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# HUMAN CAPITAL ANTECEDENT'S: THE IMPACT OF THE IMPLEMENTATION INTERNATIONAL STANDARD ON QUALITY CONTROL1 ISQC 1 ON THE AUDIT FIRM PERFORMANCE IN JORDAN: A CONCEPTUAL STUDY

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***Abstract:*** *This paper focuses on the influence of International Standard on Quality Control (ISQC 1) on the performance of the audit firms in Jordan. ISQC 1 suggests six elements to measure the quality control including leadership responsibilities, the ethical requirements, acceptance and continuation of customer, human resources, the performance of the process and finally the monitoring. In addition, the paper highlights the importance of human capital as a antecedent's variable to ISQC 1 and audit firms performance. Therefore, this study suggests the ISQC1's elements as important factors to improve the audit firm performance in Jordan.*

***Keyword:*** *ISQC 1, audit firm performance, human capital antecedents, improve performance.*

## 1. INTRODUCTION

There have been increasing occurrences of business scandals within these past few years across industries. These scandals have led to many questions and consequences. Somehow, there is one thing in common in these scandals: the fault of the auditor. The failure of Enron in 2001 was a big blow to the US economy and it became worse when the Lehman Brothers case brought shame to auditing profession. Following the occurrence of fraud, the standards around auditing firms would be typically tightened. The purpose of such act is to uncover the fraud and improve performance. This is in fact a classic response. The Congress intervention and issuance of the Sarbanes Oxley Act in 2002 in the USA after the Enron scandal is one such example (Arens *et al.,* 2009).

The cases of Enron, Parmalat and WorldCom that shocked the accounting world in the early 2000s have caused the public to scrutinise the profession of auditing. In particular, the public became increasingly interested in the audit work quality, which is acknowledged and emphasised only after the discovery of irregularities.

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Accordingly, the regulatory bodies of accounting and auditing have looked into the issues that emerge following these scandals. This is to assure the use of suitable financial reporting and audit regulation. The Sarbanes Oxley Act is one such example. This act was introduced to strengthen the accounting profession in USA.

These scandals sparked more and more research interest among the academics in audit firms' performance. As indicated by Fearnley, Brandt and Beattie (2002), Hoai, N. N., & Thanwadee, (2015) scholars in this field are attempting to identify the factors that lead to the scandals aside from strengthening the auditing profession itself. It has been noted that following this scandal, there emerges a trend of blaming the auditors and questioning the audit firms on the quality produced. This is due to audit failure's great impact on both the partakers of capital market and the general public. As such, it is important to conduct fresh researches on audit performance in order to ascertain the factors that are linked with inferior audit profession.

It should be noted that for improving the performance of auditing firm, more focus should probably be placed on both the inputs and output of the firm. Somehow, the concerns of auditing standards have always been more on firms' quality of audits rather than firms' actual management and control. Measurement of performance is crucial. However, auditing standards have not been sufficiently paying attention to the way firms should be managed. As indicated by the professional auditing bodies, performing "quality" audit is sufficient enough for audit firms to be considered as successful.

In relation to this, numerous countries have adopted the International Standards on Auditing ISA 220. As stipulated by the International Standards on Auditing ISA 220, auditing firms must have a quality control system through which firms and their personnel are reasonably assured to adhere to the professional standards and regulatory requirements when preparing the audit report. Somehow, this is not sufficient; a system to measure auditing firm's own performance is also necessitated (IAASB, 2009e). In other words, merely measuring the firm's output quality will not be enough. The problem with Standards such as ISA220 is that they are grounded only on the inside processes and the employees' human resource management while failing to incorporate a system of performance measurement that is more robust and integrated which is necessitated in an environment that is competitive and dynamic (Becker, 2015).

Accordingly, the International Auditing and Assurance Standards Board (IAASB) in March 2009 issue presented 36 of fresh updates and clarifications. The International Standards on Auditing (ISAs) and a clarified International Standard on Quality Control ISQC 1, Quality Control for Firms conducting Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements. Meanwhile, ISQC 1 was first issued in 2004. There are numerous factors that are linked with the manifestation of Audit Firm's Performance (AFP) and these factors have been under scrutiny in the past studies. All studies conducted in the last two decades have evidenced that sometimes auditors do not execute the audit procedures properly when required to apply quality control standards (Kelley & Seller, 1982; E. Cook, Kelley, 1988; Kelley & Margheim, 1990; Otley & Pierce, 1996b; Coram, Ng, Woodliff, 2003; Gundry & Liyanarachchi, 2007). For the auditing profession, this remains a primary issue.

