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DYSFUNCTIONAL AUDIT BEHAVIOUR: AN EXPLORATORY STUDY IN MALAYSIA

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ABSTRACT

Purpose The quality of the opinion provided by audit firms is an important determinant of their long-term survival, but audit quality is difficult to gauge, which makes it particularly sensitive to the behaviour of the individuals who carry on audit work. This study seeks to identify the incidence of Dysfunctional Audit Behaviours and Audit Quality Reduction Behaviours, actions taken by an auditor during engagement that reduce evidence-gathering effectiveness.

Design/methodology /approach The study is based on a survey of 244 auditors working in small/medium and big audit firms in Malaysia.

Findings The study identified key variables leading to dysfunctional audit behaviour.

Research limitations/implications The study is subject to the normal limitations associated with survey research.

Practical implications The study provides basic empirical evidence of a potentially serious risk of dysfunctional behaviours that may impair audit quality.

Originality/value The study provides empirical evidence to address the concerns of the Malaysian regulatory authorities regarding audit quality.

Keywords audit behaviour; audit quality; audit risk; dysfunctional behaviour

Paper type Research paper

1.0 Introduction

The purpose of this study is to explore the incidence of dysfunctional audit behaviour, specifically pre-mature sign off (PMSO), specific audit quality reduction behaviour (AQRB) and the effect of time budget pressure, which is one of the key operational and management control mechanisms in an audit assignment. Auditors generally perceive that their performance evaluation and career advancement in an audit firm are strongly related to their ability to complete an audit assignment on time and within the budget. At the same time, they are also expected to accomplish audit tasks to enable the formulation of an opinion in accordance to relevance auditing standards and guidelines. The results of a number studies show that time budgets are difficult to attain and this can affect audit quality (Kelley and Margheim, 1990; Cook and Kelley, 1988; Dalton and Kelley, 1997).

2.0 Audit Quality and Time Budget Pressure

Audit quality has been defined in numerous ways. The practitioner literature often defines audit quality relative to the degree to which the audit conforms to applicable auditing standards (Watkins et al., 2004). Some empirical audit quality research (DeAngelo, 1981; Wooten, 2003) defines audit quality relative to audit risk which is the risk that an auditor may fail to modify the opinion on financial statements that are materially misstated. DeAngelo (1981) defines audit quality as ‘the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach’. At the heart of audit is a tension between cost and quality (McNair, 1991). The long run sustainability of the profession depends upon the perceived quality of audit as a product and the maintenance of its reputation demands investment of time and high calibre of staff in audit work (Watkins et al., 2004; Wilson and Grimlund, 1990). The dilemma is intensified by the fact that audit quality is by nature difficult to observe and measure.

Since the quality of the audit cannot readily be evaluated, reputation therefore acts as a surrogate for quality. The market place for audit services has become increasingly competitive and audit fees have fallen considerably. Beattie and Fearnley (1994) concluded that there is significant downward pressure on audit fees generally, and particularly large reductions in fees when audits are put to tender. Faced with this situation, audit firms are under pressure to decrease man-hours in order to keep margins at an acceptable level. These competitive pressures may result in quality compromises which are not detectable in the short term by either clients or audit firm management. This places a particularly heavy burden on an audit firm's control systems, in that very tight cost control needs to be achieved in a manner which does not reduce audit quality. Margheim and Pany (1986) revealed that tight budgets often lead auditors to omit parts of the audit program, thus leading to lower audit quality. A subsequent survey by Kelley and Margheim (1990) highlighted similar findings. Coram et al (2003) suggested that the level of time budget pressure impacts on the propensity to compromise audit quality and found that under such pressure auditors do consider the level of risk to the audit task whilst executing the audit.

3.0 Dysfunctional Behaviour

Dysfunctional behaviour has its origins in Argyris' (1952) seminal case-study oriented paper. This term describes the *"...organisational and behavioural effects seen in supervisors induced by the use of budgeting"* (Hartmann, 2000) and refers to the violation of control system rules and procedures (Jaworski and Young, 1992). Hartmann (2000) contends that dysfunctional behaviour is not just an 'irrational' human tendency, but rather reactions that can be 'rationally' expected in response to controls and processes. The extent to which such controls are perceived to impact on performance, evaluation and rewards, is also viewed as having an impact on managerial stress and tension, thus leading to potential dysfunctional behaviour.

