

Factors Influencing Audit Quality: With Evidence

* *Abbas Ali Pouraghajan*

INTRODUCTION

Recent corporate scandals such as in Enron and World Com have focused the world's attention on whether audit firms are supplying audits of sufficient high quality. The concern about the quality of accounting numbers and its relation with the quality of the auditing process is increasing over time, following the periodical clusters of business failures, frauds, and litigations (Chambers 1999). Audit quality refers to the auditor's ability to detect and report accounting misstatements. DeAngelo (1981) provides a frequently cited definition of audit quality, defining it as joint probability that an auditor will both discover and report, a breach in the client's accounting system. The discovery of a misstatement measures quality in terms of auditor's knowledge and ability, while the reporting of the misstatement is dependent upon the auditor's incentives to disclose. Financial statement users lack access to the evidence gathered during the audit process and to the information audited, and thus cannot assess actual audit quality directly.

SEC Chairman, Arthur Levitt (Levitt 1998) questioned the thoroughness of financial statement audits and challenged the accounting profession to enhance the quality of financial reporting in the light of several prominent accounting failures (e.g., Sunbeam and W.R. Grace).

Wallace (1980) claimed that investors demand audited financial statements because these statements provide information that is useful in their investment decisions. This implies that the audit process adds some value to accounting information and is valued as a means of improving the quality of the financial information. Hence, an audit is an attestation of financial reports that are represented by managements and assesses the truth and fairness (or in the minds of some, validity) of those financial reports. This highlights two factors: (1) that the financial reports are indeed simply representations of managements and are not primarily the responsibility of the auditor, and (2) it is the auditor's responsibility to attest the validity and reliability of those reports. For the attestation to be of worth, it must have two crucial requirements. First, the attestation needs to be competent. That is to say, it needs to be undertaken by experts in the field of auditing (this expertise may extend beyond auditing to industry specific, asset/liability or transaction expertise) and may involve the necessity of having competent audit technologies and processes to undertake the audit. Secondly, for an audit to be valuable, it must be undertaken independent of management. That is to say the judgment exercised by the auditor needs to test the assertions made by the management and not simply concur with them. This attestation process is both competent and independent of the management of the entity, and it adds to the market's perception that the financial reports are both valid and reliable. Therefore, existence of both-competency and independence- are necessary conditions for the audit to be value adding; one cannot be a substitute for the other. There are numerous factors that can affect audit quality from the auditor's perspective, including auditor ability and economic incentives (Yardley et al. 1992). The audit quality literature can be divided into two major areas- supply side research and the demand side research. Supply side research focuses on factors affecting the auditor's ability to supply a quality audit. In contrast, demand side research is primarily concerned with factors affecting the client and audit report users, such as shareholders, creditors, and regulators. In this paper, focus is laid on the importance of audit quality and the effect of some factors on audit quality.

IMPORTANCE OF AUDIT QUALITY

The literature on auditor characteristics suggests that auditors provide two valuable roles to capital market participants: an information role and an insurance role. Auditors provide independent verification of manager prepared financial statements and can discover and report breaches in a client's accounting system (Watts and Zimmerman [1981], DeAngelo [1981]). In all markets, the established practice of fairness and transparency is an essential element in the issuing and trading of securities. Wallace (1980) claimed that investors demand audited financial statements because these statements provide information that is useful in their investment decisions. This implies that the audit process adds some value to accounting information and is valued as a means of improving the quality of the financial information.

* *Department of Accountancy, Islamic Azad University, Ghaemshar Branch, Iran.*
E-mail : abbas_acc46@yahoo.com

The auditing process is supposed to serve as a monitoring device (Wallace 1980) that will reduce managers' incentives to manipulate reported earnings. Therefore, it is hypothesized that higher the auditing quality, lower the earnings management activities by managers, *ceteris paribus*. The potential conflicts of interests among owners, managers, and other security holders create an environment in which an outside auditor may contribute significant value to investors. In fact, recent high profile misstatements and fraud by large corporations have brought increased scrutiny of the role that public firm auditors play in financial markets. The demand for auditing arises from the auditor's monitoring role in the principal agent relationship. According to agency theory, an agency relationship is a contract under which one or more principals engage an agent to perform some service on the principals' behalf and delegate the decision-making authority to the agent (Jenson and Meckling, 1976). The financial statement audit is a monitoring mechanism that helps reduce information symmetry and protects the interests of the principals, specifically, stockholders and potential stockholders, by providing reasonable assurance that the management's financial statements are free from material misstatements (Watts and Zimmerman, 1986).

