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Review of Studies on Measuring of Auditing Quality

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Abstract: ***Quality of auditing remains an issue of concern to the profession, the government and the investors. According to the Basel Committee (2008), there is no tool to measure audit quality, but there are recent efforts that appraised how to measure it. In spite of the extent of that literature, no single generally accepted definition of audit quality so far merged, nor any single generally accepted measure, many of studies found that consensus has not been reached on how audit quality should be measured. There are some audit bodies do not have a generally accepted definition of audit quality nor a universally accepted measuring technique. This difference has led to researchers to disagree on the factors that lead to enhancing the audit quality and as a consequence, prior studies have used several surrogates for measuring audit quality. This paper reviews empirical studies over the past decades from all over the world in order to assess what researchers have done about audit quality issue and identify gaps in the literature where further research is needed.***

Keywords: Audit Quality, Audit office Size, Specialization, Independence, Audit Fees

1. Introduction

Corporate scandals like Enron debacle and Andersen collapse confirmed a requirement for high quality audit and considerable attention to different factors that may have effect on audit quality. High quality audit refers to the production of financial information without misstatements, omissions or biases. From an agency theory perspective, Dang (2004) argues that audited financial statements are a monitoring mechanism to provide assurance for users of financial information. De Angelo (1981) defines audit quality by two dimensionaldefinitions: first, detecting misstatements and errors in financial statement and second, reporting these material misstatements and errors. Due to this fact that these characteristics are largely unobservable, different proxies have been used by researchers to measure audit quality like: audit size, audit hours, audit fees, reputation, litigation rate and discretionary accruals. Although so many different proxies have been utilized, Lennox (1999) believed that most researchers generally agree that the size or brand name of audit firms is an appropriate indicator of audit quality.Audit quality has been investigated within a variety of perspectives in the literature like: independence, ethics, judgments, reduced audit quality, client services and public sector, There is a vast body of literature relating to audit quality and to the measurement of audit quality (e.g. Lennox, 1999; Colbert et al., 1999; Pornupatham, 2006 ; Choi et al., 2007; Chi et al., 2009; Ebrahim, 2001; Chung, 2004; Cameran et al., 2008; Knechel & Vanstraelen, 2007; Jackson et al., ; Schauer, ; Palmrose 1988; Beck, 2006; King & Schwartz, 1999; Hillary & Lennox, 2005; Casterella et al., 2009; Grumet, 2009).

Researchers have taken one of two approaches to measuring audit quality in empirical work: a direct and an indirect approach. On the same note, Kilgore (2007) finds that; 1) audit quality has been measured utilizing a more direct approach and is based on the assumption that the probability of discovery and reporting of contract breaches will be reflected in features of the audit such as errors made by auditors. 2) Audit quality has been measured in an indirect way by looking at correlates of audit quality. Research using the indirect approach is of two types, both of which consider assessment of audit quality from an ex-ante perspective. The first type measures audit quality using surrogates of, or proxies for quality. The second indirect type assesses audit quality by checking the attributes or factors perceived to be associated with audit quality by parties involved in, or affected by, the audit process and audit reports. Studies of this type are also referred to as adopting a behavioral perspective on audit quality (Kilgore, 2007).The aim of this article is to summarize these studies and provide the comprehensive and new classification of researches that have done about this topic.

2. Audit Quality Definition

Despite the importance of the concept of audit quality, there is no agreement about its definition yet (CAQ, 2008). Sutton (1993) observes that whilst a considerable number of researches have studied issues concerning audit quality, one generally accepted definition of audit quality is still lacking. The Financial Reporting Council (FRC, 2008) recognises that audit quality is a dynamic concept and that the drivers and indicators of audit quality may change from time to time and from place to place. The International Auditing and Assurance Standards Board (IAASB) which follows IFAC, recognizes that the fact that there is no common definition for audit quality that contributes to the expectations gap (IFAC). Leventis & Caramanis (2005) provide evidence that there is no consensus among researchers on the definition of audit quality. As summarized by Sutton (1993), the cause of the absence of consensus on a single definition of audit quality is due to the apparent conflicting roles of participants in the audit market. The major audit market participants can be grouped into three categories: (1) external users; (2) the client; and (3) the auditors. Grant et al. (1996) argues that the concept of audit quality is broad and difficult to quantify. It means different things to different peoples (Daniels & Booker, 2009. Broberg (2007) claims that it is clear that audit quality is a slippery concept, but in current practice what seems to be significant is in attempts to realize it, regulation is increased, the concept of audit quality has resulted in much controversy among the previous studies.

