

**ANTESEDENT AUDIT QUALITY : ANALYSIS OF AUDITOR-AUDITEE FACTORS
IN THE PERSPECTIVE THEORY OF REGULATION
(CASE STUDY ON EXTERNAL AUDITORS OF KAP IN INDONESIA)**

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ABSTRACT

This study aims to examine the antecedent variables of audit quality and analyze based on auditor and auditee factors in the perspective theory of regulation, while operationally this research aims to test and provide empirical evidence of the effect of other services, audit tenure, and industry specialization as auditor factors; size of client company as auditee factor on audit quality both audit quality-detecting misstatement and audit quality-reporting misstatement.

Type of research is quantitative-causality conducted by survey method. The population in this study is an accountant who works as an external auditor who is in Indonesia with a sample of accountants who work as an external auditor at the firm audit (KAP) located in the Jakarta area. The number of samples used as much as 168 respondents. Withdrawal technique /sampling is done by purposive sampling based on certain considerations (judgment sampling). The scale used is the interval scale by providing 6 choices of answers. Furthermore, to test the hypothesis in this study used path analysis.

The results showed that: (1) Other services has no significant negative effect on audit quality-detecting misstatement and audit quality-reporting misstatement; (2) Audit tenure has no significant negative effect on of audit quality-detecting misstatement or audit quality-reporting misstatement; (3) Auditor specialization has no significant positive effect on audit quality-detecting misstatement but positively positive to audit quality-reporting misstatement; (4) The size of the client company has a significant positive effect on the audit quality-detecting misstatement but has no significant effect on the audit quality-reporting misstatement. The results of this study also show that not only auditor factors that affect to audit quality but auditee factor also affect to audit quality.

Keywords: Audit quality, other services, audit tenure, industry specialization, company size.

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1. INTRODUCTION

Audit practice attracted the world's attention when the Enron case involving big auditor Arthur Anderson. The existence of Enron case is perceived by many parties as evidence of decreasing audit quality in the world without exception in Indonesia. This is in line with the statements of Krisnan and Gul (2009) and Francis (2004) which state that the existence of the Enron collapse case raises the issue that audit quality has decreased. In the context of Indonesia, the decline in audit quality can be seen from several cases such as PT. Telkom, PT. KAI, and PT. Kimia Farma. Krisnan and Gul (2009) stated that the decrease in audit quality is caused by the number of firm audit that provide other services outside the audit, so that there is a conflict of interest and ambivalence. The existence of cases above suspected audit quality has decreased to make the regulator in Indonesia both government and professional institutions make some regulations to protect various interests and witnesses against public accountants who commit violations. Some public accountants have been subject to sanctions freezing permits by the Ministry of Finance in the form of a practice ban for 3 months to 1 year and even revocation of permits in June 2017. The decrease in audit

quality is due to the low audit fee that the auditor is forced to accept so that the auditor is forced to reduce the audit time, the number of personnel in the audit team and the stages in the audit process. The Regulation of the Board of Public Accountants of Indonesia (IAPI) number 2 of 2016 attachment IV has calculated the minimum tariff of audit fee of Rp 60 million. In reality, however, many public accounting firms in Indonesia are forced to accept audit fees below the minimum tariff of audit fees so that partners will make a strategy to avoid losses that impact on the audit quality. The above cases and phenomena make audit quality topics in Indonesia still interesting to be studied. In addition to the low audit fees that auditors are forced to accept, conflicting interests and ambivalence are triggered by the increasing bargaining position of auditee caused by the intensity of relationships between auditors that result in auditor independence erosion, and the critical deterioration of partners in auditing judgments (Carrey and Simnett, 2006) as well as the economic bonding factor and financial dependence of the auditor on the client (Hoitash, Markelevich, and Barragato, 2007) and the bounded rationality factor (Fischbacher and Stefani, 2007) which can be utilized by the auditee for lobbying the final audit results. It shows that the auditee factor also effects to audit quality.

