Background to Auditing and Role of Auditor

Dr. Burim Berisha
University of Business and Technology - Kosovo

Abstract

Financial markets crisis since 2007 has unfolded many issues regarding the supervision of financial institutions, financial reporting and auditing as of core importance to many regulatory bodies in order to ensure proper-functioning framework in the internal market. An audit, along with both adequate supervision and corporate governance, can contribute towards the financial health of the companies by providing assurance in terms of bringing financial stability into their reports (European Commission [EC], 2010, p. 3). The assurance provided by the auditors reduces the risk of misstatements and ultimately the cost of failure to be suffered by the firm's stakeholders' also reduces. Market trust and confidence is restored by the audit as it contributes to the protection of investors' investments and reduces the cost of capital for companies. Therefore, the auditors have been entrusted by the law to conduct statutory audits and that their role is of importance towards financial health.

Auditors in the capital market provide their services for a valuable function of lending their credibility over the financial statements of public listed companies in an attempt to reduce the information risk. The fairness and credibility of the audit depends upon the nature of the attestation provided by the auditors (Lu & Sivaramakrishnan, 2009, p. 71). For audit quality the size of the city-based audit office can be a crucial determinant to be taken into consideration along with the size of the national-level audit firm, due to the fact that the city-based offices of audit-firms serve to be semi-autonomous with their own client base.

In early years the quality may be impaired in auditor-client relationship. Carcello and Nagy (2004, p. 57) found that generally there is no evidence which proves that if auditor tenure is long, audit quality is impaired. There are certain reasons to why audit quality is supposed to be lower in the early year. One reason could be that in early years, the auditor is new to the client and doesn't possess much knowledge about the client's business, operations, controls, accounting policies and systems. Another reason could be that the new auditor is unaware of the industry error patterns. A relationship between both financial statement error patterns and fraudulent financial reporting, and, industry group has been revealed by previous studies. Fraudulent financial reporting prevails more to an extent where you have a fresh auditor having less knowledge about the client's industry.

Keywords: Audit quality, auditor-client relationship, auditing in SMEs, auditing in Kosovo, International Standards on Auditing (IAS), role of auditor, auditor size, auditor rotation, non-audit services, and auditor independence.

Introduction

Financial markets crisis since 2007 has unfolded many issues regarding the supervision of financial institutions, financial reporting and auditing as of core importance to many regulatory bodies in order to ensure proper-functioning framework in the internal market. An audit, along with both adequate supervision and corporate governance, can contribute towards the financial health of the companies by providing assurance in terms of bringing financial stability into their reports (European Commission [EC], 2010, p. 3). The assurance provided by the auditors reduces the risk of misstatements and ultimately the cost of failure to be suffered by the firm's stakeholders' also reduces. Market trust and confidence is restored by the audit as it contributes to the protection of investors' investments and reduces the cost of capital for companies. Therefore, the auditors have been entrusted by the law to conduct statutory audits and that their role is of importance towards financial health. This entrustment has been based on the societal roles of an auditor in terms of providing an opinion based on truth and fairness of the financial statements of client firm audited. Events in the past decade such as the demise of Arthur Andersen after the Enron case has left the economy with much of skepticism, and a handful of globally known audit firms (the Big 4) are available to perform their audits on large complex institutions. The potential collapse of one of these audit firms would damage the trust and confidence of investors along with its gruesome impacts on the financial stability as a whole (EC, 2010, p. 4).

DeAngelo (1981, p. 186) describes audit quality in terms of the joint probability that an assigned auditor will both find out a breach in the client's accounting system and would then report that breach. Arguments based on his study are related to the relationship between size of audit firm and audit quality, which states that there would be a decrease in the value of the services of auditors if there were revelations that the auditor either failed to discover the breach or failed to report that breach. As auditors earn client- specific rents therefore auditors who have got a strong client-base would be much prone to damages in case of an audit failure. Due to these facts related to the strong reputation of audit firms and the auditor independence, which is related to the likeliness of reporting a breach in clients' reporting, the audit firms have got more incentives to provide higher audit quality. Large audit firms that has got small chunk of percentage as part of the revenue generated from any particular audit engagement are more in position to resist the pressures from the client related to the reporting of accounting breaches (DeAngelo, 1981, p. 186).