Additionally, almost all of the past studies on AFP are restricted to the stress factors (e.g., role ambiguity, role conflict and workload), size audit office and auditor experience with respect to their implication. These factors have been understood to affect the job related outcomes in audit quality's broader model. Choo (1986) reported that audit quality control standards' implementation significantly influences job performance of auditors. Poorly performing auditors result in audit work that is substandard and this leads to low audit quality. According to Fisher (2001), low audit quality will put audit firms at risks of legal liability, loss of client and reduce the firm's reputation. As such, this study will attempt to look into the elements standard of audit quality control which may directly influence the performance of audit firm.

## 2. LITERATURE REVIEW

### 2.1. International Standard Quality of Control ISQC 1

The IAASB Clarity Project has caused the ISQC 1 to be redrafted. However, the redrafting does not change the standard's basic focus; rather, it provides clarification to its requirements. As such, firms must fully understand the clarified standard and fully comply with the standards where necessitated. Starting December 15, 2009, the clarified ISQC 1 oversees the responsibilities of firm particularly with regard to its system of quality control for audits and financial statements' reviews alongside other assurance and associated services engagements including agreements of compilation (IAASB, 2009a).

ISQC 1 lays down the objective of firm in adhering to the standard. It also provides a set of requirements (backed by application and other explanatory material as deemed fit) established to allow the firm to achieve the objective. As stipulated by the ISQC 1, the firm should aim to create and maintain a system of quality control that reasonably assures that both the firm and its personnel adhere with the professional standards and the applicable legal and regulatory requirements while the reports published by the firm or its engagement partners is situationally appropriate (IAASB, 2009b).

Elements ISQC1 As stipulated by ISQC 1, firms must create and maintain a quality control system (QC system) that comprises policies and procedures that deal with six elements which include: leadership accountabilities for firm's internal quality, applicable ethical requisites, acceptance and maintenance of client relationships and specific engagements, human resources, performance of engagement and monitoring.

For Small-and Medium-Sized Practices, the Quality Control Guide comprises two sample manuals to be perused and adapted by firms as benchmarks to match with their practice. With respect to the policies and procedures of QC systems, their elements are common to all firms. However, practices that are smaller and simpler usually employ QC systems that are smaller and simpler too. In the application, ISQC 1 also caters to smaller practices and other illustrative material section (IAASB, 2009c). For instance, for smaller firms, they may use less formal methods in the evaluation of their personnel's performance. Additionally, ISQC 1 also acknowledged that certain requirements are not relevant at all times (IAASB, 2009x).

As an example, for practitioners that do not hire staff, they do need policies and procedures for assigning the personnel to the engagement team, for some review accountabilities, and for the annual results' reporting of monitoring outcomes to the partners of engagement inside the firm (IAASB, 2012). Education and firm-wide training on ISQC 1 will contribute to the effective adherence to the standards. Through the firm-wide training, firm can reliably convey message to all relevant parties. Apart from that, ISQC 1 could also be used to assist the promotion of the firm's broader commitment to quality and the utilisation of best practices.

By way of the training programs, one will attain the opportunity to generate awareness on all changes to be done on the firm's policies and procedures. The programs also offer guidance with respect to what the changes entail, how the update on the QC system is done, and how the changes are to be implemented (IFAC, 2006). Following the session of initial training on the QC system changes, follow-up and reinforcement are to be conducted by way of intermittent reminders on the accountability of personnel to abide by the policies and procedures of the firm.

Therefore, by adhering to ISQC 1 firms would have the opportunity to support a culture that puts quality both at the front and centre. Being adapted inside the firm, this culture will assist in the objective fulfilment. Not only that, the culture may also contribute to the capacity of the firms in meeting the expectations of the stakeholder in a consistent manner.

### 2.2. Performance measurement systems

There is huge number of articles and researches in the field of performance measurement within the last two decades as the subject has sparked substantial amount of interest and attention amongst scholars (Abdul Khalid, 2000; Johnston *et al.*, 2002; Scapens *et al.*, 2003; Neeley, 2005; Yazdifar & Tsamenyi, 2005; Taticchi *et al.*, 2010;).