Jacobides and Croson (2001) define monitoring as collection of any information by the principal in the agency relationship. An audit is one monitoring mechanism. It helps stockholders to collect reliable information. Auditing serves to reduce information asymmetry and the reduction in information asymmetry is an indicator of the level of audit quality. Auditors reduce information asymmetry between managers and stakeholders by providing reasonable assurance that the financial statements are free of material misstatements (Becker, *et al.*, 1998).

On the other hand, the concern about the quality of accounting numbers and its relation with the quality of the auditing process is increasing over time, following the periodical clusters of business failures, frauds, and the litigation (Chambers 1999). The value of an audit comes about only if two quality components are present- competence and independence. An audit that is competently undertaken but not independent of management amounts to an audited financial report, which is nothing more than the mere representations of management.

The existence of both, competency and independence are necessary conditions for the audit to be a value adding and one cannot be a substitute for the other. Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement (Mautz and Sharaf, 1961).

Competency enhancements include (1) hiring and rewarding of particularly expert people, (2) development of technologies that enhance the audit process, (3) establishment of data sets that facilitate benchmarking, and (4) the use of global networks of research information, to mention a few.

While the primary responsibility for the quality of financial statements is with the management of the company producing those statements, external auditors provide independent assurance about that quality. That audit results will be relied on and recommended of audit quality improvements will be seriously considered and implemented. The organization's reputation for consistent high-quality work helps ensure that decision makers will more readily and more surely accept findings and implement recommendations. Only where this attestation process is both competent and independent of the management of the entity, does it add to the market's perception that the financial reports are both valid and reliable. Financial information that is perceived to be more valid and reliable means that the information provided has lower risk. Therefore, financial reports that have attached to them a competent and independent audit have lower information risk in the market; lower risk results in higher stock price. Audits do, therefore, add value to a company and have the potential to affect stock prices. Therefore, relative to competency levels, quality of independence is difficult to observe even in the most intimate of circumstances. There is a presumption by auditees and those interested in the audit process that independence exists, but its existence is taken on trust rather than having any substantive underlying evidence for belief in it. If this trust disappears or is eroded in any way, the outcome is likely to involve skepticism and, as a consequence, the outcome in terms of depleted value attributed to audit will be more exaggerated than would otherwise be the case.

DEFINITION OF AUDIT QUALITY

Audit quality refers to the auditor conducting the audit in accordance with Generally Accepted Auditing Standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with Generally Accepted Accounting Principles (GAAP) and (2) are not materially misstated whether due to errors or fraud.

This definition assumes that reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with GAAS and that, within the requirements of GAAS, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record, and reporting the reason for the resignation to the SEC.

Audit quality describes how well an audit detects and reports material misstatements of financial statements, reduces information asymmetry between management and stockholders and thus helps protect the interests of stockholders. High audit quality should be associated with high information quality of financial statements because financial statements audited by high quality auditors should be less likely to contain material misstatements. Audit quality contributes to the credibility of financial disclosures, and to the extent contracting with the firm is made less costly, and reduces the cost of capital (Jensen and Meckling [1976], Watts and Zimmerman [1986], Ball [2001]). In addition, because investors often use audited financial statements as the basis for asset allocation decisions, securities law provide recourse for the investor against the auditor. In this way, auditors provide investors with a means to indemnify losses (Kellogg [1984], Wallace [1988], Stice [1991], Dye [1993]).