There is also a factor other than the auditor that determines the audit quality in line with the two audit risks that are inherent risk and control risk sourced from the auditee / internal company (Arens *et al.*, 2012; and Al-Thuneibat *et al.*, 2011). Even Al-Thuneibat *et al.* (2011) concludes that clients who have a good reputation in controlling financial statements, accurate financial statements and management with high integrity and competence will create a form of confidence or trust in the audit team, and if they will retain the same client in the future upcoming will lower the level of skepticism needed to conduct an audit professionally. It also shows that the auditee factor also determine the audit quality and research that analyze the auditee factor in determining the audit quality has not been done. However, this is contrary to DeAngelo (1981) and Watkins *et al.* (2004) stating that the audit quality is the credibility of the auditor, the auditor determines of the audit quality to be generated. The dispute opens up gaps and further research opportunities on audit quality. To fill the gap and opportunity of this research hence the purpose of this research is to test antecedent variable from audit quality and analyze by auditor and auditee factor in regulation theory perspective whereas operationally this research aim to test and give empirical evidence effect of other services, audit tenure, and industry specialization representing auditor factors, and firm size representing auditee factors on audit quality. This study is different from that done previously, because in addition to analyzing the effect of auditor factor also auditee factor to audit quality both audit quality-detecting misstatement and audit quality-reporting misstatement. In addition, this research is important because of the originality in the development of hypotheses that test more specific audit quality and empirical research model, as well as the location of the research with a sample of external auditors in KAP in Jakarta-Indonesia.

2. LITERATURE REVIEW AND DEVELOPMENT OF HYPOTHESES

2.1 Effect of Other Services on Audit Quality

The researcher who stated that Others services (non audit services) negatively impacted the quality of the audit (Wooten, 2003) which stated that the large consulting fees had a negative impact on the auditor's independence and degraded the audit quality. In addition, a substantial amount of costs paid to the auditor by the client, especially for non-auditing services, will make the auditor economically dependent on the client (Hoitash *et al.*, 2007). However, non-audit services will increase the probability of finding problems within the company and will reduce the auditor's independence (Lennox, 1999). In line with the probability of finding problems within the firm, some auditors argue that there is an actual positive relationship between audit quality and additional service delivery. They argue that providing additional services gives them access to a better understanding of the client and business processes (Wooten, 2003). In addition Watkins *et al.* (2004) states that his studies do not provide evidence that the auditor's independence can be compromised through the grant of privileges such as the offering of non audit services by the auditor. In addition, a study by Frankel *et al.* (2002) found a positive relationship between the ratio of non-audit service fees to the total cost and the amount of discretionary accrual income. In addition, the results of research by Patel and Prasad (2013) found that the big 4 auditor provides less non-audit services compared to non-big auditors 4. It shows that all auditors both big 4 and non big 4 auditors provide other services in outside the audit even though the amount is different. However, there is an auditor's economic dependence on the auditee. Then the study of Watkins *et al.* (2004) explaining that regulatory actions or government actions

such as establishing rules in the Sarbanes Oxley Act will prevent an auditor from providing non-audit service fees to clients they audit, which proves ineffective in improving audit quality. In the context of regulatory theory, the decision of the Government of Indonesia to make the regulation by allowing KAP to provide other services (Law No. 5 of 2011) and (Government Regulation No. 20 of 2015) responses to specific groups' requests to maximize their prosperity (group interest theory), but require the management of the Firm to submit a business activity report (audit services and non-audit services) and financial statements to the Minister (Law No. 5 of 2011) as a form of government oversight in order to protect the public interest. Based on the above statement, where there is a group that states that there is a negative effect and the group that states there is a positive effect on audit quality, the hypothesis raised is:

H1a: Other services negative effect on audit quality-detecting misstatement.

H1b: Other services negative effect on audit quality-reporting misstatement.

