malaysia (CCM) to enhance and focus on the audit quality services provided by the small and medium sized audit firms. These regulatory bodies need to provide more audit quality training and courses to auditors and public accountants. This training also should be conducted at the lowest possible cost and fees, because small and medium size audit firms have limited money to invest in human capital and skill training. In addition, a manual and guidelines on how to deal with the reduction audit quality programs can be prepared and easily accessed by auditors from the small and medium size auditing firms.

Third, this study will draw attention to the affect on the poor ethical value and practices by the external auditor as well as their unprofessional behaviour and inferior judgment if they practice premature sign-off. The collapse and corporate scandals that involved audit firms such as Arthur Andersen show how imperative audit material is as evidence to support an audit report if any unexpected matters occur.

Finally, this study will add to the body of literature of the issues and findings on the premature sign-off and reduction audit quality practices particularly in the environment of small and medium audit firms in developing country like Malaysia. Prior research focuses on more the public practice in the developed market like in the US, UK, and Europe.

Next section provides the literature review, followed by research methodology. Section 4 discusses the findings of the research. Section 5 is conclusions. The last section contains limitations and suggestions for future research.

II. LITERATURE REVIEW

Reduction audit quality practices are described by Herrbach (2001) as an inadequate achievement of an audit procedure conducted to bring to the insufficient or small amount of evidences gathered during the audit. In addition, the collected evidence is less reliable, false, or inadequate quantitatively or qualitatively. This reduction in audit quality practices also imply dysfunctional behaviour on the part of the auditor (Otley & Pierce, 1996; Coram et al., 2003) because it will affect the quality and value of the audit report that prepared by the irresponsible independent auditor. For example, when an independent auditor commits premature sign-off of audit documents, they actually do not think the importance of the audit report itself. The impact of premature sign-off may lead to wrong judgment or misunderstanding of information given in the audit report. It also shows the auditor actually act unlikely as the independent auditor and against the code of ethics of the audit profession itself (Purnamasari et al., 2014). Shapeero et al. (2003) found that lower level auditors like senior and staff level accountants are more likely to prematurely sign-off as compared to supervisors and managers. This is unethical and may have unfavourable impact on the organization (Manan et al., 2013) and may lead to fraud (Omar et al., 2015). Many cases of corporate scandals like Enron show that moral misconduct among employees may contribute to the financial disaster of the company (Khadijah et al., 2015).

Reduction in audit quality practices and behaviour was also explained by Malone and Roberts (1996) as the deliberate and intentional actions taken by an auditor to limit evidences collected without concrete reasons that compromises the audit quality. This practice will increass the risks of wrong opinions and audit conclusions. Consequently, the usefulness of the financial statement will be impaired.

According to Graham (1985), audit failures are often caused by the unavailability of imperative audit procedures. A premature sign-off by auditors shows a bad attitude and is in contradiction with professional auditing standards. It increases many direct threats to audit quality because the audit steps are actually not performed and this omission is not disclosed (Malone and Roberts, 1996). Undeniably, the independent auditor of small and medium of audit firm have to prepare the quality and valuable audit report even though the usage of the small and medium client's audit report is not wide as compared to big clients or listed companies. Their role as an independent auditor is similar and no different irrespective whether they work for a Big 4 auditor or non-Big 4 auditor.

Prior studies show that many auditors have committed premature sign-off. Rhode (1977) and Raghunathan (1991), for example, examined actual auditor behaviour and found that more than 50 percent of auditors had prematurely signed off on an audit program. Alderman and Deitrick (1982) also found that 31 percent of the Big 8 auditors surveyed acknowledged that premature sign-off occurs in practice, while Reckers et al. (1997) found that auditors in the large international auditing firms prematurely signed off almost ten times over a period of one year and that over 78 percent of the auditors admitted to having prematurely signed off at least once. In Europe, Arnold et al. (2002) suggest that the probability of premature sign-off exists in countries like Denmark, Ireland, Italy, the Netherlands, Spain, Sweden, and the United Kingdom.