DeAngelo (1981) define audit quality as the market assessed joint probability that a given auditor will both detect material misstatements in the client's financial statements and report the material misstatements. This definition of perceived audit quality since DeAngelo (1981) emphasizes the role of the market in assessing audit quality. The willingness to report discovered material misstatements is defined by DeAngelo (1981) as auditor independence. Therefore, according to DeAngelo's (1981) definition, audit quality is a function of the auditor's ability to detect material misstatements (auditor competence) and auditor independence. DeAngelo (1981a) has argued that audit quality depends on the joint probability of an auditor discovering and disclosing a problem in an accounting system. Given that a problem has been discovered, the probability that an auditor discloses the problem depends on the degree of independence. DeAngelo (1981a) and Watts and Zimmerman (1981, 1986) define audit quality as the probability that an auditor will both discover and truthfully report a discovered breach, and suggests that the probability of reporting is a function of independence. Since high quality independent auditors are more likely to detect and object to the client firm's use of aggressive and questionable accounting practices, earnings management is expected to decrease as audit quality improves.

Palmrose (1988) defines audit quality in terms of level of assurance. Since the purpose of an audit is to provide assurance on financial statements, audit quality is the probability that financial statements contain no material misstatements. Davidson and Neu (1993) provide an audit quality definition that is based on the auditor's ability to detect and eliminate material misstatements and manipulations in reported net income.

Lam and Chang (1994) suggest that audit quality should be defined on an engagement-by-engagement basis rather than on a firm basis. Elliott and Jacobson (1998) refer to a two-pronged requirement for audit quality-objectivity and competence. They believe that objectivity can result from perfect integrity, perfect independence, or some adequate combination of the two.

Most empirical audit quality research 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 [AICPA, 1994].

FACTORS INFLUENCING AUDIT QUALITY

There are a lot of factors that have been examined by previous studies on factors influencing audit quality. Some of these factors including size of auditor, reputation or brand name of audit firm, tenure of audit firm serving the need of a given client, provision of non audit services, industry specialization, competition in the audit services market, the existence of audit committee etc. Here the author considers three items that are influencing audit quality.

SIZE OF AUDITOR

Recent accounting scandals raise serious concerns among financial markets regulators, operators, investors, and academic researchers on the credibility of financial reporting. It becomes necessary to assess the extent of earnings management or identify what kinds of firms are engaged in earnings management. The firm size has positive impacts on earnings management because large firms usually have strong internal control systems and governance

mechanisms, can access high quality services from large CPA firms, and care for its reputations. These factors may discourage earnings management. In contrast, however, the large firms may also face more pressure to report positive earnings or earnings increases have more bargaining power in negotiation with auditors, have higher abilities to maneuver given wide range of accounting treatments available, and have stronger management power to make it easier to manipulate earnings.

Large firms have usually grown up with a long history during which they may have had better appreciation of the market environment, better control over their operations and better understanding of their businesses relative to small firms. They may have established their credibility in the business community and social responsibility, including the credibility of financial information disclosed by these firms because large firms are more able to use their best expertise and modern information technology to generate reliable and timely information compared to small firms. Hence, the cost of engaging in earnings management will be higher for large firms than small firms. Therefore, their concern about reputations may prevent large firms from manipulating earnings.

Larger audit firms have better financial resources, research facilities, superior technology and more talented employees to undertake large company audits than smaller audit firms. Their larger client portfolios enable them to resist management pressure whereas smaller firms provide more personalized services due to limited client portfolios and are expected to succumb to management requirements (Lys and Watts, 1994). The focus on auditor size assumes that larger auditors have more valuable reputations and, therefore, stronger incentives to perform high-quality audits (DeAngelo 1981).

DeAngelo (1981) has theoretically analyzed the relation between audit quality and auditor's size. She argued that large auditors will have more clients and their total fees will be allocated among those clients. Defining the auditor's independence by the conditional probability that the auditor will disclose any misstatement in financial statements given that this misstatement was already discovered, DeAngelo (1981) argued that large auditors will be more independent and, therefore, will provide higher quality of audit.

DeAngelo (1981) argues that large auditors have more incentives to be accurate because they have more client-specific rents to lose if their reports are not accurate, she analytically demonstrates that auditor size is positively related to audit quality. In her study, auditor size is measured by number of clients. She argues that since auditors earn client-specific quasi-rents, auditors with more clients have more to lose by failing to report discovered misstatements in financial statements.