By law, the annual accounts of limited liability companies need to be audited; but this does not mean that the auditor is obliged to ensure that the companies' audited accounts are perfectly free from misstatements. As far as the trueness and fairness of the financial statements is concerned auditors can provide "reasonable assurance" in accordance to relevant financial reporting framework that holistically the financial statements are free from material misstatement either due to fraud or error (EC, 2010, p. 6). According to the EC notes (2010, p. 6), the evolution of statutory audits can be related to the verification of income, expenditure, assets and liabilities to a risk based approach. From the perspective of users, stakeholders should be provided high level of assurance by the auditors on the balance sheet components and their valuation at the date of balance sheet. As the primary responsibility in terms of delivering sound financial information depends on the management of the audited firm, therefore the auditors play their role in challenging the management on behalf of the users. Consideration needs to be given to the extent of information that should be provided and communicated to the public, for instance this information could be related to the firms' exposure to risk/events/intellectual property or other adverse affects on the intangible assets etc. But along with this what should be considered regarding better external communication is the timeliness and frequency of communication from the

auditors to the stakeholders (EC, 2010, p. 7).
In accounting academic research, the relationship between audit tenure and audit quality has been of much debate and concern. Recently much research studies have been taken up on the relation between audit quality and audit firm tenure. Some of the recent events and issues have stimulated the academicians to research more on the relation between audit quality and firm tenure. Worldwide interest in auditor value and earnings management has been noticeably manipulated due to a series of corporate scandals of high profile and reform efforts directed towards comprehensive corporate governance (Rusmin, Zahn, Tower & Brown, 2006, p. 167). According to Hills (2002, p. 7) in order to maintain and further develop the audit quality, it is necessary that the auditors should be retained for longer periods of time. As far as the retaining of auditor is concerned the company along with decreased costs will also be in a state to enable the auditors to learn more about its personnel, its business operations and its core values. But if the auditors are changed from time to time then over these different periods the benefits would shrink for the company (Hills, 2002, p. 7).
Auditors, in order to keep the audit quality high, need to take the internal communication into consideration as well and in order to keep the internal communication better a regular dialogue should be assured between the firm's audit committee, statutory auditor and the internal auditors. Internal control ensures that the loopholes are eliminated in the total coverage of compliance, risk monitoring, and the substantive verification of assets, liabilities, revenues and expenses (EC, 2010, p. 8). Auditors to a great extent focus on the audits of historical financial information. But a look into the future information is vital as well as far as the role of auditors in concerned and the auditors should provide an outlook of economic and financial information of the company based on the privileged access to the key information. The Directive on Statutory Audit (EC, 2010, p. 10) requires that statutory auditors be subject to principles of professional ethics and lays down a number of principles for independence, ranging from behavioral aspects to considerations around ownership, fees, rotation or companies' governance and audit committees.
The entity that needs to be audited appoints and pays for the auditor as part of a commercial tendering process. Distortion within the system is created due to the fact that auditors' responsibility is to the shareholders of the audited company and other stakeholders while being paid by the audited company. According to European Commission (2010, p. 11), the Commission is considering the feasibility of a scenario where the audit role is one of statutory inspection wherein it would be the responsibility of a third party, for instance a regulator, rather than the audited company to decide regarding the appointment, remuneration and duration of the engagement of an auditor. This concept may be of great relevance for the audit of the financial statements of large companies and/or systemic financial institutions. The exploration of this matter is needed due to the risk of increased bureaucracy on one hand and, the possible societal benefits of demonstrably independent appointments on the other hand (EC, 2010, p. 11).
Audit firms along with the audit services do provide non-audit services as well. Debates concerning the non-audit services provided by the audit firm to the audit

clients have been on the tables for long. But as far as European Union as a whole is concerned there are no official bans on the auditors preventing them from the offerings of non-audit services except from the article 22 of the directive which states that audit services should not be provided in the cases where "an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised (EC, 2010, p. 12)". This directive have been implemented across EU in a divergent manner, for instance France has implemented complete ban in regards to the provision of non-audit services by the auditor to its clients. While in other EU states the rules are still relax regarding the provision of non-audit services to the audit client by the auditor. Whereas the EC is looking forward to examine the reinforcement of the prohibition of non-audit services by the auditors in order to build the system of pure audit firms, because auditors should provide an independent opinion on the financial health of companies without any interest being held in the companies to be audited (EC,2010, p.12).