Certain actions of auditors that result in substandard audits have been termed as dysfunctional audit behaviours. Dysfunctional behaviour has also been referred to as reduced audit quality behaviour (Otley and Pierce, 1996; Coram et al., 2003). A variety of these cover behaviour such as failure to research an accounting principle, pre-mature sign off (PMSO) of audit procedures, superficial review of documents, acceptance of weak client explanations and reduction of work on an audit step below the acceptable level. These behaviours may pose a direct threat to the quality of the audit.

A second form of dysfunctional behaviour is underreporting of the actual time (URT) spent on specific auditing tasks (Donnelly et al., 2003). This occurs when auditors complete chargeable work on their own time and is usually motivated by a desire to avoid or minimise budget over-runs (Lightner et al., 1982). Although this type of behaviour does not pose an immediate threat to audit quality, it may lead to undesirable consequences such as inaccurate staff evaluations, lost revenue for the firm, unrealistic future budgets and dysfunctional audit behaviour on future audits.

Several studies have surveyed auditors about their perceptions of and participation in different types of dysfunctional audit behaviour. Rhode (1977) found 55 percent of experienced auditors (i.e., greater than three years experience) surveyed and Lightner et al. (1982) found 67 percent of the Big 8 auditors surveyed admitted to URT. Rhode (1977) also found 60 percent of experienced auditors had pre-maturely signed off on an audit step without actually performing it, while Alderman and Deitrick (1982) found 31 percent of the Big 8 auditors surveyed acknowledged that PMSO occurs in practice. More generally, Willett and Page (1996) found that only 22 percent of the finalists taking the Institute of Chartered Accountants examination in England and Wales stated that they had never participated in speeding up of audit testing by irregular methods and Coram et al. (2003) found that almost two-thirds of Australian respondents had 'sometimes' performed reduced audit quality practices. Kelley and Margheim (1990) found over one-half of the auditors surveyed stated that they had engaged in dysfunctional audit behaviours on a recent audit.

4.0 Research Questions

4.1 Pre-mature Sign-Off (PMSO)

A significant part of the literature on reduced audit quality has focused on PMSO as one primary type of reduced audit quality behaviour (Rhode, 1977; Alderman and Deitrick, 1982; Margheim and Pany, 1986; Otley and Pierce, 1996; Pierce and Sweeney, 2005). The most common aspects identified in the literature have included rejecting awkward items from a sample and accepting doubtful audit evidence. PMSO occurs when the auditors signs off a required audit step, not covered by an alternative audit step, without actually completing the work or noting the omission (Otley and Pierce, 1996). Previous studies identified time pressures as one of the significant reasons for PMSO. The consequences of this behaviour are potentially serious, since it interferes directly with the control systems which support the final audit opinion.

The specific questions addressed in this study on PMSO are:

Research Question 1: Whether Malaysian auditors have engaged in PMSO?

Research Question 2: What are the audits areas in which these behaviours are most prevalent?

Research Question 3: What are the variables leading to PMSO?

4.2 Audit Quality Reduction Behaviour (AQRB)

AQRB refers to a number of specific behaviours, in addition to PMSO, which directly threaten audit quality, such as accepting weak client explanations and making only a superficial review of documents. **Research Question 4** on AQRB is addressed in this study: During the year, how often have auditors engaged in specific AQRB when carrying out an audit?

The survey questionnaire listed four specific types of AQRB examined by Kelley and Margheim (1990) and Otley and Pierce (1996). The purpose of this study is to assess the existence of such dysfunctional behaviour among the different levels of audit personnel.

4.3 Time Budget Pressure and Under Reporting of Time (URT)

Time budget pressure refers to those time constraints that arise or may arise, in engagements from limitations of resources (time) allocated to perform tasks (De Zoort and Lord, 1997). Normally audit firms communicate these limitations to audit personnel through time budgets. Research shows that time budgets have the potential to create pressure because these budgets act not only as a control mechanism but also as a performance measurement tools within the firm. The results of a number studies show that time budgets are difficult to attain and this can affect audit quality (Kelley and Margheim, 1990; Cook and Kelley, 1998; Dalton and Kelley, 1997). Also, some studies show that auditors believe this pressure is escalating (Waggoner and Cashell, 1991; Otley and Pierce, 1996). In contrast, a more recent study has shown that time budgets are becoming more realistic (Buchheit et al., 2003).

