

Roles of Audit Oversight Bodies in Governing Financial Reporting

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Abstract

In the financial reporting ecosystem, external auditors are important players entrusted with providing quality audits in order to uphold public confidence in audited financial statements. Many mechanisms have been adopted in an effort to regulate external auditors in order to maintain quality audit practices, including the adoption of International Standards on Quality Control 1 (ISQC 1) and the International Standards on Quality Control for Audits of Historical Financial Information (ISA 220). To complement the standards that govern audit quality, audit oversight functions are introduced as a means of auditing the auditors. The present study examines the features, characteristics and best practices of selected audit oversight bodies in the United States of America, the United Kingdom, Australia, Japan, Singapore and Malaysia. A content analysis of annual reports from oversight bodies in the aforementioned countries was undertaken. The analysis reveals contrasting practices in several areas including membership registration and transparency in the disclosure and reporting of the audit firms under sanctions. Based on these findings, the best practices adopted by the selected audit oversight bodies can be set as a benchmark for other countries in learning the pathway to improve financial reporting.

Key Words: Audit oversight, External Auditors, Audit Quality.

Introduction

The integrity of financial reporting depends highly on the financial reporting ecosystem, which among others comprises external auditors, directors and management. External auditors play an important role in gaining investors' confidence concerning the integrity of the financial information reported and disclosed in the audited financial statements. The primary responsibility of auditors is to express independent opinions on the reliability and fairness of financial information presented in the financial statements. Auditors act as

agents for the shareholders in determining whether the information presented by the management is true and reflective of the real state of affairs of a business. Nevertheless, shareholders may, at times, lose their confidence in the credibility of auditors. This is evident from previous experiences of corporate failure and accounting scandals, such as Enron, WorldCom and Parmalat. Such incidents arise when auditors do not meet public expectations, which give rise to questions concerning the quality of the audit work performed by auditors. As a consequence, the shareholders, in particular, and the public, in general, lose confidence in auditors and place the blame on auditors for not performing their custodial responsibilities to protect the interests of the shareholders.

Consistent with the agency theory, a need exists for auditors to monitor the management of businesses in order to ensure that the management provides true and fair information (Mohd-Ali et al., 2008). Auditors play a crucial role as gatekeepers to ensure the security of the financial eco-system. However, it is questionable whether the quality of auditors' work is always maintained. Malaysia has not been spared from financial scandals that have dragged auditors into the picture. Several cases, such as Transmile and Megan Media in early 2000, have attracted attention of the public, leading to questions concerning the quality of auditors' work. Both cases resulted in more than RM1.1 billions of losses to the shareholders, who are left bewildered at how the financial scandals could have been left undetected by the auditors for several years. When frauds of such magnitude occur, the obvious question is "Why didn't the auditors have a clue?" Auditors are drawn into the scandals and subject to blame.

With the occurrence of a number of unfavorable incidents of corporate failures, auditors have come under close scrutiny and the quality of their work is subject to examination. Some auditors perform substandard audits due to a lack of independence resulting from economic factors, such as the threat of losing profitable non-audit businesses (Mann et al., 2006). Other auditors may contribute to low quality audits due to the lack of human resource capacity, while some may be complacent with providing low quality audits simply because the substandard audit work will not affect them negatively in any way. During the period prior to major corporate failures such as Enron, formal monitoring mechanisms for the quality audit work was virtually non-existent. At that time, no independent bodies had been established to carefully review the work of auditors. The absence of proper monitoring mechanism has partly led to substandard audit quality performed by Arthur Andersen, Enron's auditor. At that time, the monitoring of the quality of audit work was limited to self-regulation and peer review (Wegman, 2008). As a result, doubts arose concerning the capability of the auditing profession to provide reliable assurance to shareholders. As such, a mechanism is necessary to oversee the work of external auditors to ensure their effectiveness in meeting the expectations of the various stakeholders.

