

## FACTORS ASSOCIATED WITH AUDIT QUALITY: EVIDENCE FROM AN EMERGING MARKET

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### Abstract

The study aims to investigate the attributes of audit quality in Indonesia by considering input from groups of auditors, audit clients and external statement users. Beside the facts of the important to consider the issue from different groups of stakeholders such as audit committee chairpersons and loan officers, there have been very few published empirical studies of perceived audit quality in Indonesia from those groups' perspectives. This study attempts to address the gap by identifying the major attributes that enter into the determination of audit quality in Indonesia based on the perspectives of different groups of auditors, clients and external users. Survey questionnaires were sent to a random sample of the three groups. The result shows that there are significant difference perceptions between the groups.

**Keywords:** audit quality, competence, independence, relationship, service quality

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### 1. Introduction

Studies on how to define and measure audit quality and the factors that affect it have been widely conducted. However, there is still no universal agreement regarding a definition of audit quality (Knechel et al., 2013). Researchers have adopted several approaches to explain audit quality. One of those approaches involves observing audit quality from the perspective of participants in the audit market. Understanding the factors that auditors perceive affect audit quality is important, since these factors can influence actual audit quality (Chang and Monroe, 1994). According to Robbins et al. (2011), individual behaviours are often based on perceptions of what reality is, not on reality itself.

Research exploring the role of auditors in emerging markets is very rare and remains largely unexplored (Healy and Palepu, 2001). In Indonesia, audit quality has been questioned strongly after some corporate scandals involving large listed companies, such as *Kimia Farma*, *Indo Farma*, and *Bank of Century* and involving local public accountants (Suyono, 2012). These scandals resulted in the Finance Ministry of Indonesia repealing the licenses held by some public accountants and public accounting firms. This indicates that there are issues within Indonesian audit contexts.

To date, very few published empirical studies have investigated perceived audit quality in Indonesia. One exception was a study by Suyono (2012). He investigated audit quality factors based on perceptions of auditors in Indonesia. His study concluded that independence, experience and accountability were factors affecting audit quality according to the auditors. However, prior studies on perceived audit quality conducted in the United States (US), the United Kingdom (UK), Denmark, and Australia have investigated the issue from the perspective of different groups of stakeholders (such as auditees, owners, audit committee chairpersons, and loan officers). See, for example, Behn and Carcello (1997), Nieschwietz and Woolley (2009), and Kilgore, et al. (2014). These previous studies have been conducted in developed countries. Thus, the conditions may differ from that of a developing country like Indonesia. In addition, to date, no published study on audit quality in Indonesia has

investigated the perceptions of different audit stakeholders. This study seeks to address the gap within the Indonesian context by identifying the major attributes that determine audit quality in that country. The study focuses on the perspectives of three participant groups in the Indonesian audit market: auditors, audit clients, and users of financial statements. Therefore, the main motivation of this study is to evaluate audit quality attributes within Indonesian contexts (a developing country).

Based on the above objectives, the following research question was identified:

*What are the important attributes that determine audit quality in Indonesia as perceived by auditors, clients, and external users?*

## 2. Literature Review

### 2.1. Audit Quality

Even though research on audit quality has been widely conducted, there is no one exact definition of audit quality (Duff, 2004). Bedard, Johnstone & Smith (2010) illustrated that “even seasoned professionals convening to discuss the notion of audit quality have difficulty agreeing on a common definition”. The one that is broadly cited is the definition of the quality of audit services by DeANGELO in 1981 which stated that:

The quality of audit services is defined to be the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach. The probability that a given auditor will discover a breach depends on the auditor’s technological capabilities, the audit procedures employed on a given audit, the extent of sampling, etc. The conditional probability of reporting a discovered breach is a measure of an auditor’s independence from a given client (DeAngelo, 1981, p. 186)

The definition offers two important factors of audit quality, which are the auditor’s capacities in conducting an audit and the independence of the auditor over the client. DeAngelo(1981) argued that a large auditor has these two characteristics as the auditor has more technological capabilities and more reputation to lose. Therefore, she claimed that the larger the auditor the higher the perceived quality of the audit. She simply showed the audit firm size as the proxy for audit quality.