In other words, performance measurement is a subject that has been extensively scrutinised. Somehow, only few have attempted to provide a definition on the term itself. In this matter, the definition constructed by Neely et al. (2002) has been the one most commonly referred. In particular, Neely et al. (2002) define performance measurement as: "The process of quantifying the efficiency and effectiveness of past actions." Another definition of performance measurement is from Cross and Lynch (1992). According to them, performance measurement entails: "the single most powerful tool to ensure success of business strategies" and that "setting and attaining a few key performance measures will help ensure that all levels of the organization stay on track and pull together behind the corporate engine before competition beats them to it" .

The importance of performance measurement has been discussed by several authors including Peter and Waterman (1988), Neely (1999), Simons (2000), Sharma *et al.* (2005) and Sousa and Aspinwall (2010). Also, there are a number of studies that address on how performance is measured instead of why it should be measured. In relation to this, Kaplan (1984) stated that the selection of the fitting performance measures comprises a form of art that must be practiced alongside the firm's strategic goals and in direct communication with swift changes that happen in the processes of firm.

Firms customarily measured performance just financially, in particular, in terms of profits. Here, firms would put the major emphasis on decreasing cost and obtaining economies of scale. As such, the key measures of cost, especially conversion would include budgets, unit cost, standard costing, direct material, hourly labour costs and analysis of CVP (Johnson & Kaplan, 1987; Fitzgerald & Brignall, 1991; Simons, 2000; Horngren et al., 2005; Fitzgerald, 2007).

Nonetheless, there have been radical changes happening in the business environment. These occurrences have made those traditional measures to lose their relevance and become obsolete. In particular, Hope and Fraser (1997) reported that the move from the industrial era of the second wave to the information era of the third wave has caused companies to outdo one another in terms of intelligence rather than size. This has led to many changes such as competition, automation, globalization and the reduction of life cycles of products (Simmonds, 1981; Gordon & Naryanan, 1984; Johnson & Kaplan, 1987; Bromwick, 1990; Womack *et al.*, 1990; Hoque, 2003; Horngren *et al.*, 2005; Yazdifar & Tsamenyi, 2005; Zimmerman, 2009; Tangpornpaiboon, S., & Puttanapong, 2016).

It has been acknowledged by firms that in the information era, competition is focused on value, not price. Also, competition is grounded on quality, differentiation, customization and quick response.Due to non-financial measures, firms can no longer depend merely on financial figures. In fact, these financial figures have to be supplemented with the up-to-date ones. As stated by Fitzgerald and Brignall (1991), profits turn to the offshoots of success; as means instead of ends. In order to deal with the issues related to financial measures' usage, firms have to have strategic measures for indicating its imminent earnings potential. As indicated by a number of studies (e.g., MacNair *et al.* (1990), Grady (1991) and Kaplan and Norton (1992, 1996a)) in the past few years, the focus has been on establishing a system of non-financial measures associated to strategy.

Grady (1991) for example, has looked into the way the company's strategic objectives can be divided into crucial success factors and crucial actions. Meanwhile, pyramids of performance in which the strategic vision of management is divided into financial and non-financial measures at lower levels inside the company were introduced by MacNair *et al.* (1990).

Further, a study by Ittner and Larcker (2003) reported that within a five year period, companies that use non-financial measures and formed a causal linkage between the adopted measures and the financial outcomes attained higher ROA and equity. Nonetheless, the issue on which non-financial measures to be employed in performance evaluation, out of multitudes of such measures, is still unresolved. The usage of BSC as a strategic management system has been scrutinised by Malmi (2001). In particular, the author was looking into the issues of goals setting, planning and budgeting, resource allocation, compensation and strategic feedback. The author also highlighted on learning which includes making the necessary modification on the course of action where business management ensues.

However, the subject of financial measures has also received criticism. In particular, history has always highlighted the past actions of company but there has been no mention about the company's future preparedness (Merchant, 1985; Maciariello & Kirby, 1994; Kaplan & Norton, 1996).

Further, several authors including Anthony *et al.* (1984), Merchant (1985), Eccles (1991) and Maciariello and Kirby (1994) have reported that accounting figures do not include the elements that may lead to good or poor future financial outcomes. This is particularly the case for the professional services including the auditing practices in which auditing firms' partners attempt to attain quality and reasonable presentation of financial statements in order to preserve their reputation and endorse their businesses.