URT arises when an auditor carries out chargeable work and does not charge it to the client for whom the work has been done. Although this behaviour does not immediately affect audit quality, it does result in artificially low time records and it may lead to undesirable consequences such as inaccurate staff evaluations, lost revenue for the firm, unrealistic future budgets and audit quality reduction behaviour on future audits. URT is likely to lead to very tight time budgets, which previous studies (Alderman and Deitrick, 1982; Otley and Pierce, 1996) have highlighted as being a major cause of dysfunctional behaviour but need not necessarily lead to a reduction in audit quality. As the ability to meet time budgets was considered a 'very important' factor affecting advancement and performance evaluation in the audit firms, URT has become a relatively easy strategy for auditors (Rhode, 1977; Lightner et al., 1982; Pierce and Sweeney, 2005).

The auditors were given six options to choose from, these could be classified as functional responses (request and obtain budget increases and work harder but charge all time properly) and dysfunctional responses (URT by working on personal time, shift time to non-chargeable code, reduce the quality of audit work to meet budget and shift time to

a different client. These responses allowed two further research questions to be addressed:

Research Question 5: Do time-budget pressures cause audit personnel to engage in dysfunctional behaviour? and,

Research Question 6: Do time budget pressures cause the under-reporting of engagement time?

5.0 Data Collection

Participants for this exploratory study are Malaysian auditors in public practice. A random sample of 244 auditors was obtained from the audit firms listed with the Malaysian Institute of Accountants (MIA). The 244 auditors comprised 131 audit staff; 18 audit seniors; 80 audit managers and 15 partners of firms, ranging from small and medium size to the 'Big 4' firms. A questionnaire was developed from the original version of Otley and Pierce (1996) and was distributed late in 2007.

6.0 Results and Discussion

The analysis and discussion of the results are structured around the answers to the six research questions specified above. Thus the responses relating to Research Question 1 allows us to conclude that a PMSO problem exists, with 57 percent of respondents admitting to signing-off prematurely.

Data from Table 1 address Research Question 2, and indicates that the incidence of PMSO is most common in the review/testing of the Internal Control System (ICS), followed by PMSO at the time of vouching of expenses. The same two areas were highlighted by Alderman and Deitrick (1982) and Otley and Pierce (1996). ANOVA analysis revealed that these two areas had a significantly greater likelihood of PMSO than other major areas of the audit ($F=82.16$; $p=.000$). These same two areas are expected to have a higher incidence of PMSO because of the relatively small amount of working paper documentation involved (Alderman and Deitrick, 1982). Besides, the

review/testing of ICS and vouching and expenses are concerned only with the existence and completeness of transaction on audit assertions and objectives. In addition, the auditor can use the previous year's recorded understanding and assessment of ICS.

By comparison, Raghunathan's (1991) US study, found that PMSO are perceived as most likely to occur during the analytical review stage, followed by PMSO at the time of checking the internal auditor's work and supervision of the work of subordinates. Again, as expected the least likely areas of PMSO incidence are cash, accounts receivable and account payable. These three accounts are interrelated by cash, as cash is involved in cash sales, credit sales (receivables) and cash payments (payable). These are the critical areas of audit where auditors have to obtain sufficient and appropriate evidence about each significant assertion for the applicable transactions and balances. All assertion categories need to be confirmed at the audit working paper stage. The high levels of working papers prepared for these areas explain why they are the least likely to be subject to PMSO. Auditors have to use various combinations of tests of control and substantive procedures in order to meet all assertion categories in these accounts: existence or occurrence, completeness, rights and obligations, valuation or measurement and disclosure.

Participants were then presented with a list of possible causes of PMSO, based on Alderman and Deitrick (1982) and Otley and Pierce (1996). The perceived importance of these possible causes, ranked in descending order, is shown in Table 2. Budget constraints and the perceived necessity of an audit step have been highlighted as major causes of PMSO and dysfunctional audit behaviour, thus providing an answer to Research Question 3.

Table 1
Perceived PMSO in Areas of Audit

Area	Mean Score	SD	% of Respondents who reported that PMSO occur at least sometimes
Review/testing ICS	3.24	1.11	78
Vouching of expenses	3.25	1.12	75
Other Inventory	2.41	0.85	43
Fixed Assets	2.26	0.83	38
Physical Inventory Count	2.19	0.83	32
Accounts Payable	2.09	0.68	24
Accounts Receivable	2.10	0.65	23
Cash	1.89	1.76	16

Table 2
Perceived Importance of the Causes of PMSO

Perceived Cause	Mean Score	SD
An audit step appearing unnecessary/immaterial	4.05	1.12
Time budget constraint	3.83	1.01
Client imposed deadline	3.57	1.07
Inclination to readily accept client explanations	3.01	1.02