3. Literature Review

A large body of accounting research investigates the drivers and consequences of audit quality. The more commonly used proxies for audit quality can be categorized into input-based proxies and output-based proxies (Defond and Zhang 2014). Input-based proxies refer to auditor-specific characteristics, and auditor fees. The most popular measure for auditor-specific characteristics is auditor size, the Big firms have incentives to deliver high quality audits as supported by DeAngelo (1981), Palmrose (1988), Davidson (1993), Lennox (1999), Colbert et al. (1999), Sori et al. (2006) and Choi et al. (2007). Everal researchers contended that industry specialist auditors provide higher quality audits than non-specialist auditors (e.g. Gramling & Stone,2001; Abbott & Parker,2001 ; Schauer, 2002; Low, 1973; Nagy, 2007; Lim & Tan, 2008; Reichelt & Wang, 2010). Reichelt and Wang (2010) highlighted the recent evidence stating that audited financial statements are of higher quality when audited by industry specialists. Beasley and Petroni (2001) pointed out that according to Gramling and Stone (1998), industry specialists should provide higher quality audits due to: (1) better audit technologies (2) lower costs through economies-of-scale or (3) superior knowledge due to economies-of-knowledge Low's findings indicate that the auditors' knowledge of the client's industry improves their audit risk assessments and directly influences the nature and the perceived quality of their audit-planning decisions, On a similar contention, Reichelt and Wang (2010) argued that (1) industry specialists auditors presumably have a greater knowledge of their client's industry and are better able to evaluate whether an industry specific client has substantial doubt about their ability to continue as a going-concern, (2) They have more effective procedures to measure a client's risk of business failure and they impose stricter quality standards on their staff when performing these procedures, (3) Industry specialists have developed a reputation for higher audit quality, so they have a greater incentive to protect their reputation against possible litigation in the event of a client's business failure, to protect themselves against client pressures to express an unqualified opinion, which would otherwise increase their risk of litigation, (4) An industry specialist will express a going-concern audit opinion based on a lower probability of client business failure than that of a non-specialist.Auditor independence is the most important features in audit profession, Lack of auditor independence may cause injustice, problem between the audit firm and the client; in some cases it may cause bankruptcy of business and damage it as Enron and WorldCom scandal which considered the largest bankruptcy reorganization in American history (Nagy, 2007), When the auditor is regarded being independence, the financial information are more confidential for the public and used to make right decisions (Ghoshand Moon, 2004). To increase independency auditors must follow and implement two aspects: first to be independent and objective as individual (Practitioner's Independence), second the apparent independence of the auditor as a professional group to the society (Professional independence) (Ettredge et al., 2002), the auditor should be independent on both of these aspects to provide a high level of professionalism on his work.

Long auditor tenure is a major issue that effect negatively on audit independence, as the long relationship between the auditor and the client may lead to deterioration on the quality of the audit report (Mautz & Sharaf, 1961). The objectivity of the Auditor's opinion and his judgment on his client decreases over time due to the extended relationship between them. The personal and long-relationship between auditor and client tend the auditor to issue a qualified audit report, Independency of auditors may increase through implementing the mandatory audit rotation in order to improve transparency between auditing committees and investors, mandatory audit rotation should reduce the risk of collusion and enhance the audit quality over the years (Hoyle, 1978).Auditors' independence is an important factor in the audit profession, therefore a lack of this independence will lead the auditor to take wrong decisions, and even more it may cause bigger problems such as business damages and bankruptcy (Ghosh, 2004). The financial statements will gain confidentiality and accuracy in the public eye when the auditor is independence (Cameran et al., 2005), Audit fees have a significant effect on the loyalty of auditor to his client, whether the client paying more or less than audit fees being paid to similar competitors. The client has the right to switch audit firms whenever there is dissatisfaction with the services provided by the Auditor. (Carcello & Neal, 2000) findings show that high audit fees lead to high auditor dismissal, in other words it leads to auditor switching.

(Ettredge et al., 2007), results show that when the client is paying lower audit fees comparable with other companies in the industry more likely to be loyal to their audit firms, on the other hand the audit quality can be clearly affected by the fees paid to the auditor, financial satisfaction that obtained by high audit fees paid to auditors may increase the professionalism and the effort exerted by the auditor which enhance the audit quality, finally,the audit quality is measured based four dimensions as (Audit Office Size, Specialization in the Industry, Auditor independence, and audit fees) used by (Defond and Zhang 2014, DeAngelo ,1981,, Palmrose ,1988, Davidson ,1993, Lennox ,1999, Colbert et al ,1999, Sori et al. (2006) and Choi et al. (2007).(e.g. Gramling & Stone,1998; Abbott & Parker, Schauer, 2002; Low, 2004; Cenker , Lim & Tan, 2008; Reichelt & Wang, 2010; Khan, 2002, Ghoshand Moon, 2004, Sharaf, 1961, Hoyle, 1978,Ghosh, 2004,Cameran et al., 2005,Carcello , Neal, 2003, and Ettredge et al., 2002).

4. Conclusion and Future Studies

Audit quality is a concept that has different definitions for different people. Users of financial statements perceived audit reports to provide absolute assurance that company financial statements have no material misstatements and do not perpetrate fraud (Epstein & Geiger, 1994). Audit quality has been investigated within a variety of perspectives in the literature. This paper has reviewed the literature on audit quality in the current professional environment. I have focused our review on issues associated with the audit quality from different dimensions. In each case, recent studies that have added to the body of knowledge relating to audit quality have been discussed. Overall, analysis reveals the several gaps in this literature that suggests for future studies. Due to the importance of having high quality audit, more research should explore other areas that relate to audit quality such as customer service satisfaction, customer loyalty, auditors switching and auditors turnover. Another extension that might shed more light on the question of the audit effort is the incorporation of corporate governance characteristics into the analysis (e.g. quality and independence of management and board membership; internal audit considerations).

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