The study was then followed by others that demonstrated a positive relation between audit firm size and audit quality (Dopuch et al., 1987, Deis and Giroux, 1992, Lennox, 1999, DeFond et al., 1999, Reynolds and Francis, 2000, Craswell et al., 2002, Ireland, 2003). The general hypothesis was that audit services offered by larger audit firms tend to be of higher quality than those offered by smaller ones because large auditors have more valuable reputations and more wealth at risk from litigation.

However, other published definitions of audit quality emphasized another various aspects of audit quality that can be noticed in various studies of audit quality. For example, some studies focused on the impact of audit firm arrangement and processing such as audit contract type, audit tenure, audit fees, and non-audit services on audit quality (Carey and Simnett, 2006, Chang and Monroe, 1994, Son, 2005). Meanwhile, other studies explored the company’s characteristics such as company size, business complexity, institutional ownership and leverage, as variables that affect audit quality (Kane and Velury, 2004, Mitra et al., 2007, Wan Abdullah et al., 2008). Some others examine the effective components of corporate governance and its relationship with audit quality (Carcello and Neal, 2000, Cohen et al., 2002, Goodwin and Seow, 2002, O’Sullivan, 2000, Salleh and Stewart, 2006, Adeyemi and Fagbemi, 2010).

To be concluded, audit quality involves a broad variety of interconnected important factors reflecting the role of professional standards, auditor effort, and independency of the auditor and attributes of inputs, process, and output.

## 2. 2. Previous Related Studies

Duff (2004) stated that the issue of audit quality has been examined from three approaches. The first group of studies have focused on the pricing differentials in examining the issue of audit quality. The second group emphasised the audit differences between audit firms using various measurements of quality performance. The last group considered the issue from the behavioural perspective. This study will investigate audit quality attributes from the last approach, which is the behavioural perspective. Studies on audit quality from behavioural perspective are characteristically intended to identify factors that are perceived by clients, auditors and users related to audit quality (Duff, 2004). Some of the studies are summarised below.

In 1986, Schroeder, Solomon & Vickrey conducted a survey of audit-committee chairpersons and auditors in the United States to provide insight into the factors that they perceive to be important determinants of audit quality during the auditor nomination/selection process. The 15 audit quality factors that presented in the questionnaire were separated into two classes, which were audit-firm factors and audit-team factors. From the result, it showed that audit-team factors are perceived to be relatively more important than firm-wide factors.

Carcello, Hermanson & McGrath (1992) surveyed high-ranking auditors, prepares, and users in the United States as a basis for comparing their perceptions of the underlying components of audit quality. Forty-one attributes of audit quality identified from the literature and also referred to the personal experiences of the authors were included in the questionnaire. The participants were then asked to evaluate the degree to which each attributes improves audit quality. The result showed that audit team and firm experience with the client, industry expertise, responsiveness to client needs, and compliance with the general standards of generally accepted auditing standards (GAAS) were four factors that reported being most important in determining audit quality.

Beattie & Fearnley (1995) examined audit quality attributes in the UK by surveying finance directors of 210 listed UK companies. Twenty-nine auditor characteristics identified from the literature were presented in the questionnaire. The exploratory factor analysis resulted in five main factors of audit quality, which were integrity of the firm, the technical competence of the firm, the quality of the working relationship with audit partner, the reputation of the firm, and the technical competence of the audit partner.

Warming-Rasmussen & Jensen (1998) investigated how the shareholders and financial journalists in Denmark perceive audit quality and analysed if the financial reporting preparers and auditors appraise the attributes of quality differently. The study tried to identify a possible relationship between quality and confidence attributes. Fifteen attributes concerning quality and confidence identified from in-depth dialogues with four external user groups presented in a set of questionnaires. The result showed that the external users tend to perceive audit quality attributes as attributes that also inspire confidence in the auditor, and that moral and ethical aspects are the main quality dimensions.