Inadequate supervision	2.83	0.94
Desire to obtain a favourable evaluation	2.83	1.27
Dislike for the work required	2.70	1.09
Misunderstanding of professional responsibilities	2.69	1.01
Lack of technical knowledge	2.53	0.95

Respondents were asked to indicate the frequency of each of the specific AQRB within the last year practices. Their responses are listed in Table 3 and all responses are close to 2 (i.e., the ‘rarely’ category), indicating that none of the individual behaviours are widespread. However, of some concern is the fact that 72 percent of all respondents admitted to engaging in one or more of the specified behaviours, at least ‘sometimes’.

Table 3
Frequency of Specific Audit Quality reduction Behaviour (AQRB)

AQRB Behaviour	Mean Score	SD
Made superficial reviews of documents	2.24	0.89
Accepted weak explanations from client	2.15	0.86
Reduced amount of work below level considered reasonable	2.09	1.10
Failed to research an accounting principle	1.91	0.84

A summary of the results presented in Table 4 addresses Research Questions 5 and 6. Ranking based on mean scores showed that the most likely response to a tight budget is to ‘work harder but charge all time properly’, followed by URT by working on personal time and quality reduction of audit work in meeting budget.

Table 5 presents the comparison of results of the present study with those of Kelley and Seiler (1982) and Otley and Pierce (1996). This comparison provides some evidence that

auditors are less likely to request and obtain an increase in their budgets. ‘Work harder but charge all time properly’ is the most common response. ‘Reduce the quality of work to meet budget’ is reported higher for the present study compared to those reported in the US by Kelley and Seiler (1982). In comparison, Malaysian auditors are more likely to engage in dysfunctional behaviour involving ‘quality reduction of audit work to meet budget’ than their Irish counterparts from Otley and Pierce (1996).

Table 4
Responses to Tight Budget

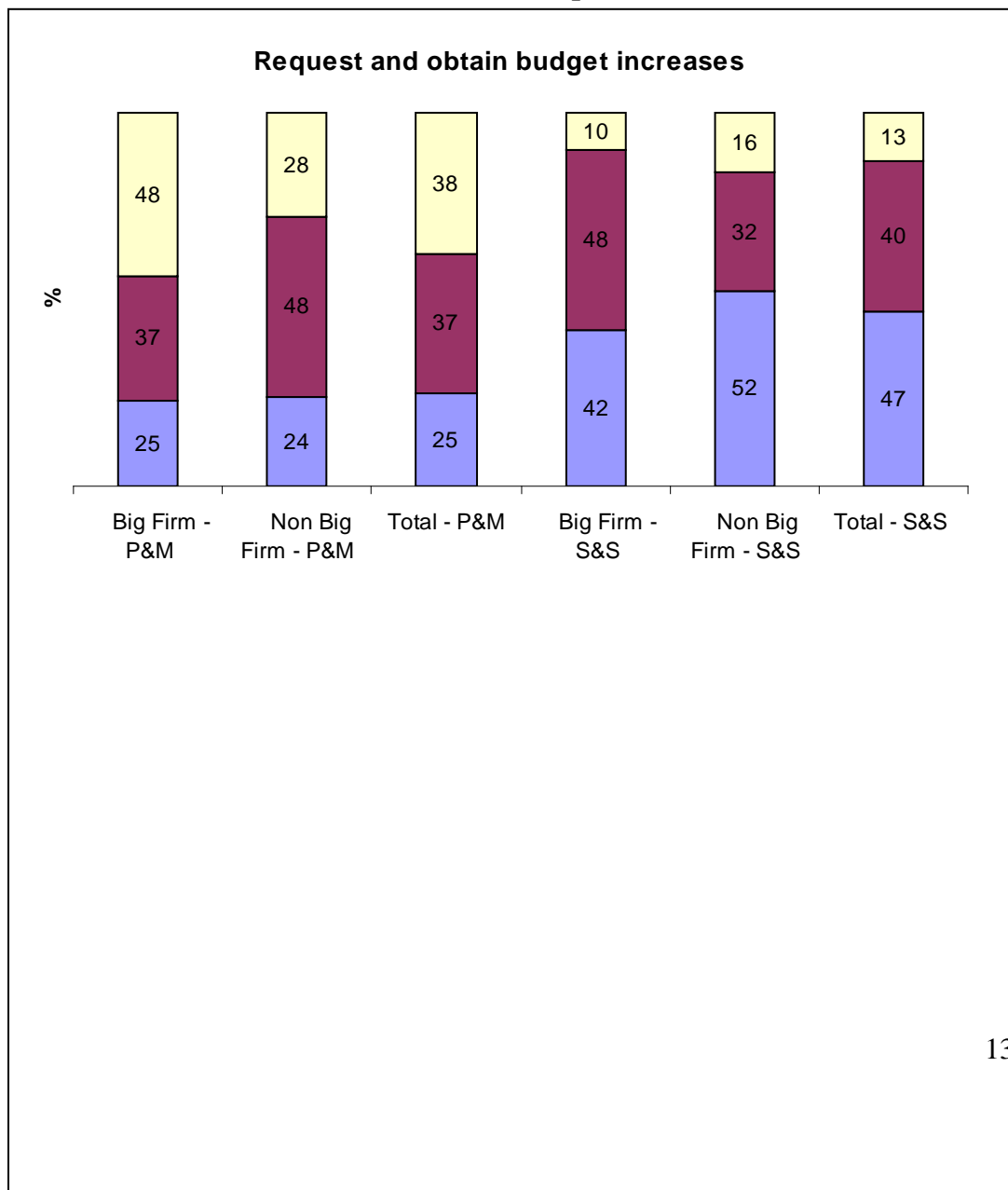
Response to Tight Budget	Mean Score	SD
Work harder but charge all time properly	3.31	1.16
URT by working on personal time	2.82	1.43
Reduce the quality of audit work to meet budget	2.41	1.20
Request and obtain an increase in the budget	2.16	1.10
Shift time to a non-chargeable code	2.16	1.08
Shift time to a different client	1.51	0.75