2.2 Effect of Tenure Audit on Audit Quality

The decision to reapply audit assignments from the same client by KAP management will establish a personal relationship between the auditor and their clients that impact on the erosion of independence and the critical deterioration of partners in the assessment (Carey and Simnett, 2006). Then the results of research Al-Thuneibat et al. (2011) indicates that the length of cooperative relationship between client and auditor will give negative effect (negative) on the audit quality result. Anis (2014) research results related to tenure audit stated that: there is a negative relationship between the length of the auditor and the audit quality. The final result of Bedard and Johnstone (2010) states that it is significant that the rotation or turnover of such partners is costly to the public accountants firm, and no significant advantages can be achieved. It will not be different for clients who have a partner relationship with a duration of more than five years versus a shorter duration partner relationship. Then research from Taiwan conducted by Chen (2008) found that the value of abnormal accruals will decrease along with the length of partnership relationship between auditors with this client took place. This implies that the quality of income increases. The findings of Bedard and Johnstone (2010) and Chen *et al.* (2008) differ from the results of a study conducted by Carey and Simnett (2006) suggesting a lower quality audit when the relationship between the auditor and the client lasts longer. The findings of Bedard and Johnstone (2010) and Chen *et al.* (2008) is in line with the statements of Geiger and Raghunandan (2002) which states that the number of audit failures actually occurs in the early years of the auditor-client relationship so that additional auditors may need additional time to avoid audit failure. In the context of regulatory theories, Government Regulation No. 20 of 2015 concerning Public Accountant Practices which provides the same constraint limitation on audit services for the same client for 5 (five) consecutive years only to Public Accountants (not KAP) and for certain entities industries in the capital market sector, commercial banks, pension funds, insurance / reinsurance companies, and state-owned enterprises. The policy is the government's response to the interests of the group. In addition, the existence of several cases related to audit quality, such as the enron case behind this research, formed the initial perception of audit quality. Based on the above statement then the hypothesis raised is:

H2a: Audit tenure negative effect on audit quality-detecting misstatement.

H2b: Audit tenure negative effect on audit quality-reporting misstatement.

2.3 Effect of Industrial Specialization on Audit Quality

KAPs that have different types of clients in one type or the same industry scope will provide a deeper understanding of the unique audit risks arising from a particular industry. KAPs that have few clients in a particular industry may not have a critical time so they can keep up with the pace of news and practice development in the industry (Wooten, 2003). Craswell et al. (1995) reported that industry experts set a premium cost, which gives an indication of the difference in quality pricing. The more clients a KAP has in a particular industry, the larger the KAP builds its reputation because it is considered to have successfully provided a good audit service within a particular industry type. The results of their research stated that the audit cost for the big 8 auditors contain premiums relating to general brand name and industry specialization. The results of Behn et al. (2008) indicates that high audit quality is given by big 5 auditors and industry specialists non big 5 auditors. This result is in line with the results of Inaam et al. (2012) which states that industry specialist auditors and big4 auditors are associated with low levels of earnings management accruals. In addition, industry specialization may offset the negative effects of mandatory

rotation on audit quality (Anis, 2014). KAPs with higher client concentrations in certain industry types will have higher quality levels as well because they have more resources to use (Deis and Giroux, 1992). In the context of regulatory theories, the decision of KAP management to make its auditors specialist in certain industries is in line with the Standards of Professional Public Accountants related to KAP quality control standard. Based on the above statement then the hypothesis raised is:

H3a: Industry specialization positive effect on audit quality-detecting misstatement.

H3b: Industry specialization positive effect on audit quality-reporting misstatement.

2.4 Effect of Client Company Size on Audit Quality

Two audit risks that are innate risk and control risk are sourced from the auditee / internal company (Arens *et al.*, 2012). The existence of audit risk that is sourced from internal / auditee factor causing some researchers associate audit quality with factors that come from auditee. Research Fernando *et al.* (2010) linking audit quality to client size and equity capital costs. In addition, Chen *et al.* (2008) also attributes the importance of clients with audit quality. The results of Leventis and Caramanis (2005) stated that the audit effort ratio is calculated based on the actual minimum hour that has been determined and found to be positively correlated with firm size. It shows that to get high audit quality, each company of different size will be allocated different minimum audit hour. Other research results from Adeyemi and Fagbemi (2010) suggest that the size factor of a company and business effect are important factors in audit quality for companies on the Nigerian Stock Exchange. Companies of all sizes have different interests when they request an audit. The problem is that their interests tend to contradict the auditor's desire to maintain audit quality as Xin-jun's research (2007) states that the client's interests are negatively related to the quality of the audit. Further research on audit quality-related, Al-Thuneibat *et al.* (2011) has used firm size as a control variable in its research. In the context of regulatory theories, companies with a certain scale and already go public, are required to be audited by a registered KAP at BAPEPAM. Similarly, for state-owned companies must be audited by BPK RI or KAP who have permission / registered in BPK RI. Based on the above statement then the hypothesis raised is:

H4a: Company size has a positive effect on audit quality-detecting misstatement.