III. RESEARCH METHODOLOGY

This study employs survey questionnaires as a data collection methods and analysis. Questionnaires are usually described as a list of prudently structured questions (Collis & Hussey, 2003) and are the most popular technique for collecting data (Oppenheim, 1992; Easterby-Smith et al., 2002; Collis & Hussey, 2003; Saunders et al., 2007; and Sekaran & Bougie, 2013) because it offers a user-friendly, cost-effective, and time saving option (Smith, 2015).

The questionnaires were distributed to 30 respondents from external auditors of six (6) small and medium audit firms around Klang Valley, Malaysia. However, only 20 respondents responded to the questionnaire. This is due to many targeted respondents being gone for field audits (outstation) and not responding to contacts via post and email.

To increase the response rate, efforts were made to collect the data personally from the audit firm around capital city to collect the data. Permission to conduct the research from the partner of the audit firm was obtained before the respondents filled in the questionnaire. Brief explanation was given in order to make them clearly understand the actual objective of this research.

The design of the questionnaire consists of two sections. The first section enquire the demographic information of the respondents. Section two comprises 24 questions relating to the commonly practiced in premature sign-off of audit documents by the auditor. This section also covers the causes that contribute and impacts of the financial statement's participants to premature sign-off of audit documents.

Below is the data on the audit firms involved in the study.

Table 1
Distribution of Respondents

Name of Audit Firm	The Numbers of External Auditor	Percent
AA & Co	6	30%
AH & Co	2	10%
AZ & Co	3	15%
HS & Co	5	25%
HY & Co	2	10%
JL & Co	2	10%
Total	**20**	**100%**

Table 1 shows that there are 6 small and medium size audit firms around Klang Valley, Malaysia that participated in the survey. Due to privacy and confidentiality, the name of all the audit firms were changed to maintain their secrecy. Overall, 20 respondents participated in this study. The small number of participants was due to various factors. Many auditors are very busy and unable to provide sufficient time to answer the questionnaires. However, the biggest challenges of this study is the topic itself is highly sensitive. Although assurance was given on the secrecy of this research, many auditors were reluctant to give cooperation because the issues under research will portray their behaviour and practices. They fear that the information given by them may leak to the public and regulatory authorities. Consequently, it will damage their reputation. Furthermore, they risk being fined and their audit license may be revoked if the information was known by the regulatory bodies.

The highest respondents came from AA & Co, which consists of 6 external auditors and contribute 30 percent, followed by AH & Co, HY & Co and JL Co which have 10 percent contribution to the number of external auditors (2 persons). AZ & Co and HS & Co have 3 and 5 external auditors, respectively. All the auditors come have different ages, experiences, and positions. They junior external auditors, senior external auditors, or audit managers. The combination of 20 respondents fulfils the criteria of the respondents for this research.

IV. FINDINGS AND DISCUSSION

Table 2
Common Practices of PSMO

Q	Statements	Percentage of Respondents		
		Yes	Neutral	No
1.	An external auditor has been asked to audit the financial statements for the client for the first time. Does he need to prepare an engagement letter?	100%	0%	0%
2.	Does the external auditor send a letter of bank confirmation to the banker before the start of audit work?	55%	20 %	25%
3.	Does the external auditor need to identify all significant or unexpected variances?	65%	20 %	15%
4.	Does the external auditor need to check the amount of unabsorbed tax losses of corporate clients on tax computation?	40%	40%	20%
5.	Does the external auditor really check the petty cash of corporate clients at the end of accounting period instead of relying on client's check book?	55%	20%	25%
6.	Does the external auditor need to seek the clarifications from clients regarding the unusual items?	90%	10%	0%
7.	Does the external auditor need to check the orders of number in the sale invoices given by clients?	65%	35%	0%
8.	Does the external auditor need to check on the existence of employees in the corporate clients?	55%	35%	10%
9.	Does the external auditor need to calculate and check the gross profit margin of financial statements?	65%	15%	20%
10.	Is the external auditor in a hurry to complete the audit report within the duration?	35%	45%	20%
	Total	**63%**	**24%**	**14%**

Overall, the study found that almost half of the external auditor commonly practiced the behaviour of premature sign-off of audit documents of their corporate clients. Some of them appear not to follow professional practice due to several reasons, such as meeting the clients' demands as well as business association and to compete with the other small and medium sized audit firms.