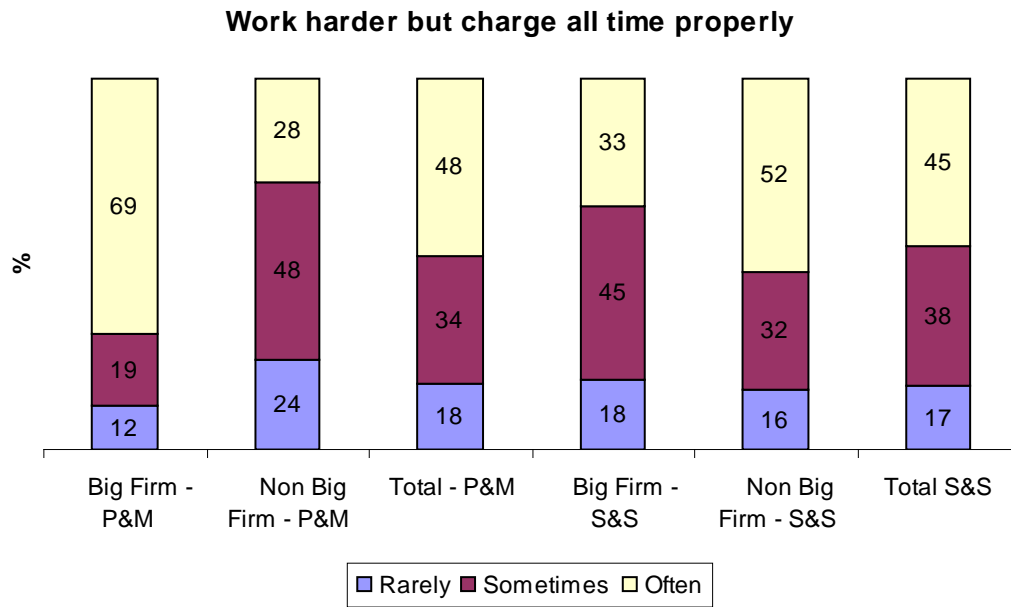
Table 5
Responses to Tight Budget: Comparison of Study

Response to Tight Budget	Kelley and Seiler (1982) - US Study	Otley and Pierce (1996) - Irish Study	This Study
Work harder but charge all time properly	90%	75%	81%
URT by working on personal time	33%	54%	42%
Reduce the quality of audit work to meet budget	10%	36%	40%
Request and obtain an increase in the budget	57%	36%	43%
Shift time to a non-chargeable code	19%	40%	29%

Figures 1 and 2 show the breakdown of participants' responses to tight budgets or time budget pressures by position and by type of firm (Big 4 and non-Big 4). Figure 1 shows functional responses and Figure 2 shows dysfunctional responses. Partners and Managers (P&M) i.e. auditors holding higher-ranks, as well as auditors holding lower-ranks i.e. Staffs and Seniors (S&S), both appear to resort to functional and dysfunctional means in coping with pressure

Figure 1: Responses to budget pressure by type of firm and type of position
- **Functional responses**





Notes to Figure 1:

Participants responded to a Likert-type scale of 1 to 5 (1= never; 2=rarely; 3=sometimes; 4=often; 5=nearly always). In this figure, the two responses i.e. never and rarely are classified as 'Rarely' and often and nearly always as 'Often'.