H4b: Company size has a positive effect on audit quality-reporting misstatement.

3. RESEARCH METHODS

This research is conducted by survey method by using path analysis to explain the above variables. The population in this study is an accountant who works as an external auditor residing in Indonesia. This is because the external auditor is still considered a party responsible for audit quality (DeAnggelo, 1981; Watkins *et al.*, 2004). The sample in this study are the accountants who work as auditors in firm audit (KAP) located in the Jakarta area. The selection of auditors located in the Jakarta area is due to the largest external auditor population (active IAPI members) in Jakarta area as many as 475 people from 808 people or as much as 58.79% (IAI, 2010). In addition they conduct audits not only in Jakarta but also outside Jakarta. Withdrawal technique / sampling is done by purposive sampling based on certain considerations (judgment sampling). The sample consideration / criteria are as follows: (1) external auditor working in KAP, (2) working in Jakarta area. Data collection techniques used in this study is the technique of collecting data by using questionnaires by way of delivering and sending questionnaires via the post office. The construct/variable measurements in this study used the interval scale by providing answer choices to the following questions: 1 = strongly disagree, 2 = disagree (TS), 3 = Somewhat disagree (ATS), 4 = Somewhat agree, 5 = agree (S), and 6 = Strongly agree (SS).

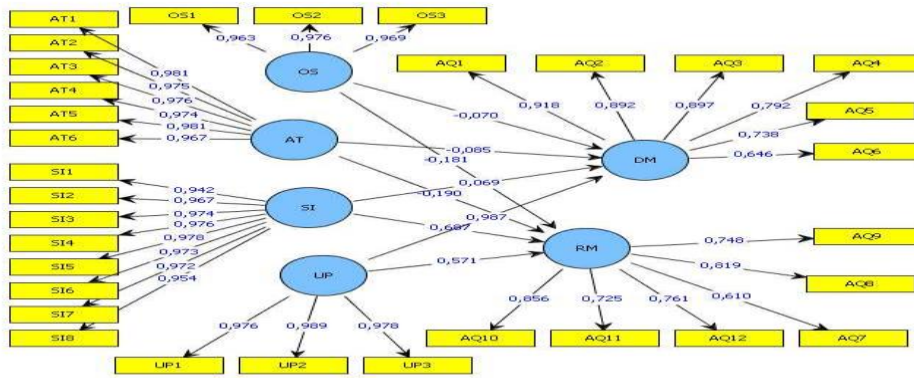
4. RESULT AND DISCUSSION

4.1 Data Analysis

4.1.1 Measurement Model or Outer Model

The model of measurement or outer model with reflexive indicator is evaluated with convergent validity, discriminant validity of the indicator and composite reliability for indicator block. Convergent validity and discriminant validity are performed to test validity while composite reliability is performed to test reliability.

Figure 4.1 Full Model Research Using Path Analysis



Source: PLS (2017)

Information :

OS = Other Services;

AT = Audit Tenure ;

SI = Industrial Specialization;

UP = Size of Company Client;

DM = Audit Quality-Detecting Misstatement;

RM = Audit Quality-Reporting Misstatement;

4.1.2 Hypothesis Testing

Table 4.1 Statistical Results of Endogenous and Exogenous Variables

Hypotesis	Test	Original sample estimate	Mean of sub Samples	Standard deviation	T-Statistic	Note
1a (-)	OS ->DM	-0,070	-0,122	0,228	0,309	Negative effect, not significant
1b (-)	OS ->RM	-0,181	-0,173	0,180	1,003	Negative effect, not significant
2a (-)	AT ->DM	-0,085	-0,073	0,160	0,533	Negative effect, not significant
2b (-)	AT ->RM	-0,190	-0,279	0,238	0,799	Negative effect, not significant
3a (+)	SI ->DM	0,069	-0,196	0,426	0,162	Positive effect, not significant
3b (+)	SI ->RM	0,687	0,634	0,307	2,241**	Positive effect, significant
4a (+)	UP ->DM	0,987	1,296	0,563	1,755*	Positive effect, significant
4b (+)	UP ->RM	0,571	0,705	0,444	1,284	Positive effect, not significant

Note: ***p<0,01= 2,576; **p<0,05=1,960; dan *p<0,10=1,645.