In auditing standards, the issue of how audit firms have their own performance measured and evaluated has not been sufficiently addressed. In fact, these audit firms are more focused on what the firm establishes instead of how it establishes its own performance measurement. The same also could be said about researches; they have been focusing too much on the processes and procedures employed by the auditing firms for sustaining the output quality. Meanwhile, researches that look into the audit firms' inputs and internal management are still lacking. As such, a research gap in this field has emerged.

The building blocks of competitive strategy formulation are dictated by the linking of a company with its competitive powers within the industry (Porter, 1980, 1985). As such, the strategy must be grounded on the targeted market segments followed by the identification of the numerous inside processes that must be mastered by the company so that its value propositions to the consumers in the focused market segments can be established.

Therefore, to be innovative and competitive, the adoption of a multidimensional approach would be invaluable to auditing firms in evaluating their performance. However, it should be noted that implementing such measurement task can be difficult considering that auditing firms have to deal with the unique predicament of generating services to fulfil the needs of their customers while at the same time, keeping their distance and independence from the customers preserved. The worth of the auditing services offered by these audit firms hinges on the conjecture that they are third-party evaluators that are independent.

Further, the client's financial statements are perceived as fair and that these audit firms should not be perceived as being linked with or being influenced by the client at all. In relation to this, Kinney (2005) further added that auditing is an industry that is heavily regulated. In developing a system of performance measurement, the elements that influence firm's performance as well as the achievement of its quality objectives and reputation should be taken into account. At the same time, adherence with the related auditing standards must also be assured.

As an example, performing non-audit services for certain clients of which the services could result in extra revenues and profits for the firm is prohibited by the auditing standards. Nonetheless, the aforesaid revenues and profits would become the extra resources to the management and also partners for establishing and maintaining the services of high quality. Thus, aside from significant amount of revenue loss, having the revenues and profitability maximization restricted, may impact the auditing firms' capacity in sustaining the quality of their services.

Auditing firms must ensure sufficiency of available resources so that they could maintain audit quality and that partners will not succumb to the pressure of accepting the illegal non-audit services. As such, a performance management tool must be available within the auditing form. Via this tool, the auditing firms could offer their services using their resources in the most efficient manner. Also, the system of performance measurement must take into account the imposed restrictions and incorporates them.

Further, auditing firms should employ comprehensive and cutting-edge information system with certain instruments such as IDEA and ACL to provide them assistance when conducting their audit with the quality required. Also, firms could evaluate their own performance. As audit firms are prohibited from giving their clients non-audit services, their available resources may be reduced. This may affect these firms' capacity in implementing such information system by prioritising the audit tools that are perceived as more essential for attaining the desired services quality. This situation appears to be prevalent among the audit firms of small and medium size that have restricted amount of clients and resources.

Besides that, it is not easy to evaluate the performance of employees in auditing firms. Evaluating audit service quality is a task done in group, not individually. In other words, the release of the audit opinion is an outcome of everyone's effort in the audit team. As such, the nature of audit service in itself makes it difficult to evaluate the performance of manager, individual auditor and audit supervisor. In audit firms' systems of performance measurement, the non-financial and subjective measures including the appropriate application of audit standards, capacity to recognise misstatements and endeavours for the audit services performance are regarded as crucial.

Therefore, those professional firms must emphasise more on qualitative measures including the internal business process and learning and growth, rather than merely focusing on financial measures. Focusing on such qualitative measures, it is expected that the rewards that employees are to receive would be linked to the measures of the performance systems.

As reported by Johnston (1988), there have been extensive researches conducted on the subject of performance measurement in the sector of manufacturing. However, the author indicated that there are differences existing inside the services sector which makes it impossible to smoothly transfer the concepts. In the context of services, establishing performance measurement is more difficult to do. This is because services are intangible which makes them challenging to measure and control. In addition, the output is varied from employee to employee and customer to customer and therefore, attaining consistent evaluations is difficult. Besides that, the generation and usage of services happen at the same time, which means that customers are present during the giving of the service.

## 3. CONCEPTUAL FRAMEWORK

A research framework based on contingency theory, legitimacy theory, and human resources theory, as the theoretical framework. Under this theory, and clarify the relationship between the ISQC 1 and performance of audit firms, also how ISQC 1 can to improve the performance in the audit firm.