Figure 1 shows about a third of the partners and managers (for both 'big 4' and non-big 4 firms i.e. 38%) requested and obtained budget increases often, only 13% of the auditors holding lower-ranks tend to do so (for both big and non-big firm). This may indicate that those holding lower-rank positions are reluctant to come forward with budget increase requests. The responses of the two groups (P&M and S&S) are significant at the 0.01 level, where auditors in P&M group admitted making requests for budget increases more often than S&S. This is consistent with an expectation on the part of managers and partners that they will succeed in obtaining budget changes, while staff and seniors may be less successful. Respondents for both groups also indicated that they often worked harder and charged all time properly when faced with stricter time budgets. This is evident from 48% for P&M group and 45% for S&S group (i.e., no statistically significant difference between the two user groups).

Figure 2 illustrates the responses on dysfunctional behaviour. Both groups resort to some dysfunctional activity to cope with time budget pressure. For example, 25%, 32% and 30% of P&M group, at least sometimes, tend to URT either by working in personal time, by shifting time to non-chargeable or by shifting time to different client respectively. Whereas for the S&S group at 22%, 35% and 34% on the same dysfunctional responses. These high percentages may be construed as a warning that URT is a common practice among auditors at all levels in Malaysia. This tendency might be a strategy for avoiding budget over-runs by the S&S group. Auditors at the lower-ranks (S&S) also tended to reduce the quality of audit work when faced with the tight time budgets. This is evident from Figure 2 as many auditors indicated, at least sometimes, responding to tight budgets by reducing the quality of audit work i.e. Partners/Managers at 7% and Seniors/Staffs at 23% (Often at 7%). Accordingly, audit personnel holding relatively lower ranks (S&S) are sometimes responding to time budget pressure with extreme measures. The responses of the two groups (P&M and S&S) are significantly different here at the 0.05 level, with auditors in S&S group admitting to undertaking quality reduction acts.

Figure 2: Responses to budget pressure by type of firm and type of position
- Dysfunctional responses