Table 2 contains questions to investigate whether the external auditors of small and medium sized audit firms commonly practiced premature sign-off of audit documents of their corporate clients. The first question asks about the importance of the preparation of the engagement letter between client and external auditor. This is the first step of the auditing process. All respondents agreed that an engagement letter needs to be prepared in order to start the business between both parties.

The remaining questions from questions two to nine tested some of the most fundamental audit programs that need to be performed by the auditor. Question four, regarding the verification of unabsorbed tax losses on the tax computation, received the least positive results. Only 40 percent confirmed that they perform analysis while the remaining 40 percent gave a neutral answer (meaning neither yes or no) and 20 percent answer no. As the external auditor, it is important to check the balance of the unabsorbed tax losses in client's tax computation. This is because sometimes, the carelessness of the tax agent can cause an over or under recorded amount of unabsorbed tax losses. This effect the tax payable or tax refundable. However, 4 respondents (20 percent) did not agree on that question. This is possibly because sometimes, in the small and medium sized audit firms, the person that acts as an external auditor also acts as a tax agent for the business. Thus, they undoubtedly will approve their work and hesitate to re-check their own work or ask somebody else to verify it.

Questions two, five, and eight received slightly more than half positive response at 55 percent. Question two, for example, enquires about the requirement to send a bank confirmation letter to the bank before the start of audit work. As many as 11 respondents (55 percent) realized the importance of sending a particular letter to the banker. Otherwise, 4 and 5 respondents (20 percent and 25 percent) give a neutral answer and a no, respectively. The external auditors who give the no answer did not agree with the statement to prepare and send the letter before start of audit work. It is possible that the external auditors do not get verification from the banker on the client's bank statement. Actually, this action is very important to avoid forgery of the bank statement given from the client. Normally, the banker will perform the audit process and if there any unusual transactions occur, they will alert the auditor after sending the letter of bank confirmation.

Questions three, seven and nine received satisfactory results with 65 percent positive answers. Question three, for example, requests information about whether the external auditor need to identify all significant or unexpected variances on every item in the financial statements. 13 respondents (65 percent) agreed with that statement. The external auditor needs to ask the client if there are unusual or unexpected transactions in the client business. Sometimes, this happens because change of the principal activities of the business, fraud or error. Thus, the external auditor needs justification from client. However, 4 respondents (20 percent) gave a neutral answer. Possibly, they were not aware on the importance of asking about the unexpected variances. The remaining respondents, 15 percent, gave no answer. Perhaps, the external auditor did not realize the significant variances until they identify them.

Overall, the remaining questions are about the requirement of the external auditor perform essential audit steps like petty cash verification, checking the orders of the numbers in the sales invoice, seek the clarification from the unusual items, confirmation of the employee existence and re-calculations of profit margin in the financial statement. More than 50 percent of the respondents give the positive answer on these questions. The external auditors should ask those questions to the clients. This is because there are important practices that the external auditors should ask. Less than 50 percent of respondents give the neutral and no answer. These were the sign they did the premature sign-off practices on the audit documents of clients.

This relates to the last question, number 10, asking whether the external auditor in a hurry to complete audit report within the duration. 35 percent of the respondents agreed with the statement. This indicates that, during the start of audit work, the external auditor tries to move on quickly to the audit task and risking by not asking much about the client's financial statements. Perhaps the client gives all the relevant documents to the auditor in the shortest time and very near to the deadline. Therefore, the external auditor tries to finish the audit process within the limited time given by the client. Eventually, client will get a penalty for the late submission from the Companies Commission of Malaysia (CCM) and will blame the external auditor. In order to maintain a good reputation in the eyes of client, the small and medium sized audit firm need to sustain the business relationship by trying to complete the audit work although lack of supported evidence given by the client.