Following DeAngelo's (1981) argument that the size of audit firms is positively associated with audit quality, many studies use size (Big 8/6/5 vs. non-Big 8/6/5) as the audit quality proxy (Krishnan, 2003; Becker *et al.*, 1998; Firth and Smith, 1992; Nichols and Smith, 1983).

The deep pockets hypothesis used by Dye (1993) who argued that large auditors will be more accurate because they have greater wealth that is exposed to risk in case of any litigation. Lennox (1999) examined the relation between auditor size and litigation and found greater support to the deep pocket hypothesis than reputation hypothesis. Lennox (1999) looked at the two explanations of the hypothesized positive relation between audit quality and auditor size. Colbert (1998) focused on small CPA firms and the peer review activities between such firms and found some evidence that the auditor quality is positively associated with firm size. Many audit quality studies indicate that when accounting firm size is used as the indicator of audit quality, higher audit quality is associated with less information asymmetry and higher information quality. The results of studies that test the relationship between audit quality and audit firm size using other proxies for audit quality (e.g., Teoh and Wong, 1993; Palmrose, 1988) usually support the hypothesis that audit quality and audit firm size are positively associated. The results of some empirical papers have provided additional support for the use of auditor size as a proxy for audit quality. Davidson (1993) used an indirect method to support the argument that size is a good proxy for auditing quality. He argued that managers have incentives to manipulate the reported earnings to meet the analysts' forecasts. Therefore, if large auditing firms provide higher-quality audits than small auditing firms, we may expect the forecast errors of big auditing firms' clients to be larger. Using data for Canadian firms, his results support expectation, indicating that the auditor size is a good proxy for auditing quality.

Pearson (1985) found the level of auditor independence to be positively associated with size of the audit firm. Large audit firms did not rely on revenue from a single client because the impact to their financial position was not

material, as compared to smaller audit firms. Pearson (1985) reported that smaller firms would experience more difficulty in resisting client pressures in situations of conflict.

On the issue of the association between size of audit firm and users' perception of the reliability and therefore confidence in the information content of financial statements, Goldman and Barley (1974) argued that companies tend to switch from small to large audit firms during initial public offerings (IPO) due to the high reliance of banks and financial analysts on the reports certified by large audit firms. Consistent with this argument, McKinley et al. (1985) discovered that the type and size of the audit firm were positively associated with auditor independence. The respondents indicated that financial statements audited by Big Eight audit firms would be less likely to contain undetected fraud (proxy to measure financial statements reliability) as compared to those audited by smaller firms.

TENURE

Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement (Mautz and Sharaf, 1961). The literature has long been concerned that the duration of the relationship between the auditor and the client potentially affects audit quality, but contains conflicting arguments (e.g., Mautz and Sharaf 1961; Shockley 1981; Lyer and Rama 2004). The general concern is that as this relationship gets longer, auditors are more likely to accede to their client's accounting and reporting choices in order to retain the client. Regulators have pushed for mandatory auditor rotation. However, recent accounting scandals, involving corporations such as Enron in the US and HIH Insurance in Australia, have cast doubt over the independence of auditors and overall value of auditing. In particular, the economic dependence resulting from the provision of non-audit services, the familiarity developed from lengthy auditor tenure, and personal relationships built through alumni employees have been alleged to contribute to this erosion of auditor independence. In order to restore public confidence, policies such as mandatory audit partner rotation, prohibition/disclosure of certain NAS have been initiated by regulators and accounting bodies in the US, Australia and elsewhere (Sarbanes Oxley Act, 2002; SEC 2000). We define audit-firm tenure as the number of consecutive years in which the audit-firm client (audit-partner client) relationship exists. Since, at certain times one audit partner resigns and the other remains. According to Section 207 of the Sarbanes-Oxley Act, mandatory rotation refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer. Previous studies which empirically examined the association between audit tenure and abnormal accruals (e.g. Johnson et al. 2002; Myers et al. 2003), defined audit tenure as the number of years that a client has retained its "audit firm" rather than the lead or the coordinating "audit partner" which is stated in the SOX Act.