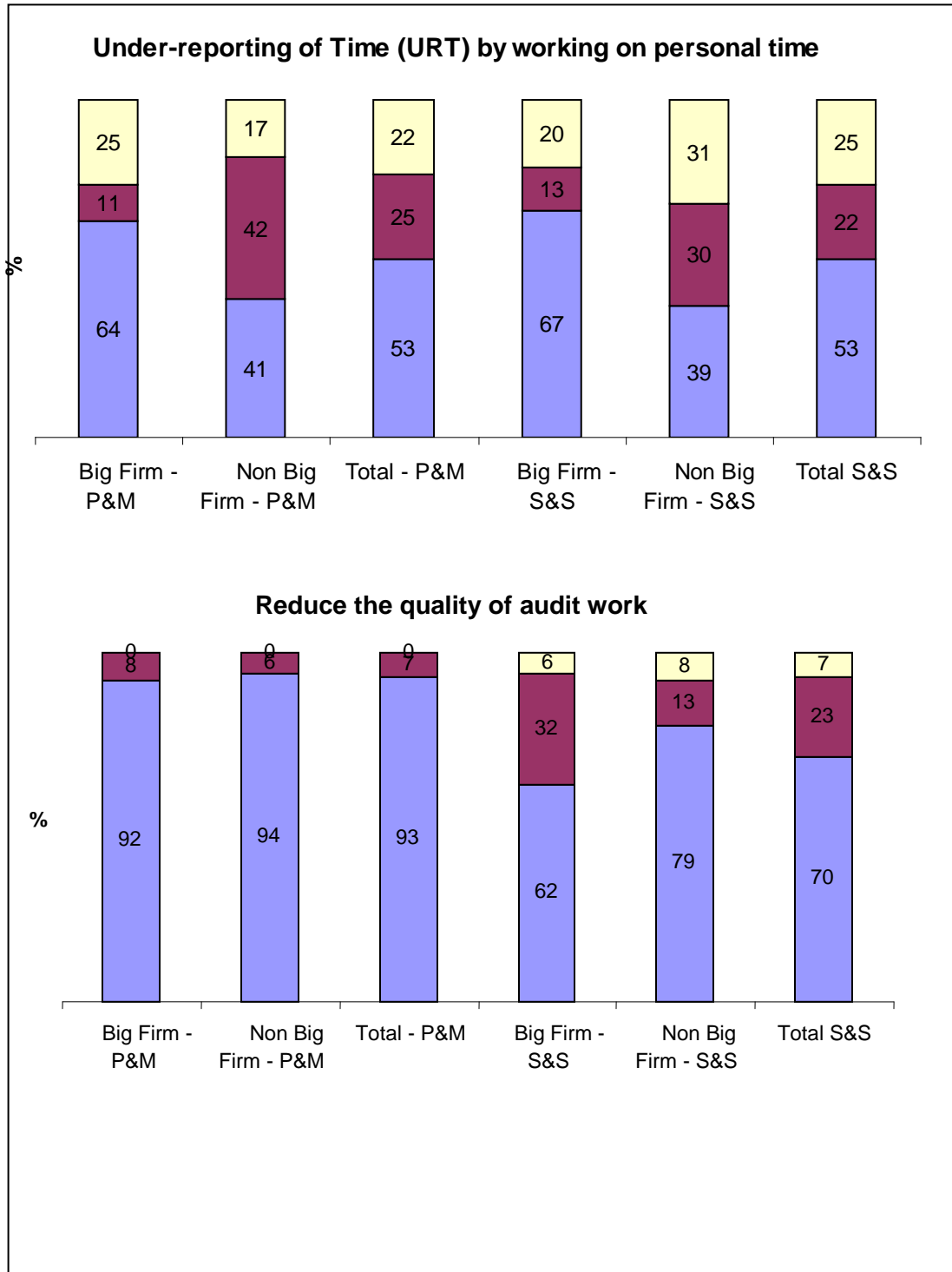
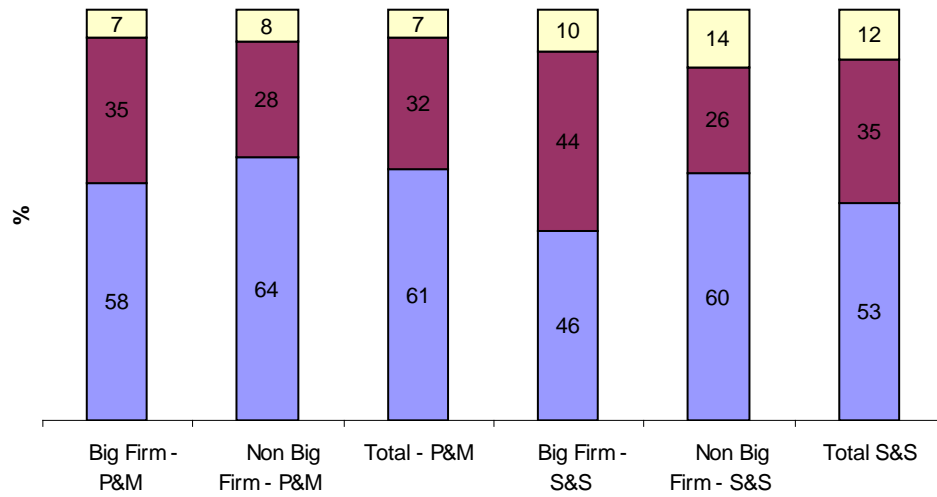
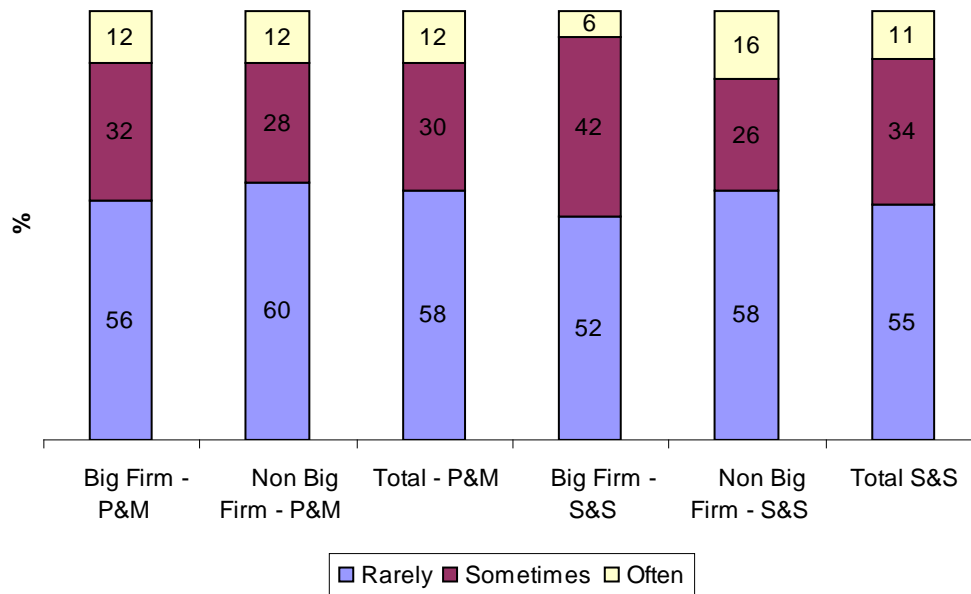