High performance is not an accident. It is the result of continuous, sustained efforts at improvement. Auditors can contribute to this improvement process by integrating performance improvement audits into the audit approach. In the past, auditors have identified problems but might not have taken the extra step to elevate performance and recommend ways to improve the underlying business practices. The goal of improvement audits is not only to root out inefficient processes and procedures but also to recommend ways to improve business performance in order to help the organization achieve desired results. Even a quick assessment of performance measures as part of a regularly scheduled compliance, financial, or risk-based audit can yield great benefits to the company for relatively modest effort, while providing an opportunity for the audit team to enhance its knowledge of the business (Patrick, 2011). The American Institute of Certified Public Accountants (AICPA's) and Enhancing Quality control initiative, launched in May 2014, addresses quality challenges on a holistic, ongoing basis with the goal of improving audit performance, particularly in specialized industries such as employee benefit plans and governmental entities. In August 2014, the AICPA published a discussion paper seeking feedback from practitioners and other stakeholders on ways to accomplish that goal (AICPA, 2015).

Implementing ISQC 1 published in 2014, challenges, solutions and benefits associated with the standard, for consultation on contentious accounting and auditing issues, most of the challenges faced by sole practitioners stem from their limited resources (ISQC 1, 2014). As the only partner in the firm and many tasks fall on them, they often do not have sufficient time to focus on implementing ISQC 1. Sole practitioners typically have few staff and may not have staff who are competent or experienced in ISQC 1 implementation. The absence of qualified internal personnel also makes it difficult to conduct internal consultation on complex accounting and auditing issues, or to perform an Engagement Quality Control (EQC) review as the firm may not have an eligible person to take on the role of EQC reviewer (Jason, 2014).

ISQC 1 is essentially a tool for enhancing the performance and quality of the firm's work. Firstly, having sound controls in place will minimize the incidences of incorrect engagement procedures, poor documentation, or even "over-auditing." Implementing ISQC 1 allows firms to improve their engagement procedures. The risk of issuing inappropriate engagement reports is also reduced, thereby lowering the practitioners' exposure to the risk of liability (IFAC, 2014).

Most importantly, ISQC 1 will help firms develop a culture of quality in the long run. This will encourage the continuing professional development of staff, helping to improve overall competency and retention rates, and lay the foundation for the firm's ongoing growth and ability to respond to the dynamic changes in its environment. It is recognized that some of the resolutions for the challenges will inevitably require time and cost investment but in the long run, the benefits of implementing ISQC 1 will far outweigh the cost, which ultimately leads to support the performance of the audit process in the firm (ISCA, 2013).

Thus, ISQC 1 recommended using Audit Delivery Models (ADMs), issued by International Auditing and Assurance Standards Board (IAASB) refers to centralized locations performing audit and audit-related procedures on behalf of the core engagement team, it would be useful to explore how ISQC 1, and the ISAs could acknowledge the use of ADMs. And emphasize the need for appropriate policies and procedures for these structures as part of the firm's system of quality control and at the engagement level. For example, the International Standards on Auditing (ISAs) might better emphasize the importance of considering how responsibilities for direction, supervision, and improve performance (IAASB, 2015).

Finally, ISQC 1 contributed to the support performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Include 1.Making personnel aware of the firm's expectations regarding performance and ethical principles. 2. Providing personnel with evaluation of, and counseling on, performance, progress and career development. 3. Helping personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action (MIA, 2009).

## 4. CONCLUSION

This study's comprises the worth of applying the audit firm performance concept in the audit firm to attain benefits. By adopting AFP, auditors are encouraged to be effective and efficient and employ the financial and human resources optimally. As this topic is worth discussing, this concept has been adapted by the economic community in many countries, both developed and developing. Auditor's report is important to both the client and shareholders. The trust between the auditor and the client can be sustained via sound performance of audit firm, staff and the attainment of targeted profit. Hence, this study adds to the field of audit performance by determining the degree of high or low level of performance in Jordan's audit firms.

This study looks into the worth of auditing itself. Auditing is an important pillar in the economic and financial system of all countries. This may be attributed to stakeholders and decisions that influence a country's economy. As such, the profession of auditing may tie the numerous sectors and economic activities together.

This study is important practically and theoretically. To begin with, by way of better comprehension of audit performance and its impact on the behaviour of auditors, the audit work performance can be improved. Further, comprehending the audit control elements of ISQC 1 and their linkage with the performance of audit firms could offer invaluable knowledge on the factors that encourage the auditors to increase their audit performance.

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