4.1. Factors Contributing to Premature Sign-off of Audit Documents

Table 3
Reasons of PSMO Practices

Q	Statements	Percentage of respondents		
		Yes	**Neutral**	**No**
11.	Does the external auditor agree that the quality of audit report on completion is affected by hastened audit work?	65%	20%	15%
12.	Does laziness among external auditors on engagement of regular corporate clients cause them to agree on the adequacy of information given by corporate clients?	40%	30%	30%
13.	Does the allocation of inadequate number of hours for auditors to complete specified audit procedures lead to performance deterioration?	65%	20%	15%
14.	Does inadequate supervision from senior external auditors lead to other external auditors contributing to early sign-off of an audit report?	60%	25%	15%
	Total	**58%**	**24%**	**19%**

There are many possible factors that can influence the premature sign-off behaviour and practices. Overall, this study found that majority of the respondents agreed that the causes contributing to premature sign-off of audit documents are hastened audit work, laziness due to auditing regular corporate clients, allocation of inadequate number of hours and inadequate supervision.

For question number 11, 13 respondents (65 percent) agreed with the statement. This study found that an external auditor agrees that the quality of audit report on completion will be affected by hastened audit work. This is because the auditor prone to make mistakes and overlook important issues if they perform their task in hurry. The respondents who were considered as not agreeing with the statement totalled 15 percent. 20 percent remained neutral.

Question number 12 asked whether the laziness among external auditors causes them to agree on the adequacy of information given by corporate clients. 8 respondents (40 percent) agreed that the laziness is the cause that contributes tow premature sign-off. Another 60 percent of respondents recorded on neutral and no answers equally.

For the next question, 13 respondents (65 percent) agreed with that statement. It shows that the external auditors need ample and sufficient time to complete the audit task. However, 20 percent and 15 percent of the respondents gave a neutral and no answer, respectively. It indicates that, some external auditors did not believe that an inadequate number of hours are the causes of premature sign-off.

Lastly, question number 14 asked if inadequate supervision from senior external auditors lead to other external auditors contributing to early sign-off of audit report. 12 respondents (60 percent) agreed with the statement, while 25 percent and 15 percent of respondents give a neutral answer and negative answer respectively. This indicates that poor monitoring by the top management and supervisor can influence negative behaviour by the lower level of external auditors like junior staff.

4.2. Impact of the Behaviour of Premature Sign-off of Audit Documents on the Users of Audit Report

Table 4
Affect of PSMO Practices

Q	Statements	Percentage of respondents		
		Yes	Neutral	No
15.	Do the external auditors realize that many parties rely on audit reports prepared by them?	95%	5%	0%
16.	Does the external auditor know that his or her opinion in the auditor's page of the audit report affects the users of the audit report, including bankers?	95%	5%	0%
17.	Does the external auditor realize that an audit report affects the financial statements participants?	90%	10%	0
18.	Do the users of audit reports rely on income statements to determine a company's profit or loss?	95%	5%	0%
19.	Do the users of audit report rely on statement of cash flow to determine the company's operations generate surplus cash for each year?	95%	5%	0%
20.	Does the external auditor know that the statement of cash flows in the audit report provides interested parties valuable information on the company's monetary fluctuations?	95%	5%	0%
21.	Do the users of audit report rely on balance sheet to know about the company borrowing to support its operation?	90%	10%	0%
22.	Does the external auditor realize that the completion of audit reports affects the decision making of the users?	90%	10%	0%
23.	Does the external auditor realize the usefulness of audit report for regulators such as inland revenue board Malaysia?	95%	5%	0%
24.	Does the information in an audit report show the company's performance and activity that will attract the stakeholder's interest?	100%	0%	0%
	Total	**94%**	**6%**	**0%**

Table 4 shows that majority of the respondents (94 percent) agreed with the behaviour of premature sign-off of audit documents by the external auditors of small and medium sized audit firms affects the users of audit report. They realised that many parties rely on audit reports prepared by them and their opinion in the audit report affects many users like bankers. These statements relate to question 15 and 16, which were agreed with by 95 percent of the respondents.

The next set of questions from 17 to 21 verifies whether the auditors agree on the impact of the audit reports which are relied on by the users to obtain relevant information from the financial statement. For question number 20, for example, 19 respondents (95 percent) agreed that the function of the statement of cash flows in the audit report provides valuable information on the company's monetary fluctuations. Besides that, question number 18 also asked whether users of audit reports rely on income statements to determine a company's profit or loss. 19 respondents (95 percent) agreed with the statement. Some users of audit reports are concerned about the profitability of the company. Therefore, they have interest in the income statement of the company that has been audited as well as the cash flow. Thus, this proves that behaviour of premature sign-off of audit documents by the external auditors of small and medium sized audit firms affects the users of audit report. The remaining questions also pose similar overwhelming results.