Figure 2 continued

Shift time to non-chargeable code



Shift time to a different client



Notes to Figure 2:

Participants responded to a Likert-type scale of 1 to 5 (1= never; 2=rarely; 3=sometimes; 4=often; 5=nearly always). In this figure, the two responses i.e. never and rarely are classified as 'Rarely' and often and nearly always as 'Often'.

As budget attainability or achievement is significantly positively related to performance evaluation (Kelley and Seiler, 1982; Cook and Kelley, 1988; Otley and Pierce, 1996), respondents were asked direct questions on the perceived importance of budget achievement in the overall evaluation of performance. There was evidence that budget achievement is seen by many respondents as being critical for a successful career in auditing. They were asked how important time budget achievement is in the overall evaluation of performance (Perceived), and their opinion of how important time budget achievement should be (Desired). Responses for Audit Managers are summarised in Table 6 :

Table 6
Importance of Budget Achievement in the Evaluation of
Audit Manager's Performance

	<u>Perceived</u>	<u>Desired</u>
Very Important	38.3%	8.3%
Quite Important	33.2%	31%
Of Some Importance	26.3%	52%
Of Little Importance	4.6%	7.6%
Of No Importance	1.2%	1.1%

Table 6 indicates a strong feeling that budget achievement is given too much importance in the overall evaluation of performance. It is observed that time budgets are perceived to be 'very important' to 'quite important' (71.5% and 26.3% of respondents selected 'of some importance'). Surprisingly, when desired importance of budget achievement in the overall evaluation of performance is measured, half of the respondents observed a lower level of importance i.e. 'of some importance'. There seems to be a general acceptance that a certain amount of budget pressure is an unavoidable fact of life in auditing firms. Managers felt that, ideally, budget achievement should be 'of some importance' with respect to their performance evaluation.

Respondents' perceptions on the attainability of their budgets in the last year are shown in Table 7. More than half of all respondents believed that last year's time budget were either difficult to attain or unattainable. Table 7 and Table 8 (for comparative studies) indicate that more than half of respondents considered their time budget to be unattainable or difficult to attain. Accordingly, Malaysian auditors considered their time budget to be 'unattainable' to a slightly higher degree than their Irish and New Zealand counterparts, but lower at a 'difficult to attain' degree, i.e., 32% as compared to Irish (58.1%) and New Zealand (50%).

Table 7
Perceived Budget Attainability

<u>Response</u>	<u>% of Respondents</u>
Attainable	29.8%
Difficult to Attain	32%
Unattainable	38.2%

Table 8
Perceived Budget Attainability: Comparison of Study

Response	This Study	Otley and Pierce (1996) - Irish Study	Liyanarachchi and McNamara (2007) - New Zealand Study
Attainable	29.8%	25.4%	31%
Difficult to Attain	32%	58.1%	50%
Unattainable	38.2%	16.5%	19%

7.0 Conclusions

The study yields persuasive empirical evidence of the existence of dysfunctional behaviour involving PMSO, specific AQRB and some aspects of URT and time budget pressure. The study also produced important findings in relation to auditor's control system on time budget and budget emphasis. In general, many auditors in Malaysia think that time budgets are difficult to attain. Auditors seem to resort to practices such as URT and shifting to non-chargeable code and different client when faced with time budget pressure. The variations in the perceived levels of PMSO across different areas of audit is also a notable result as it would enable peer reviewers and practice reviewers to focus on key areas with higher probabilities of PMSO.

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