Duff (2004) conducted a research aiming to identify the determinants of audit quality using samples of auditors, financial directors, and external users in the UK. The project extended

previous study on audit quality to include service aspects of quality. As a result, Duff (2004) developed an audit quality model (AUDITQUAL) that categorizes audit quality into two elements: technical qualities and service qualities. Technical qualities including competence and independence, as mentioned before by DeANGELO(1981), while the service qualities involving factors such as responsiveness, non-audit services, and understanding.

Duff (2009) continued his previous work by considering changing perceptions of audit quality in the UK during a period of significant environmental change. His study conducted a new survey data in February 2005 and compared the result to a dataset collected in February 2002, coincident with the Enron/Andersen debacle. The results showed that the mean scores for the technical audit factors, which are competence, relationship, and independence, fell from 2002 to 2005. However, there is no change in value for the service qualities. The work presented four higher-order factors for audit quality that were different from previous study, which demonstrated nine important attributes.

In conclusion, audit quality studies on the perceptions of participants in audit market have captured many factors and dimensions of audit quality. A comprehensive study by Duff (2004) has presented audit quality factors drawn from the extant audit quality and service quality literature in one model, the AUDITQUAL model.

### **3. Research methods**

#### **3.1. Survey participants**

As already indicated, this study involved three groups of audit market participants in Indonesia: auditors, clients, and users of financial statements. These groups were selected as it was considered that they would be best placed to provide an understanding of many of the possible factors that affect audit quality, in order of importance.

Audit clients and users of financial statements were identified from the IDX website 2010 (<http://www.idx.co.id/>). The IDX is the Self-Regulatory Organization (SRO) providing oversight of Indonesian capital markets. The IDX acts as a single bourse that facilitates trading in equities, fixed income and derivative instruments in Indonesia. However, as regulated by Law No.8 of 1995 concerning the capital market, the IDX is supervised by an agency under the Ministry of Finance of the Republic of Indonesia, the Indonesia Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK). This agency is obligated to supervise the daily activities of the capital market in Indonesia. It executes policies and technical standards in the field of financial institutions. BAPEPAM-LK provides information regarding the capital market in Indonesia, including the supporting institutions and professions such as auditors. Participants for the auditor group were identified from its database.

To attain a satisfactory response rate for the survey questionnaires, a census survey was conducted, collecting data from the entire population. Green et al. (1988) explained that the nature of the subject within the accounting field usually leads to a response rate of between 10% and 30%. Using the census survey, the total number of sample units for the auditor group was the same as the target population: 395 auditors. All questionnaires were completed anonymously and 134 usable responses were returned with a response rate of 34%.

For the client group, the questionnaire was mailed to 354 audit committee members. All questionnaires were completed anonymously and 74 usable responses were returned,

representing a response rate of 21%. Further, the total sample for the user group was 66 institutional investors and creditors (35 fund managers of investment companies and 31 chief lending officers of banks). The respondents from these institutions were derived from the database of Indonesian stock exchange. From the list of institutions, researchers chose the head of the audit committee (Creswell, 2013.) All questionnaires were completed anonymously and 29 usable responses were returned, representing a response rate of 43%.

### 3.2. Questionnaire

The survey questionnaire sought to elicit empirical evidence of the attributes of audit quality perceived by participants. The questionnaire was developed in English and was translated subsequently into Indonesian. To enhance reliability and validity, the translated questionnaire was pilot-tested. This is important to validate the instrument, to develop or expand the questions, format, and scales (Creswell, 2009).

The questionnaire contained five sections to facilitate respondents' completion. The first section included items relating to audit firm factors. The second section contained items related to engagement partner factors. The third section contained questions relating to audit team factors. The fourth section contained an open-ended question for respondents to comment on audit quality. The last section contained general questions about the background details of each respondent, such as work experience and the type of company they were employed by. To help encourage a strong response rate, respondents were promised a copy of research findings upon request.

Questionnaires were distributed in November 2011 and collected from participants from that time until March 2012. Follow-up reminder phone calls were made one week after the first questionnaire was sent. The same questionnaire was sent again to respondents who had not replied to the first questionnaire four weeks after the first posting. To identify non-responders, there were separate response envelopes: one to confirm response and one with the questionnaire. These will ensure the identity of respondents remained anonymous. However, there were questionnaire characteristics (e.g. different paper colour) to identify the group to which each respondent belonged.