Auditor tenure has two aspects: the tenure of the audit firm and the tenure of individuals engaged in the audit, particularly the engagement partner. Although both have been tested in the literature, the emphasis has been on audit firm tenure due to difficulties in identifying the engagement partner in most countries. The linkage between auditor tenure and audit quality is not clear. Some argue that longer tenure improves audit quality through learning, while others argue that longer tenure decreases audit quality because of independence concerns. The auditor independence hypothesis posits that audit quality is compromised as auditor tenure increases, while the auditor expertise hypothesis contends that audit quality increases with auditor tenure.

The auditor independence hypothesis incorporates three different arguments as to why audit quality might decrease as auditor tenure increases. First, over time, the auditor's incentives shift towards maintaining and profiting from the client and the audit. The prospect of "client-specific rents" that the auditor can extract only over time may create an economic dependency on the client concerned, which impairs auditor independence (DeAngelo 1981a, 1981b; Magee and Tseng 1990). Second, as the auditor-client relationship lengthens, auditors may develop a "learned confidence" in the client (described in the IFAC Code of Ethics as a familiarity threat), which may result in the auditor not testing financial report assertions, anticipating results instead of being alert to anomalies, using less rigorous audit procedures or using static audit programs (Hoyle 1978; Shockley 1981; AICPA 1992; Arrunada and Paz-Ares 1997; Johnson et al. 2002; GAO 2003). Third, a long relationship between a client and its auditor may lead to the development of personal relationships to the extent of developing bonds of loyalty, trust or emotive relationships (psychological dependence) so that truly independent auditor behavior becomes difficult (AICPA 1992; Arel et al. 2005). The consequences of diminished independence with long auditor tenure include the increased

likelihood of the auditor acceding to client pressure in relation to their choice and application of accounting policies and, at the extreme, the possibility that excessive familiarity results in collusion between the auditor and the client (McLaren 1958).

The auditor expertise hypothesis is based on information asymmetry between the client and the auditor, which reduces over time as auditors acquire client-specific knowledge. Because increased client-specific knowledge provides a comparative advantage in detecting material misstatements in financial reports, the lack of this knowledge in the early years of an audit engagement may result in a lower quality audit (Beck et al. 1988; Hoyle 1978; Knapp 1991; Solomon et al. 1999).

Additionally, low-balling theory also implies that it is important for auditors to keep their clients in the early years of engagements to recoup the initial investment in the clients. Thus, these assertions predict that audit quality improves with auditor tenure. Additionally, if the assimilation of client-specific knowledge and development of learning experience is very important for auditors to conduct high quality audits, then mandatory rotation that disturbs the accumulation on client-specific expertise will hurt audit quality.

The Sarbanes-Oxley Act of 2002 requires that the lead audit partner and audit review partner be rotated every five years on public company engagements. Proponents of the SOX Act suggest that rotation could significantly improve the overall quality of an audit and enhance the quality of the financial reporting process.

Geiger and Raghunandan (2003) used knowledge and independence arguments when questioning whether the length of auditor–client relationship was related to the issuance of going concern opinions for bankrupt companies. Their results indicated that the likelihood of a company receiving a going concern opinion prior to bankruptcy was lower when auditors were in the initial years of the engagement.

Farmer et al. (1987) pointed out that auditors could be inadequately influenced if they perceive a risk of losing the client when they do not agree with managers' financial reporting preferences.

Dopuch et al. (2001) find that mandatory rotation reduces the auditor's willingness to issue biased reports. Dopuch et al. conclude that mandatory rotation, with or without mandatory retention requirement, can increase auditor independence. Also, using a model to analyze the cost and benefit of mandating the rotation of auditors, Gietzman and Sen (2002) conclude that in certain well-defined circumstances, mandatory rotation of auditors is a desirable policy. In audit markets with relatively few new client opportunities, removing the ability of management to influence the auditor reappointment decision can improve the incentives for auditors to maintain independence.

Davis et al. (2003) show a positive relation between discretionary accruals and auditor tenure and conclude that audit quality decreases with longer auditor tenure. Similarly, Casterella et al. (2002) find that audit failures are more likely when auditor tenure is long, supporting the view that longer the tenure, the lower audit quality.