2. Auditor Size and Audit Quality

Auditors in the capital market provide their services for a valuable function of lending their credibility over the financial statements of public listed companies in an attempt to reduce the information risk. The fairness and credibility of the audit depends upon the nature of the attestation provided by the auditors (Lu & Sivaramakrishnan, 2009, p. 71). For audit quality the size of the city-based audit office can be a crucial determinant to be taken into consideration along with the size of the national-level audit firm, due to the fact that the city-based offices of audit-firms serve to be semi-autonomous with their own client base. Thus, it is the local audit office which gets into direct engagement with the client-firm with their direct administration and implementation of audit operations with the deliverance of audit services and audit opinions (Choi, Kim C, Kim J & Zang, 2010, p. 74). Choi et al. (2010, p. 94) in their study have found that there is positive association between office size and the audit quality, and that audit-offices of large size with large number of clients are less dependent on a particular client making them less prone to the risks of issuing either substandard or biased reports, according to the pressures from the client. Their other findings related to the high levels of audit quality provided by the large local offices that in return for the audit quality charge higher fees, which in the market of audit services is known as fee premium, than does the small local audit-offices. Thus, the results of Choi et al. (2010, p. 94) conclude that audit-firm size is one of the crucial determinants of both audit quality and audit pricing. Their suggestions seek concerns from both the regulators and the audit firms in terms of directing their attentions towards the behaviors of small audit offices as their dependency over the specific clients can be higher and are more prone to the dangers of compromising the audit quality. This holds true particularly for the small local audit offices of the Big 4 audit firms for whom such strategies should be designed on the basis of which poor-quality audits should be avoided by keeping a homogeneous level of audit services across all the offices. This is important due to the fact that if a small local office provides lower quality then it would significantly damage the reputation of entire firm as is evident from the Enron-Andersen case, where the Arthur Andersen's local office of Houston was involved in the audit of Enron (Choi et al., 2010, p. 94).

Audit quality has been defined by DeAngelo (1981, p. 186) as the joint probability assessed by the market that a breach will be discovered in the accounting system of the client based on the audit procedures and the technological capabilities of the auditor, and that this breach will be duly reported by the given auditor. An independent verification in the form of an unqualified opinion on the firm's financial data with consideration of quality is the output of audit quality. Audit quality has been divided into two categories; one of them is functional audit quality and the other technical audit quality (Dassen, 1995, p. 30-31). Functional audit quality refers to the degree to which the expectations of stakeholders' are met in terms of the processes involved in conducting the audit engagement and then communicating the results of the audit. Users of audit services, comprising of auditees and the 3rd party beneficiaries such as bankers and stakeholders, for the assessment of audit quality base their assessments on the reliability and responsiveness of the auditor. Technical audit quality refers to the degree to which the expectations of stakeholders' are met in terms of the success an audit engagement to detect and then report any errors or irregularities regarding the financial reports of an audited firm (Dassen, 1995, p. 30-31).

In order to evaluate the audit quality costs are incurred by the consumers, in order to assess the capabilities of an auditor to both discover and then report any breaches in the audit of a client (DeAngelo, 1981, p. 186). The consumers of audit services comprise of the current and the potential shareholders and bondholders, business managers, customers, employees and the government agencies. The cost of evaluating audit quality is significant due to the fact that firstly the consumer generally does not observe the audit procedures employed by the auditor in their audit engagement, and secondly the consumer has got no or little information regarding the incentives agreed in the contract between auditor and client. Another aspect of consumers' evaluation of audit quality costs is that auditors should specialize in the uniformity of the audit quality levels both over time and across clients. The reason for this is that the consumers tend to re¬evaluate the audit quality over time if the auditor varies in the levels of audit quality from one time period to another; or if the auditor varies in the level of audit quality from one client to another. Thus consumers would want to compensate for those auditors who could relatively maintain consistency in the levels of audit quality and could avoid the costs of evaluation by the consumers. Maintaining the levels of audit quality have been of consideration to the auditors themselves as well because the auditors can demand more fees as an incentive for specializing in uniform levels of quality (DeAngelo, 1981, p. 186-187).