Audit oversight bodies, as a mechanism to monitor the auditors' work, have been established in many countries around the world, including the United States of America, the United Kingdom, Australia, Japan, Singapore and Malaysia. To date, there is a lack of literature concerning the ability of audit oversight in enhancing the quality of financial reporting. Thus, the objective of the paper is to provide an insight on the roles of the different audit oversight bodies in six different countries. The paper provides evidence of audit oversight best practices in the selected countries that may be used for benchmarking purposes.

The remainder of the paper is organized as follows. Section 2.0 includes discussions on improvement of financial reporting that relates to the rationalization for the need of audit oversight bodies. Section 3.0 presents the research method adopted in carrying out this study and Section 4.0 analyses the audit oversight features, characteristics and best practices in the selected countries. Section 5.0 concludes the paper and provides some areas that could be potential for future research.

Driving the Improvement of Financial Reporting

The demand for auditing services arises from a need to facilitate dealings between the parties involved in business relationships, namely the shareholders, creditors, public authorities, employees and customers (Arrunada, 2000). The accounting profession is faced with increasing pressure from external parties to monitor and improve the quality of the audit process (Sutton, 1993). A number of extant studies examine different aspects of audit quality in an attempt to address the issues faced by the auditing profession, which include corporate collapses, expectation gaps and corporate governance.

Audit quality is viewed as one of the important factors that affect the credibility of financial statements (Arrunada, 2004). Users are more likely to demonstrate a high level of confidence concerning the information presented in financial statements if the audit of the financial statements is perceived to be of high quality. In order to remain competitive in today's environment, audit firms must continue to improve the quality of audit services provided and, hence, maximize the client satisfaction. Therefore, an assessment of the audit quality of audit firms must be performed in order to ensure that the audit processes implemented by audit firms are systematic, effective and comply with the relevant standards (Brinkley, 2006).

In the post-Enron era, the auditing profession has been closely monitored by regulators as part of the external mechanism of corporate governance of the firms. All over the world, auditors are bounded with the movement from the International Federation of Accountants (IFAC) to improve the quality of audit services provided to the clients. The assessment of audit quality has been extended to evaluate audit services at both the audit firm level and audit engagement level. Figure 1 summarizes the elements of both International Standards on Quality Control 1 (ISQC 1) and International Standards on Quality Control for Audits of Historical Financial Information (ISA 220).

Audit Firm Level Control (ISQC 1)	Audit Engagement level Control (ISA 220)
Leadership	Engagement partner's responsibility
Ethical requirements	Compliance with ethical requirements
Client acceptance and continuance	Client acceptance and continuance
Human resource	Engagement performance
Engagement performance	Engagement quality control review
Monitoring	Documentation

Source: Malaysian Audit Oversight Board (AOB)

Figure 1: Quality Control Elements of ISQC 1 (Audit Firm Level) and ISA 220 (Audit Engagement Level)

The ISQC 1 deals with the issue of firm wide quality control and contains requirements consistent with professional standards, regulatory and legal requirements that must be complied with by audit firms and their personnel in order to provide reasonable assurance on the appropriateness of audit services performed by the firm or engagement partners. On the other hand, the ISA 220 establishes quality control standards that are applicable at the individual audit engagement level.

Despite the existence of such standards, audit firms sometimes fail to see the association between audit quality and the benefits to be derived from the application of the standards, which may come in the form of improved reputation and market share and reduction in audit liability. A study by Esch et al. (2005) in South Africa highlights concerns regarding the implementation of the standards. Some of the issues identified in the study include the increase in compliance costs, a lack of guidance, the attitudes of audit partners, the evaluation of quality control reviews, consultation and documentation, the scope of the standards and the diversity and structure of an audit market (Esch et al., 2005). Similarly, in Malaysia, evidence shows that the implementation of ISQC 1 among small and medium audit firms is limited (Omar & Johari, 2007). Small and medium audit firms tend to operate based on non-standard operating procedures, which essentially do not reflect total compliance with ISQC 1.