Source: PLS (2017)

4.2 Discussion

4.2.1 Other Services Effect on Audit Quality

The result of statistical test of the effect of other services on audit quality in general, the result of negative effect is not significant. The above test results indicate that the negative effect of the others services on audit quality in this study is proven although not significant. The existence of the relationships that were established when other services before the audit and economic troubles (Hoitash, et al., 2007), and the bounded rationality (Fischbacher and Stefani, 2007) experienced by the auditor triggered a decrease in audit quality. The results of this study also reinforce the concerns of conflicts of interest and ambiguity due to the provision of other services outside the audit and the prejudice that the audit quality has decreased as stated by Krisnan and Gul (2009). It is argued that there is an actual positive relationship between the quality of the audit and the provision of additional services in the form of their access to a better understanding of the client and business processes (Wooten, 2003), and arguing that when a public accountants firm can provide non-audit services to clients which is audited, there is likely to be leakage of knowledge/information resulting in efficiency for audit results (Simunic, 1984), the positive effect in this study is not proven. In the context of auditor-auditee factor analysis, if the auditor is in prime condition without any problem of economic difficulty (Hoitash, et al., 2007) and bounded rationality (Fischbacher and Stefani, 2007), the auditor will be able to detect and report errors committed by the client. This is because audit quality is the auditor's credibility (Watkins et al., 2004). This shows that the auditor factor is more dominant in determining audit quality. In the context of regulatory theories, regardless of the results

of this study are not significant, but the government of Indonesia still needs to regulate related services other than audit as a preventive effort. This is done in order to improve audit quality and protect public interest (Stigler, 1971, Posner, 1974).

4.2.2 Effect of Tenure Audit on Audit Quality

The result of statistical test of tenure audit effect on audit quality in general has negative effect not significant. Audit tenure negatively affects the audit quality-detecting misstatement and reporting misstatement but not significant. This is in line Carey and Simnett (2006) Al-Thuneibat et al. (2011), Anis (2014), and Deis and Giroux (1996). This is in contrast to the results of Bedard and Johnstone (2010) research which states significantly that the rotation or turnaround of such partners is costly to the public accountants firm, and no significant advantages can be achieved. It will not be different for clients who have a partner relationship with a duration of more than five years versus a shorter duration partner relationship. The results of this study are also different from the results of research Chen et al. (2008) and Geiger and Raghunandan (2002). Nevertheless, regardless of the results of this study, it has negative effect not significant, Government Regulation No. 20 of 2015 concerning Public Accountant Practices which grants constraints on the limitation of providing audit services for the same client for at least 5 (five) consecutive years only to Public Accountants (not KAP institutions) and for certain entities industry in the capital market sector, commercial banks, pension funds, insurance/reinsurance companies and State-Owned Enterprises. This is done in order to improve audit quality and protect groups interest and public interest (Stigler, 1971, Posner, 1974). In the context of auditor-auditee factor analysis as well as in other services cases, if the auditor is in prime condition without any problems of economic difficulty (Hoitash, et al., 2007) and bounded rationality (Fischbacher and Stefani, 2007), then the auditor will not be affected by any conditions or circumstances so that it is still able to detect errors committed by the client. This is because audit quality is the auditor's credibility (Watkins et al., 2004). It also shows that the auditor factor is more dominant in determining audit quality.

4.2.3 Effect of Industrial Specialization on Audit Quality

The statistical test of the effect of industry specialization on audit quality in general has a positive effect. The industry specialization positively impacts the audit quality-detecting misstatement but is not significant, while industry specialization positively affects the audit quality-reporting misstatement and is significant. These results prove that the number of clients in similar industries are handled, can improve the audit quality generated, especially related to the ability to detect and report any errors. This may be because the auditor uses the client's auditing experience on the same industry, technical ability and professional expertise it has to detect errors committed by the client. The results of the insignificant study may be due to the large number of respondents coming from small KAPs causing the results of this study to have an effect but not significant. This is because small KAP does not specialize to the auditor. The results of this study are in accordance with Wooten's (2003,) Deis and Giroux (1992), Craswell et al. (1995). The results of Behn et al. (2008) indicates that high audit quality is given by big 5 auditors and industry specialists non big 5 auditors. This result is in line with the results of Inaam et al. (2012) which states that industry specialist auditors and big4 auditors are associated with low levels of earnings management accruals. In addition, industry specialization may offset the negative effects of mandatory rotation on audit quality (Anis, 2014). The results of this study provide evidence of differential risk-specific effects of customers on all types of auditors. In the context of auditor-auditee factor analysis, the positive effect of industry specialization on audit quality shows that since auditors have frequently audited clients in the same industry, auditors become more specialized to audit certain industries in order to improve audit quality. It shows that the dominant auditor factor effects audit quality. In the context of regulatory theories, the decision of KAP management to make its auditors specialist in certain industries is in line with the Standards of Professional Public Accountants related to KAP quality control standard. The standards are made in order to maintain audit quality and protect public interest (Stigler, 1971, Posner, 1974).