According to DeAngelo (1981, p. 188), there is bilateral monopoly in the relationship between clients and their current auditors due to the presence of transactions costs and start-up fees. Bilateral monopoly in this case refers to the established relationship between auditors and clients due to the incentives involved and the high cost of switching to a perfect substitute. The termination of the relationship will result in higher costs for both the parties. For instance, the client specific auditor will lose the revenue stream from the client; while the client would have to bear the transaction cost of switching and the start-up costs of duplication with the associated costs of new auditors training. Based on the threat of termination the client can obtain accounting concessions from the client-specific auditor, and the incumbent auditor would become less independent from the client in terms of reporting the discovered breach. Rational consumers are aware of this fact that it is difficult for an incumbent auditor to be independent from its client, therefore they in turn lower the prices which they are willing to pay for the securities of such firms who try to retain their auditors for long¬term. In short, the lower level of expectancy over the independence of the auditor is reflected in the reduction of the client firm's value. In order to overcome this issue and avoid the consequences of negative valuation, rational clients try to choose those auditors whose perceived independency in the market is higher and has got little interest in the incentives that could lead them to cheat in a way to retain their client (DeAngelo, 1981, p. 188-189).

The so-called incentives to cheat factors in order to retain any of its clients by the auditor is reduced, when the auditors work with a number of client-firms and the client- specific costs/rents are identical across these firms. This ultimately makes the auditors more independent and provides higher level of audit quality due to the magnitude of collateral losses involved. Auditor size serves as a surrogate for the audit quality when the client-specific costs/rents vary across the clients because for large auditors the collateral is higher. From the consumer point of view, the auditor-size alone cannot serve as the surrogate to audit quality and for this reason the consumers develop other quality surrogates as well. For brand-established audit firms the collateral associated with the brand-name is considered to be more if any misrepresentations are provided (DeAngelo, 1981, p. 193).

3. Auditor-client Relationship and Auditor RotatioIn early years the quality may be impaired in auditor-client relationship. Carcello and Nagy (2004, p. 57) found that generally there is no evidence which proves that if auditor tenure is long, audit quality is impaired. There are certain reasons to why audit quality is supposed to be lower in the early year. One reason could be that in early years, the auditor is new to the client and doesn't possess much knowledge about the client's business, operations, controls, accounting policies and systems. Another reason could be that the new auditor is unaware of the industry error patterns. A relationship between both financial statement error patterns and fraudulent financial reporting, and, industry group has been revealed by previous studies. Fraudulent financial reporting prevails more to an extent where you have a fresh auditor having less knowledge about the client's industry. Summarizing, in early years of auditor client relationship, those individuals and groups who are against audit firm rotation would find that the fraudulent financial reporting is highest but when the auditor tenure is longer, it is lowest (Carcello & Nagy, 2004, p. 58-59). According to Geiger and Raghunandan (2002, p. 67), auditors prior to a bankruptcy filing in early years of auditor-client relationship are more likely to issue a clean audit report. In the study conducted by Lee, Mande and Son (2009, p. 87) it has been concluded that as the auditor tenure increases the audit delays decrease due to the increased efficiency of the auditor over the time, and thus oppose the views regarding mandatory auditor rotation with the opinion that it would imply additional costs on the markets as the announcement of the audited earnings would be delayed.

Myers, Rigsby & Boone (2007, p. 73-74) findings have associated long audit-tenures with higher earnings quality. They used absolute abnormal accruals and absolute current accruals to proxy for earnings quality. They propose that given the longer auditor tenure the audit quality tends to be higher. Another finding from Davis, Soo & Tromperter (2000, p. 2) indicates that discretionary accruals increase with auditor tenure. They have also found that as the auditor tenure increases the management gains additional reporting flexibility. Casterella (2002, p. 3) found that audit failures are more likely when auditor tenure is long and less likely when auditor tenure is short. She argues that audit quality is lower given longer auditor tenure. Fraud, auditor reporting and litigation against the auditor are combined prior to bankruptcy because the relation between tenure and SEC enforcement actions is not analyzed separately.