Johnson et al. (2002) find that the absolute value of unexpected accruals is higher in the early years of audit firm tenure. Myers et al. (2003) report a negative relation between audit firm's tenure and earnings quality measured by discretionary accruals and special items. Myers et al. (2003) indicate that the quality of reported earnings improves with audit firm tenure.

Brody and Moscovice (1998) asserted that auditor rotation enhances greater independence through a reduction of clients' inadequate influence on auditors.

Farmer et al. (1987) pointed out that auditors could be inadequately influenced if they perceive a risk of losing the client when they do not agree with managers' financial reporting preferences. Mansi et al. (2004) document an inverse relation between firms' cost of public debt and auditor tenure. Ghosh and Moon (2005) show that the impact of reported earnings on (1) stock returns, (2) stock rankings, and (3) analysts' one-year-ahead earnings forecast is directly related to the length of the auditor–client relationship.

REPUTATION

A longstanding view in accounting literature holds that the demand for audit quality is driven by information asymmetry and conflicts of interest between managers and investors (Dopuch and Simunic 1980; Watts and Zimmerman 1983, 1986; Healy and Palepu 2001). Managers can enhance the credibility of their firms' financial reports by subjecting them to an independent audit. The higher the quality of the audit presumably, stronger the assurance to investors that the financial reports are free from material misstatements. Investors do not observe

directly the quality of an audit though, but instead tend to rely on the auditor's reputation or brand name as an indicator of financial reporting credibility. Not surprising then, the manager's point to reputation as a key factor in their choice of auditor (GAO 2003). The primary role of financial reporting is to provide current and potential investors with information useful in making rational investment decisions (FASB 1978, 34). Financial reporting mitigates information and agency problems between managers and investors (Watts and Zimmerman 1986; Healy and Palepu 2001).

An auditor with a tarnished reputation would not provide investors with sufficient assurance that managers are reporting in accordance with generally accepted accounting principles (GAAP) and complying with contractual requirements. Information problems arise when managers have incentives to overstate their firm's prospects to attract investors, whereas agency problems arise when managers have incentives to misallocate or expropriate investors' funds. An independent audit can weaken these incentives by assuring investors that managers are reporting in accordance with GAAP and complying with contractual requirements (Dopuch and Simunic 1980; Benston 1985; Watts and Zimmerman 1983, 1986; Healy and Palepu 2001).

Investors' perceptions about reputation are influenced by multiple sources, including corporate financial reports, analyst reports, and press coverage (Fombrun and Shanley 1990). Because financial reports play a crucial role in investor decision-making, a strong reputation for credible reporting enhances investors' confidence that managers will actually report truthfully and fulfill their contractual duties, thus reducing the cost of capital (e.g., Beatty and Ritter 1986; Milgrom and Roberts 1986). A reputation for credible reporting is built over a long period based on consistent behavior; it may be lost quickly through an action that investors deem unacceptable (Fombrun and Shanley 1990; Podolny 1994; Fombrun 1996). Reputations are most valuable in highly uncertain environments (Kreps and Wilson 1982; Shapir 1983; Weigelt and Camerer 1988).

The impact of a service provider's reputation on its clients has been a topic of great interest in financial literature. However, the impact of reputation losses of service providers has not received as much attention. Since brand name is one of the most visible, low cost and easily available information regarding an incumbent auditor, it should be included in any experimental study on the perceptions of auditor independence and audit quality because these assessments cannot be complete if the auditor's brand name is excluded or unknown. The brand name variable was operationalized at two levels, Big Six and non-Big six auditors. In fact, a firm's ability to repeatedly deliver goods and/or services of high quality is the cornerstone of the reputation building process (Klein and Leffler (1981); Shapiro (1983)). Specifically, in auditing theory, there are two competing forces that influence auditors' reporting strategy when they discover a breach from a given client: economic dependence and reputation protection (Reynolds and Francis 2001).