### 3.3. Data analysis techniques

Analysis of the quantitative data collected from the survey questionnaire used the statistical analysis software SPSS, version 20. First, the Wilcoxon non-parametric statistic was used to test for similarities between early and late responders. Then, the descriptive statistics were ascertained for mean scores and standard deviations of audit quality factors for each group. A one-way ANOVA then ascertained whether there were differences in perceptions of audit quality factors between the groups. The one-way ANOVA "compares the variance (variability in scores) between the different groups (believed to be due to the independent variable) with the variability within each of the groups (believed to be due to chance)" (Pallant, 2010). This analysis calculates an  $f$  ratio that represents the variance between the groups. A large  $f$  ratio indicates more variability between the groups than within each group. However, ANOVA does not show which of the groups differ. Therefore, a post-hoc test was conducted to determine where the differences between the groups lay.

## 4. Findings

### 4.1. Tests of normality

A number of tests for normality were conducted to test the distribution of data. Normality of data distribution is a requisite of parametric statistical methods such as those used in the

analysis (i.e. ANOVA and ANOVA with post-hoc tests). Kolmogorov-Smirnov/Saphiro-Wilk, Normal Plot and Box-plot were conducted to test for normality, linearity and outliers for each group. Collectively, the results show that all assumptions were satisfied.

#### 4.2. Group perceptions

This section presents the mean values and standard deviations of the audit quality attributes for each group. The descriptive statistics provide results on nine dimensions of audit quality: reputation; capability; assurance; independence; expertise; experience; empathy; responsiveness; and non-audit services.

Table 1 provides the mean scores of respondents' responses to the nine audit quality dimensions based on the AUDITQUAL questionnaire. A score of 1 signifies not important and a score of 5, most important. The factor of which the dimension is a component is also provided.

Table 1: The AUDITQUAL dimensions per group

Audit Quality Factors	Audit Quality Dimensions	Auditor		Client		User	
		Ranking	Mean score (SD)	Ranking	Mean score (SD)	Ranking	Mean score (SD)
Competence	Reputation	2	4.26 (0.37)	1	4.07 (0.48)	1	4.30 (0.59)
	Capability	1	4.29 (0.36)	2	3.84 (0.54)	2	4.27 (0.61)
Independence	Assurance	4	3.95 (0.47)	5	3.55 (0.66)	4	4.07 (0.52)
	Independence	6	3.75 (0.50)	8	3.05 (0.50)	9	3.48 (0.59)
Relationship	Expertise	3	4.09 (0.42)	4	3.68 (0.66)	5	3.88 (0.54)
	Experience	5	3.83 (0.61)	3	3.80 (0.73)	3	4.15 (0.90)
Service quality	Empathy	9	3.03 (0.77)	9	2.98 (0.60)	8	3.53 (1.00)
	Responsiveness	7	3.51 (0.43)	6	3.42 (0.28)	6	3.87 (0.60)
	Non-audit services	8	3.39 (0.68)	7	3.21 (0.58)	7	3.77 (0.75)

Table 1 shows that auditors rated capability as more important than reputation for audit quality (the mean scores were 4.29 and 4.26, respectively). Capability is the ability of the auditors to conduct work with high professional standards. Reputation is the standing which an auditor enjoys in the market. Capability relates to the engagement partner and the audit team staff, while reputation relates to the audit firm. Therefore, the Indonesian auditors indicated that the capability of auditors to conduct their work with high ethical standards matters more for audit quality than the reputation of the audit firms in the market.

Auditors in Indonesia placed greater importance on expertise than assurance (the mean scores were 4.09 and 3.95, respectively). In the audit quality literature, auditors' reputation, capabilities, and assurance are the most important aspects of audit quality. They represent the competence factors of auditors. Assurance refers to the processes the auditor has in place to assure a high quality audit (such as arranging regular meetings with clients). Expertise is a relationship factor. This reflects the possession of relevant specialist knowledge by the auditor. Therefore, the finding reveals that, for Indonesian auditors, it was more important

to have relevant specialist knowledge of the clients' industry than it is to give more attention on things such as regularly meeting with clients.