Auditor rotation and auditor retention has been discussed by the concerned bodies over the last 25 years from time to time in order to enhance the audit quality and auditor independence. Auditor rotation of mandatory nature requires that the client firm does not retain an auditor for more than specified period of time. This concept is supported by the idea that auditor rotation would not allow the auditors to have incentives in terms of seeking future economic growth from its clients and in a way would reduce the likeliness of biasing the reports in favor of the client's management. On the other hand, auditor retention relates to the concept of retaining an auditor for a specified period of time. This concept is supported by the idea that as the auditors would not face any risks of dismissal within the specified time period of retention therefore they can operate more independently of the management (Comunale & Sexton, 2005, p. 235-236). In general the accounting firms due to reasons provided below in the bullet form oppose mandatory auditor rotation and retention:

- cost-benefit analysis suggests that the costs exceeds benefits;
- diminution in the audit-quality due to loss of audit-knowledge and experience over a client;
- auditor rotation cannot completely eliminate the risks of financial frauds;
- safeguards like engagement partners rotation, peer reviews and second partner reviews are already in the system;
- changes in the composition of audit teams and clients' management takes place normally (Comunale & Sexton, 2005, p. 236).

The scandals of Enron, WorldCom and Parmalat have ignited debates over the merits and demerits of many practices related to auditing, such as auditor rotation. One of the most promoted benefits of auditor rotation is its usefulness towards the restoring of investors' confidence on the financial accounting system. The stakeholders lost their faith over both the corporate governance in general and financial reporting in particular after the big scandals over the last decade, which needs to be overcome in order to make them comfortable over their long-term investment. Along with stakeholders' faith and confidence, the other benefits which are linked to auditor rotation are that it would develop an effective peer-review system that would discourage aggressive accounting practices by encouraging critical reviews upon each auditor turnover; conflicts of interest which would arise during the long-tenure auditor-client relationship could be prevented; and a more competitive market would be promoted for the audit firms leading to the audits of higher quality. Auditor rotation would also pressurize the audit firms in a way to separate their non-audit services from their core audit-services (Healey & Kim, 2003, p. 10-11). Start-up costs associated with auditor rotation has been one of the major detractors. Both monetary and non-monetary start-up costs are frequently discussed by the auditors, clients and the stakeholders associated with the audit firm turnover. The other demerit of auditor rotation which is of much discussion is the fall in the audit quality due to loss of knowledge held by the auditor of the clients' businesses and operations as the ongoing relationship of auditor and client is disrupted by the auditor rotation (Healey & Kim, 2003, p. 10-11).

It is argued that long-tenured auditor-client relationships results in making the auditors to become more complacent and slack in their role as an attester (Lu & Sivaramakrishnan, 2009, p. 71). Carey and Simnett (2006, p. 673) in their study while examining the going-concern modified opinions found that the auditor's inclination towards the issuance of fair opinions in the relation established over audit-partner tenure do diminish if other factors that could affect the propensity are controlled. Supporters of the mandatory audit firm rotation argue that the incumbent auditor either faces pressures from its client or their long-term relationship makes the auditors feel more comfortable, and thus affecting the operations of auditors in an adverse manner to deal with the issues related to the financial reporting which can affect the financial statements in its materiality. While the opponents of the mandatory audit firm rotation are of the opinion that the new auditor lacks the knowledge of the client-firms' operations, information systems and practices of financial reporting thus making the relationship complex during the initial years by increasing the time required to gain firm-specific knowledge along with the risk of not detecting the material errors in the financial reporting of the firm (General Accounting Office [GAO], 2003, p. 13).