Previous studies support the notion that the existence of standards (i.e., ISQC 1 and ISA 220) alone are not sufficient to maintain and improve audit quality (Esch et al., 2005; Omar & Johari, 2007). The various accounting scandals involving auditors have signaled the need for another mechanism that can provide for the enforcement of the standards. Oversight by an external and independent party in the structure is able to provide more stringent enforcement, which perceived as fair and justified.

Research Methodology

The study employed a sample of 6 audit oversight bodies out of the 38 audit oversight bodies currently exist around the world (IFIAR, 2011). The paper analyzed the audit oversight bodies in six selected countries: the United States of America, the United Kingdom, Australia, Japan, Singapore and Malaysia. The six countries are selected based on the fact that their audit oversight bodies have been the most established and most active in their role as bodies that oversee issues pertaining to audit quality in the respective country.

Based on the information extracted from online annual reports of selected countries' audit oversight bodies for the year 2012, the study examines the features, governance, characteristics, policies and practices adopted by the audit oversight bodies in those selected countries. A checklist is utilized to extract information from the annual reports and indicates the applicable policies and practices of the audit oversight bodies. The items examined encompasses information that relates to the governance and establishment structure of the audit oversight bodies (e.g. mandated acts that govern audit oversight bodies in the respective countries, specific vehicles that conduct audit oversight functions, types of audit firms under purview) and audit oversight practices adopted by the respective audit oversight bodies (i.e. membership and registration; inspection; inquiry, sanction and enforcement; and standard setting).

Roles Audit Oversight Functions in Selected Countries

All the six countries under study have in place a body that is entrusted to oversee the audit firms. The other audit oversight bodies under study are Public Company Accounting Oversight Board (PCAOB) of the United States of America, Financial Reporting Council (FRC) of the United Kingdom, Australian Securities and Investments Commission (ASIC) of Australia, Certified Public Accountants and Auditing Oversight Board (CPAAOB) of Japan, Accounting and Corporate Regulatory Authority (ACRA) of Singapore and Audit Oversight Board (AOB) of Malaysia.

In understanding the roles played by the audit oversight bodies, Table 1 illustrates the governance and establishment structure of the audit oversight bodies under study. The table shows that the audit oversight bodies in all the selected countries were established post-PCAOB in 2002. Although some of the countries established the bodies before 2002, audit oversight functions were only performed after 2002. For example,

FRC and ASIC were formed in 1991 and 1998 respectively, but the audit oversight functions (the Audit Inspection Unit in the case of FRC and the Audit Inspection Program in the case of ASIC) only began to be performed in 2003 and 2004 respectively. This demonstrates that the establishment of PCAOB has created greater awareness on the importance of audit oversight bodies in monitoring external auditors' work in the other countries.

Three of the six countries, namely the United States of America, Japan and Malaysia have independent and exclusive bodies that carry out the audit oversight function and examine audit related matters. Their establishments are exclusively for the purpose of monitoring the external auditors' work. The establishment structure in the United Kingdom, Australia and Singapore, on the other hand, represent organizations that are not formed exclusively for performing audit oversight functions. These organizations, which are not exclusive for audit oversight function, have specific vehicles that cover audit oversight matters. For instance the Audit Inspection Unit (AIU) was formed to perform audit oversight functions for FRC; the Audit Inspection Program (AIP) was formed to perform audit oversight functions for ASIC; and the Practice Monitoring Program (PMP) was initiated to perform the audit oversight functions in ACRA. The organizations also have extended functions in other areas, for example, FRC is involved in regulating actuarial bodies, ASIC is involved in the registration of companies and the regulation of financial markets while ACRA is engaged in the registration of companies or business entities.

Table 1 also shows that the audit oversight bodies are established under the respective countries' mandated legislations that provide the bodies with power and right to oversee the external auditors' work. The mandated legislations, while giving the power and right for the audit oversight bodies to carry out their functions, are also prescribing many other facets of legislations covering various scopes outside the audit oversight matter.