4.2.4 Effect of Client Company Size on Audit Quality

The result of statistical test of firm size effect to audit-detecting misstatement quality got result have positive significant effect while company size to quality audit-reporting misstatement have positive but not significant effect. The results of this test prove that the higher the size of the company, the higher the audit quality generated by the Auditor / KAP in terms of the ability to detect or report any mistakes made by the

client. The positive effect of firm size on audit quality lies in good internal control and support of data generated by good systems that have been built by large scale companies so that accelerate and facilitate the work of auditors to find any errors in the client / auditee financial statements and complete the auditor's work papers as well as the basis for the preparation of audit reports. This is in line with the statement of Arens *et al.* (2012) which states that the two audit risks that are inherent risk and control risk are sourced from the auditee / internal company. If the two risks are well controlled then the risk of audit failure is low and that means the quality of the audit increases. In line with the results of Leventis and Caramanis (2005) research which states that the audit effort ratio calculated based on the minimum hours found to be positively correlated with firm size. It shows that to get high audit quality, each company of different size will be allocated different minimum audit hour. In line with the results of Adeyemi and Fagbemi (2010) research which states that the size factor of a company and business effect are important factors in audit quality for companies on the Nigerian Stock Exchange. In the context of auditor-auditee factor analysis, positive effect indicates that the larger the size of the client company the higher the audit quality is generated. Al-Thuneibat *et al.* (2011) concludes that clients who have a good reputation in controlling financial statements, accurate financial statements and management with high integrity and competence will create a form of confidence or trust in the audit team. It reinforces the existence of other factors besides auditors that effect audit quality. The results of this study also dismissed the notion that the audit quality depends on the audit qualityors such as the statement Watkins *et al.* (2004) which states that audit quality is the auditor's credibility. In the context of regulatory theories, companies with a certain scale and already go public, are required to be audited by a registered KAP at BAPEPAM. Similarly, for state-owned companies must be audited by BPK RI or KAP who have permission/registered in BPK RI. This is done in order to improve audit quality and protect public interest (Stigler, 1971, Posner, 1974).

5. CONCLUSIONS, IMPLICATIONS, AND LIMITATIONS

5.1 Conclusion

The research conclusion are: 1(a) Other services have no significant negative effect on the audit quality-detecting misstatement; (b) Other services have no significant negative effect on the audit quality-reporting misstatement. 2(a) Tenure audit has no significant negative effect on the audit quality-detecting misstatement; (b) Tenure audit has no significant negative effect on the audit quality-reporting misstatement. Furthermore: 3(a) Industry specialization positively insignificant to the audit quality-detecting misstatement; (b) Industry specialization has a significant positive effect on the audit quality-reporting misstatement. 4(a) The size of the client company positively affects the audit quality-detecting misstatement; (b) The size of the client company has a positive effect on the audit quality-reporting misstatement.

5.2 Implication of Research Results

Regulatory theories are implication to industry specialization and the size of the client company. Practical implication are: For Regulators: Supporting regulations that permit KAP to provide other services, rotation for auditors, quality control standard regarding personnel assignment, and employment, minimum auditing time, and minimum auditing fees. For Auditors: Independensi to be maintained and not affected by the client. The economic dependence of the auditor on the client should be avoided as it may decrease the independence.

5.3 Limitations of Research

This study is a perception of external auditors working on KAP in Jakarta, so some things can happen such as: (a) individuals see the same thing but interpret it differently; (b) the observation time of 2015 which may be different from the current conditions so that it will produce different research; (c) the background and the resemblance to events abroad form the initial perception.

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