Another relationship factor is experience. This considers audit tenure. Experience was rated as more important (mean 3.83) for audit quality than independence (mean 3.75). Independence is the foundation of the auditing profession. However, the results show that auditors in Indonesia placed more emphasis on the experience they had with auditees than they did on their independence in conducting the audit.

Responsiveness, non-audit services, and empathy dimensions are service quality factors in the AUDITQUAL model. According to the model, auditors are better able to deliver expected audit services if they understand their customers' (clients') expectation. However, the results of this study show that the service quality dimensions were not regarded as essential for audit quality by Indonesian auditors. These dimensions were given relatively low scores (means ranged from 3.03 to 3.39).

Table 1 also provides the mean results of client responses with regard to the nine audit quality dimensions on the AUDITQUAL questionnaire. The table shows that clients in Indonesia did not rate all the technical dimensions as more important than the service quality dimensions. Responsiveness and non-audit services are the service quality factors that were rated higher than independence (technical quality factor). The highest mean score was for the reputation dimension (competence factor).

After reputation, the dimension that ranked second in importance was capability. Experience (mean 3.80) and expertise (mean 3.68) ranked third and fourth, respectively, in terms of their perceived importance by clients. Experience and expertise are two dimensions that form the relationship factor. Expertise and experience are audit quality dimensions relating to clients. They show how expert and knowledgeable auditors are about their clients' industry and how long auditors have been working with clients. Therefore, it is not surprising that clients regarded these two dimensions as more important than the fifth ranked factor, assurance (mean 3.55), which refers to the processes the auditor has in place to assure a high quality audit (e.g. frequent communication between the audit team and audit committee).

The lowest mean score for audit quality, according to the client group, was empathy (mean 2.98). This dimension refers to the degree of understanding the auditor demonstrates with the challenges that auditees face. For example, auditors provide the client with personal attention and emphasize that they have the client's best interests at heart. This is the expectation of audit quality from the clients' point of view. However, the results show that clients in Indonesia did not expect such empathy from auditors. It seems that they placed more emphasis on auditors' responsiveness and the non-audit services provided by auditors than on auditors' empathy.

Table 1 provides the results of the users of financial statements' responses to the nine audit quality dimensions based on the AUDITQUAL questionnaire, as well. The table shows that users in Indonesia rated all the technical dimensions to be more important than the service quality dimensions, except for one technical dimension: independence. With similarities to the client group, the highest mean score for the user group was for the reputation dimension (mean score of 4.30). The dimension ranked second in importance was capability, with a mean score of 4.27, followed by experience (mean 4.15).

The independence dimension was regarded as the least important for audit quality, with the lowest mean score of 3.48. This is an unanticipated result. It was expected that the user group would rate all the technical dimensions (including independence) as more important than the service quality dimensions. In fact, users rated the service quality dimension as more important than the technical quality dimension: independence. Responsiveness, non-audit services, and empathy were rated 3.87, 3.77, and 3.53 respectively. These mean scores were higher than independence (mean 3.48).

### 4.3. Comparison of groups' perceptions

The ANOVA determines whether there are differences in perceptions of audit quality dimensions between pairs of the groups. Table 2 shows that at a significance level of .05, there are significant differences in perceptions between the groups for most of the dimensions. As Pallant (2010) explained, "if the significance value is less than or equal to .05 there is a significant difference somewhere among the mean scores on your dependent variables for the three groups". In the analysis, the mean scores of nine dimensions of audit quality were treated as the independent variable and the three groups were auditors, clients, and users of financial statements.