The audit oversight bodies have also defined the type of audit firms that fall under their purview. Generally, majority of the audit oversight bodies emphasizes their monitoring efforts on the larger scale audit firms. For instance, the United States, Australia and Malaysia specify that audit firms auditing public interest entities (PIEs) are their main focus (on the proxy that the audit firms auditing PIEs are those large firms) while the United Kingdom defines the audit firms that fall under its scope by looking at the market capitalization and turnover of the audit firms' clients. Japan and Singapore, on the contrary, do not indicate the audit firms under their purview by size but specifically describe the type of audit firms reviewed. All the audit oversight bodies under study have appointed board members, which are mandated in the legislative act. The number of appointed the board members ranges from as small as four members (PCAOB) to the highest of 18 members (FRC). The huge dispersion on the numbers of appointed board members could indicate extends of the comprehensive coverage carried out by the various bodies/organizations.

In meeting the objective of monitoring the quality of external auditors' work, the audit oversight bodies have in place structured practices implemented and enforced on both the auditors and audit firms. The most common functions performed by the audit oversight bodies in the different five countries under study include membership and registration; inspection; inquiry, sanction and enforcement; and standard setting. Audit oversight bodies in the five countries have different regimes in registering their members. Some audit oversight bodies register only the audit firms, while others made it compulsory for the audit firms to register their individual auditors.

In 2010, under the new reporting framework of PCAOB, registered audit firms are required to file their annual reports. The annual report of each firm must disclose information concerning the audit client's related practices, as well as the internal and external resources upon which the firm draws when performing the audit. Audit firms are also required to file special reports within 30 days of any particular event, such as

the withdrawal of an audit report when a client fails to comply with reporting requirements; a change in the number of audit clients above or below 100; and the commencement or conclusion of criminal proceedings or government-initiated civil proceedings against a firm, partner, shareholder, principal and others (PCAOB, 2009 and PCAOB, 2010).

Table 1 Governance and Establishment Structure

	Audit Oversight Board (AOB Malaysia)	Public Company Accounting Oversight Board (PCAOB United States of America)	Financial Reporting Council (FRC United Kingdom)	Australian Securities and Investments Commission (ASIC Australia)	Certified Public Accountants and Auditing Oversight Board (CPA AOB Japan)	Accounting and Corporate Regulatory Authority (ACRA Singapore)
Year of establishment	2010	2002	1991 (AIU 2003)	1998 (AIP 2004)	2004	2004
Establishment Structure	Independent body	Independent body	Audit Quality Review (AQR) (Formerly known as Audit Inspection Unit (AIU))	Audit Inspection Program (AIP)	Independent body	Public Accountants Oversight Committee (PAOC) administering Practice Monitoring Program (PMP)
Mandated Legislation	Securities Commission (Amendment) Act 2010	Sarbanes-Oxley 2002	The Companies (Audit, Investigations and Community Enterprises) Act 2004	Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosures) Act 2004 and Corporations Act 2001	Certified Public Accountants Act (CPA Act) and Article 6 of the Act for Establishment of the Financial Services Agency	Formed by the merger of Registrar of Companies and Businesses and Public Accountants Board in 2004 and govern by the Accountants Act
Type of audit firms reviewed	Audit firms auditing public interest entities (PIEs). PIEs include public listed companies, government linked companies, financial institutions, brokers and fund managers.	Auditors of public companies, as well as the auditors of brokers and dealers.	Audit firms auditing entities include incorporated companies with listed equity and/or listed debt, plus quoted companies with market capitalization in excess of £50M and others, and other unquoted companies with turnover in excess of £500 million.	Audit firms auditing significant public interest entities (PIEs), focusing on entities and industries with perceived heightened risks.	To inspect CPAs, audit firms, foreign audit firms, and the Japanese Institute of Certified Public Accountants (JICPA)	Public accountants, accounting corporations, accounting firms or accounting limited liability partnership
Members of the Board/ Commission	7	4	16-18	5	9-10	7