According to the economic dependence, auditors would compromise their independence and report favorably in order to earn future quasi-rents by retaining clients. Alternatively, the reputation protection incentive leads the auditor to refrain from compromising independence to avoid lower audit fees from potential new clients (Davis and Simon 1992) or being fired by some of their existing clients (DeAngelo 1981b). If the important client is the auditor's "core asset", i.e., the negative effect of loss of reputation is extremely severe, then there is a tradeoff between economic dependence and reputation protection on the important client.

Slovin, Sushka, and Hudson (1990) find that the stock price reaction to the announcement of a seasoned equity offering is a positive function of the quantity of bank debt, the quality of the firm's investment banker, and the quality of the auditing firm. The result indicates that the deteriorating reputation of Arthur Andersen might exacerbate the negative announcement effects of their client's firms.

Carter and Manaster (1990) find a negative relation between initial public offering (IPO) under pricing and underwriter reputation. More importantly, Carter and Manaster (1990) provide evidence that low dispersion issuers signal their low risk characteristics by engaging prestigious underwriters who, in order to preserve their high reputation; market only IPOs of low dispersion firms. The rationale for this standard is that larger audit firms supply higher quality because they have more to lose than smaller firms with respect to reputation. In the light of recent events, a particularly interesting study by Reynolds (2000) finds that economic dependence (within a particular office) does not cause Big Five auditors to report more favorably. In fact, Reynolds' findings support the notion that reputation dominates auditor behavior.

Based on Shockley's [1981] results, it is expected that Big Six auditors' perceptions of auditor independence will be influenced by audit brand name reputation while the non-Big six auditors' perceptions will not be affected. Big Six auditors will rate auditors in their same brand name class as more independent, i.e., they are more likely to report a discovered misstatement and that there will be no difference in perceived independence between the two types of auditors for non-Big Six auditors.

In 2001, Andersen and the other Big 5 public accounting firms audited about 76 percent of U.S. publicly traded firms, representing 98% of public company sales. The Big 5 also controlled the global market for audit services. Because of their sheer size, these auditors were viewed as having the scale, technical expertise, and reputation incentives to uncover and expose most financial reporting irregularities.

Healy and Lys [1986] regard the auditor's investment in reputation capital as a bond, which guarantees audit clients that they will receive the audit quality that was contracted for and the brand name of the auditor signals to financial statement users the quality of the audit firm. High reputation auditors maintain a high level of audit quality by diligently detecting misstatements and disclosing them in the audit report. DeAngelo [1981b] argues that audits conducted by Big Eight firms were more likely to discover the presence of material errors in financial statements compared to smaller firms as they possess technological advantages over their competitors. We can say Auditors' assess of audit quality as higher when the audit is conducted by a Big Four auditor compared to when the audit is conducted by a non-Big four auditor. Also we can say auditors' assess the auditor to be more independent when the audit is conducted by a Big four auditor compared to when the audit is conducted by a non-Big four auditor. Auditors' assess the auditor to be more likely to discover the material misstatement when the audit is conducted by a Big four auditor compared to when the audit is conducted by a non-Big four auditor.

CONCLUSION

Corporate fraud and accounting scandals around the world have led to a heightened focus on the regulation of auditors, audit quality and auditor independence. Perhaps the most visible and significant results of a focus on audit quality has been the establishment of national auditor oversight authorities, and the strengthening of audit standards and their enforcement with a significant emphasis on independence. The heightened focus on audit quality is a positive development for investor assurance and confidence. However, in order for capital markets around the world to receive the maximum benefit from increased investor confidence, the auditor independence regulations and requirements supporting that confidence need to be robust, conceptually sound, and well understood. In short, with regard to the research finding in the literature, large audit firms try to supply high quality for protection of its brand name and reputation. Because small audit firms with few clients and lacking reputation tend to be lenient and easy going in the report in order to be favorable to retain the client. In contrast, large audit firms are more risk averse in respect of damage to their reputation from events, such as public scandals or audit failures. And also, limitation of tenure will increase audit quality and mandatory rotation reduces the auditor's willingness to issue biased reports and is a cause for increasing auditor independence. In order to increase audit quality the following are suggested;

- May be tenure decreases knowledge of the auditor of his client but industry specialist audit increases knowledge and auditor independence.
- Aim for the survival and protection of the small audit firms which are necessary by specializing in any one particular industry.

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