Majority of the external auditors also agreed with the statements that if they commit premature sign-off of audit document, it will give impact on the user of audit report. Question number 22 for example enquires whether the external auditor realizing the completion of audit report affects the decision making of the users. 18 respondents (90 percent) agreed with the statement. The rest of the questions asked whether auditor realise the usefulness of the audit report to the regulatory bodies and other stakeholders. 95 percent and 100 percent of the respondents also agree with the questions, respectively.

V. CONCLUSION

In summary, this study found that the premature sign-off of audit documents is commonly practiced in the small and medium audit firms. This is consistent with study conducted by Herrbach (2005) that found irregular auditing practices such as false sign-off play important roles in audit firms in French. Other prior studies also found the same (Rhode, 1977; Alderman & Deitrick, 1982; Raghunathan, 1991; Reckers et al., 1997; and Arnold et al., 2002).

The results described that the practice of premature sign-off is continuously occurred because the culture of the firm which too concern and follow the corporate client demand. Consequently, the external auditors are manipulated and unable to restrain premature sign-off behaviour. This is because the audit firm needs to retain the client to survive and compete with other audit firms. As a result, the corporate clients will take advantage of the weaknesses of the audit firm that desperate to hold their client.

This study also has identified the causes contributing and the impacts of the premature sign-off of audit documents. Time limitation and poor supervision will lead external auditor to premature sign-off of audit documents, supporting many prior empirical research like Azad (1994), Cook and Kelly (1998), Shapeero et al. (2003), Gundry and Liyanarachchi (2007), McNamara and Liyanarachchi (2008), Barrainkua and Espinosa-Pike (2015) and Mohammad Rezaei et al. (2015). Besides that, insufficient documents from corporate clients cause the external auditors to agree and verify the transaction and items in financial statements without supporting documents.

Eventually, this study found that premature sign-off behaviour of external auditors will affect the corporate client's stakeholders such as banker, shareholders, inland revenue, and creditors. The stakeholders search for information from the audit report for different objectives. For example, when the corporate client wants to apply the loan from the financial institution, the officer will check and analyse the information and data that comes from the audited financial statements from the audit report. Opinion from independence external auditors will influences the decision making of the audit report users. Wrong opinions in the audit report will lead to incorrect decision making by the users which will tarnish the reputation of the auditor. Irani et al. (2015) found that an auditor will be likely to be fired by the client if there are a large number of items re-stated in the financial statement.

There are several implications of the study. The Audit Oversight Board of Malaysia needs to expand their monitoring and regulatory jurisdictions to all audit firms, including small and medium size audit firms. This will avoid the external auditors in this firm size taking advantage of the absence of the laws and regulations and monitoring by the regulatory bodies. The Audit Oversight Board also needs to audit, monitor, and conduct inquiries into the auditing standard and quality performed by these firms. These will help enhance the professional standards of the auditing profession as a whole and boost the trust and confidence of the public which is currently only associated with Big 4 firms.

In order to increase the level of motivation of external auditors among small and medium sized audit firms to practice professional behaviour and good integrity, accounting bodies like the Malaysian Institute of Accountants can evaluate their work and reward them with awards such as a good star rating based on their performance and audit quality. This also can be assessed from the aspect of professional standards, quality of audit work, and other related matters on audit development. Consequently, it will increase goodwill of the external auditor, as well as their firm, and enhance their reputation.

5.1. Limitations and Suggestion for Future

There are several limitations of this study. First is the small sample size. This study only involved six small and medium size audit firms in the capital city area. As explained in the section research methodology, this is due to the busy schedules of the potential respondents and the sensitivity of the topic that causes many external auditors reluctant to participate in this study. In future, it would be better if a study could expand the sample size in order to get more reliable and accurate information and data.

Second, because of the small sample, only descriptive analysis can be provided. In future, inferential statistics and comprehensive analysis can be employed to give more robust and accurate results. Causal analysis such as finding the significant factors that trigger premature sign-off also can be conducted.

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