The observations indicate that the audit oversight bodies are primarily involved in the inspection of firms that audit public-interest entities, especially the Big Four (Ernst & Young, PricewaterhouseCoopers, Deloitte and KPMG) and the medium size auditors. The Big Four and some medium size auditors are inspected on an annual basis, while others are inspected at least once in three years. Certain countries, such as Australia and Singapore, also extend their audit oversight inspections to smaller firms that conduct audits on non-public-interest entities. The analysis of the selected audit oversight bodies shows that oversight functions involve two types of audit inspections: firm reviews (based on ISQC 1) and engagement reviews (based on ISA 220).

The audit oversight bodies are at times selective in their inspection scope. The AIU, for instance, focuses on a number of specific issues during its reviews. For example, in 2010/11, the areas of attention where the fair value measurement of assets and liabilities; the impairment of assets (including goodwill and other intangible assets); revenue recognition and fraud risks; segmental reporting; the evaluation of going concern; and compliance with ethical standards (FRC, 2011). The selection of specific areas allows AIU to be more focused during inspections and more standardized during the evaluation of audit firms. Firms that audit more than ten entities within AIU's scope are subject to full scope inspections. Meanwhile, firms that audit up to ten entities falling within AIU's scope are limited to a review of individual audit. The AIU monitors the responses of the audit firms to AIU's inspection findings to ensure an optimal contribution to the improvement in the overall quality of audit work. This view is supported by the outcome of follow-up reviews of individual audits undertaken by AIU, where it usually discovered that all or most matters identified during the review have been satisfactorily addressed. The AIU focuses on specific areas where flaws could most likely occur, such as by determining whether sufficient appropriate audit evidence was documented to support the key conclusions made by auditors. Some of the major findings found during such reviews are a lacking of audit documentation and evidence; an absence of professional skepticism; and non-audit service issues.

As such, the inspection program by AIP emphasizes the assessment of the audit quality of firms through engagement file reviews. On the other hand, smaller firms are only subjected to an inspection of limited scope due to the size, client profile and nature of the firms. The inspection of a smaller firm also includes reviewing one listed entity audit engagement file and inquiring about the key features of the quality control systems of a firm. The AIP focuses on key risk areas for each audit. The objective of the review is not to uncover minor instances of non-compliance, but to concentrate on reviewing the independence systems and processes of each firm. Only a limited testing of each firm's system will be conducted. In addition, each firm's audit methodology is scrutinized to determine whether the firm complies with auditing standards in Australia (ASIC, 2009-2010). Essentially, the review focuses on the substance of the work performed, such as on the issues of auditor independence and the assessment of fraud risks. The AIP also examines whether sufficient appropriate audit evidence is available to substantiate the conclusions reached of the audit assignments.

In Japan, the audit oversight body under CPAAOB is JICPA, which conducts quality control reviews on auditors. The JICPA conducts assessments of the general affairs; deliberates disciplinary actions against CPAs and audit firms; and conducts CPA examinations. On the other hand, the Office of Monitoring and Inspection oversees the quality control review process. The CPAAOB makes recommendation to the Commissioner of the Financial Service Agency concerning administrative dispositions and other measures when audit firms fail to comply with laws and regulations; or the quality control reviews are not properly performed by JICPA. Alongside ensuring the effectiveness of oversight, CPAAOB also perform on-site inspections of JICPA, audit firms and audit clients (JICPA, 2010). Once every three years, JICPA reviews and assesses whether audit firms have complied with laws, regulations and audit standards in principle. The CPAAOB examines the reports of JICPA after receiving the results of the review. When necessary during the course of examinations, CPAAOB may request the submission of reports or other materials from JICPA or audit firms. Based upon the results of the examination, CPAAOB will inspect JICPA, audit firms and any other related entities, including audited companies. This is conducted in the event that CPAAOB finds such inspections necessary and appropriate for public interest or investor protection. The CPAAOB may also perform such procedures, when it deems necessary, to ensure the appropriate operation of JICPA. Among the findings discovered are on the assessment of audit risks and fraud risks. Based on the results of an inspection, CPAAOB may make recommendations for administrative actions or other measures to ensure the performance of fair and reliable audit services by audit firms; and/or to ensure that the administrative operations of JICPA are fair and equitable (JICPA, 2010).