Table2: One-way ANOVA of groups' comparisons

	Source	Sum of Squares	df	Mean Square	F	Sig.
<b>Reputation</b>	Between groups	1.954	2	.977	5.101	<b>.007</b>
	Within groups	44.817	234	.192		
	Total	46.771	236			
<b>Capability</b>	Between groups	10.312	2	5.156	24.608	<b>.000</b>
	Within groups	49.029	234	.210		
	Total	59.342	236			
<b>Assurance</b>	Between groups	9.093	2	4.547	15.448	<b>.000</b>
	Within groups	68.872	234	.294		
	Total	77.965	236			
<b>Independence</b>	Between groups	23.357	2	11.679	44.929	<b>.000</b>
	Within groups	60.825	234	.260		
	Total	84.182	236			
<b>Expertise</b>	Between groups	8.454	2	4.227	15.532	<b>.000</b>
	Within groups	63.681	234	.272		
	Total	72.135	236			
<b>Experience</b>	Between groups	2.794	2	1.397	2.934	<b>.055</b>
	Within groups	111.390	234	.476		
	Total	114.184	236			
<b>Empathy</b>	Between groups	7.068	2	3.534	6.181	<b>.002</b>
	Within groups	133.790	234	.572		
	Total	140.858	236			
<b>Responsiveness</b>	Between groups	4.242	2	2.121	12.322	<b>.000</b>
	Within groups	40.276	234	.172		
	Total	44.517	236			
<b>Non-audit Services</b>	Between groups	6.525	2	3.263	7.472	<b>.001</b>
	Within groups	102.167	234	.437		
	Total	108.692	236			

Only one out of nine AUDITQUAL dimensions, experience, was ranked with equivalent importance by the three groups of respondents. With a significance value of .055, the null hypothesis that the three groups (auditor, client, and user) have similar perceptions (or no difference) of the importance of the experience dimension was accepted. Experience relates to the engagement partner, manager of the audit firm, and senior manager factors. This considers the length of time auditors have performed the audit with clients (audit tenure). The three groups of participants seem to have the same perceptions on this issue. As for the



other eight dimensions (i.e. reputation, capability, assurance, independence, expertise, empathy, responsiveness, and non-audit services), the null hypothesis was rejected indicating that there was a difference in importance scores with all eight dimensions by the three groups of participants.

The significance test, however, did not show which of the groups differed and therefore, a post-hoc test was conducted. Table 3 presents the results. The most significant differences between the mean of the groups were apparent when clients were compared with users. The client and user group have different perceptions on seven dimensions, while there are only four dimensions perceived differently by auditors and users. Auditors and clients have significantly different perceptions on five dimensions. Users disagree with auditors and clients regarding the three service quality dimensions: responsiveness, non-audit services, and empathy. The most significant differences between auditors and users, in term of their perceptions of the importance of audit quality dimensions, related to the responsiveness of auditors. Auditors and clients disagreed mostly on the technical dimensions of audit quality: capability; assurance; independence; and expertise.

Table3: AUDITQUAL dimensions which are significantly different between groups

Auditors and clients groups			Auditors and users groups			Clients and users groups		
No	Audit Quality Dimensions	Sig.	No	Audit Quality Dimensions	Sig.	No	Audit Quality Dimensions	Sig.
1	Capability	.000	1	Responsiveness	.000	1	Capability	.000
2	Assurance	.000	2	Empathy	.003	2	Assurance	.000
3	Independence	.000	3	Non-audit services	.017	3	Responsiveness	.000
4	Expertise	.000	4	Independence	.024	4	Non-audit services	.000
5	Reputation	.011				5	Independence	.001
						6	Empathy	.003
						7	Reputation	.043

### Conclusion

The findings indicate that the most important audit quality dimension for auditors was capability (part of the competence factor), while the client regarded reputation (still part of the competence factor) as the most important dimension for audit quality. The findings also suggest that the three participant groups in Indonesia had different perspectives on almost all audit quality factors. This study shows that it cannot be assumed that audit stakeholders around the world will have the same perception of what factors mostly affect audit quality. Perception will lead to the interpretation and application of the regulations, affected significantly by the characteristics of the professionals applying those regulations and standards. Thus, it is important for the profession (i.e. audit practitioners, international audit firms) to acknowledge this effect. Further studies are expected to use greater sample sizes to enhance the generalizable of the findings. In addition, selecting specific audit segments, such as small-medium enterprises, might provide deeper insights.

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