During the initial years, when an auditor is changed under audit-firm rotation, the audit costs would tend to be higher in order to acquire much of the necessary knowledge related to the client firm than the audit costs in the subsequent years. Other costs that would be incurred by the client firm are the auditor selection cost and the auditor support costs (GAO, 2003, p. 6). According to the study of GAO (2003, p. 8) they believe that audit-firm rotation is not the most efficient way of enhancing either the auditor independence or the audit quality if the additional financial costs and loss in the firm-specific knowledge is taken into consideration. Results of the survey conducted by GOA of Fortune 1000 public companies shows concerns over the risks of an audit failure during the initial stages of audit firm rotation because the new auditor at initial stages is in the process of learning the knowledge regarding the client firms' operations, systems and financial reporting practices. Although the additional costs associated with mandatory audit-firm rotation are certain, the benefits to be achieved from it are difficult to either predict or quantify. Supporters of audit firm rotation believe that the value associated with fresh-look which would protect those stakeholders who rely on the financial statements outweighs the additional costs associated with it. Conversely, those who oppose mandatory audit firm rotation are of the opinion that the costs would be increased for the audit firms and the public companies resulting in the costs outweighing the value associated with the fresh-look (GAO, 2003, p. 13). The increased costs associated with the mandatory audit firm-rotation include:

- marketing costs incurred by the audit firm in order to either attract new audit-clients or to retain the existing ones;
- audit costs incurred by the audit firm in order to carry out an audit over the financial statements of client-firm;
- audit fees refers to the amount that is being charged from the client-firm by the auditor for performing the audit of their financial statements;
- selection costs are the internal costs incurred by the client-firm in an attempt to select a new audit firm to audit their records;
- support costs are the internal costs incurred by the client-firm in order to support;
- the auditor in terms of understanding the client-firms' operations, systems, and financial reporting practices (GAO, 2003, p. 27).

Conclusions

Respecting the order so far shown the scheme of exposure, in accordance with the set hypotheses, it is possible to pass the following important conclusions:

This research study was taken up in order to study the effects of long-term auditor-client relationship on audit quality. Although the effects of the long-term relationship were limited to the audit quality, the research topic still seemed to be broad and obscure. Apart from this less attention has been paid in the previous research on the relationship between audit-client tenure and audit quality in small and medium-size enterprises (SMEs). And as SMEs tend to formulate and contribute to the major portion of any nations economy especially that of Kosovo, we further refined our research topic and distilled it to study the relationship between audit tenure and audit quality in SMEs in Kosovo. For this reason, all the associated factors related to the audit tenure, auditor- client relationship and audit quality were identified in the literature review by previous studies, on the basis of which empirical evidence were collected, analyzed and now concluded in this chapter.

The results from the finding of this study shows that although majority of the respondents were in favor of long-term auditor-client relationship and that it is favorable for the audit quality, some of them in their answers to specific question did mention that certain risks that may lower the audit quality exist in the long relationships. These factors of risks being identified in this study are in accordance to those discussed in the previous literature, for instance, the risk of complacency, risk to the auditors' independence, and risk of bilateral monopoly etcetera. If these risks could be either avoided or minimized then both the entities such that the auditors and the SMEs, does not have any issues with long-term relationship. Long-term relationship does increase the knowledge of auditor regarding specific client-firm but the complacency which develops in between both the parties over the years could not be avoided.

The audit opinion provided by the auditors over the financial reports of a client-firm is regarded of much value in terms of the success of an audit in reducing the

risk of material misstatements, and enhancing the quality and credibility over the financial reports. But the findings of this study cannot justify that long-term audit tenure would provide uniform level of audit quality over the years. Findings further suggest that audit quality saturates after a period of seven to ten-years, and that audit quality would be either high or uniform if the members of the audit team are rotated annually. As far as the audit-firm size and the brand-name are concerned then they do matter in keeping the audit quality higher because of the firms' reputation, resources, and expertise. During the early years of audit engagement, although the audit quality might be lower but the engagement is taken up by the auditor with great enthusiasm and zeal. This portrays the value which an auditor might give to the auditors' reputation, which is the perceived competence and independence, such that the independence of an auditor both in appearance and in reality affects the audit quality to a great extent.
The overall research study concludes that in case of SMEs, long-term auditor-client relationship is beneficial, if the risk of auditor independence and the risk of complacency which might develop during the relationship can be avoided or minimized. Apart from this the other factors which could increase the audit quality are NAS, industry specialization, knowledge and experience of the auditor, internal control in the client-firm, professional ethics involved, proper planning by the auditor, providence of true, fair and complete information by the client to the auditor, and appointment of auditor by the client-firm itself rather than the regulators.

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