Under PMP practice, a review stage exists that is referred to as a 'hot review'. Such reviews occur when public accountancy work that fail to meet accounting and auditing standards or statutory requirements are required to be reviewed by another suitably qualified person. Further action by ACRA may include issuing 'revisit orders', which are issued to public accountants that are still allowed to practice despite failing to meet the expected standard in certain areas. However, such firms are required to have three audit engagements reviewed by a suitably qualified person as a 'peer reviewer' after audit opinions are signed. The procedure is designed to ensure that the 'peer reviewer' assigned can act as a mentor and advise the public accountant concerning adherence to any requirements of ACRA (ACRA, 2010).

The PCAOB utilizes non-public disciplinary proceedings, which allows accounting firms to continue performing audits without public notice of pending charges. While the PCAOB disciplinary proceedings are currently non-public proceedings, PCAOB has submitted a request to the US Congress to amend SOX in order to allow for disciplinary proceedings to be conducted publicly (PCAOB, 2010). The PCAOB is seen as the most active audit oversight body in regards to penalisation and sanctions. The PCAOB imposes sanctions in instances that involve a failure to comply with the prescribed requirements, including monetary penalties; the suspension of practicing licenses; and the cancellation of the registration or license of audit firms. Additionally, the process of penalizing audit firms through the use of sanctions includes transparent

disclosures and reporting. The PCAOB annual reports provide extensive details of the cases by publishing the names of audit firms which are under sanctions and publicly disclosing the actions taken against the firms. Some of the main concerns regarding the practices of audit firms in the United States are relate to the lack of audit documentation and evidence; reporting issues; inconsistencies in fair value measurements and impairments of assets; and going concern issues.

Conclusions and Areas for Future Research

The existence of audit oversight bodies is undeniably important in regulating the work of external auditors, particularly concerning audit quality. Although auditors are obliged to adhere to auditing standards when conducting audit work, evidence suggests that this may not be sufficient for auditors. External evaluations performed by independent bodies are seen as providing greater value for improving audit quality. As such, the audit oversight body is seen as an indispensable mechanism for auditing the auditors.

The present study suggests few recommendations for the roles of audit oversight become more visible. The first suggestion is made in relation to increasing the membership registration. Firmer actions regarding audit firms and/or individual auditors who have failed to register with the respective countries' audit oversight bodies should be imposed, such as by restricting their access to primary clients. The issuance of a warning letter to those who have failed to register may be seen as just an administration act without any serious implication. The second suggestion is to increase the transparency in reporting of individual auditors and audit firms against whom action has been taken. Such action could create awareness among other audit firms to be vigilant in their practices and to maintain good quality of audit work. These practices, however, should be reviewed and adjusted to suit the country-specific environment.

Among the oversight bodies examined, PCAOB is seen as the most mature, with a more structured framework and varied practices. One of the highlighted strengths of PCAOB relates to the transparency of the sanctions imposed. In the United States, information concerning audit firms under sanctions is made publicly available. As a result, the potential reputational impacts of the sanctions are greater and can motivate audit firms to continuously improve its quality of audit work. In the case of ACRA in Singapore, the 'hot review' and 'revisit orders' are two mechanisms that have proven to work effectively in safeguarding the quality of the audit work.

The learning process for the audit oversight bodies should be dynamic and its oversight practices should be fairly benchmarked against other comparable matured oversight bodies. Vast learning opportunities exist that should be captured by the audit oversight bodies. For future research, it is suggested that a study can be conducted to evaluate and measure the impact of the audit oversight bodies in improving financial reporting.

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