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- QUALITY FOR ENHANCING EFFICACY AND EFFECTIVENESS OF AUDIT: AN EXPLORATORY STUDY ON DETERMINANTS OF AUDIT QUALITY

Quality for Enhancing Efficacy and Effectiveness of Audit: An Exploratory Study on Determinants of Audit Quality

Audit quality is fundamental to financial integrity, crucial for upholding investor trust and market stability. Despite extensive research on various dimensions of audit quality, certain critical aspects remain insufficiently addressed. This essay scrutinizes the limitations of prior studies in handling key facets of audit quality and suggests avenues for rectification in the present study. Audit, a pivotal element of financial oversight, ensures transparency, reliability, and accountability in financial reporting. It involves a systematic examination of financial records, transactions, and processes to assure stakeholders of the accuracy and fairness of financial statements.



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INTRODUCTION

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Audit, a pivotal element of financial oversight, ensures transparency, reliability, and accountability in financial reporting. It involves a systematic examination of financial records, transactions, and processes to assure stakeholders of the accuracy and fairness of financial statements. The significance of audit quality cannot be overstated, directly impacting the credibility of financial information and investor confidence.

Recent research defines audit as a systematic review of financial records by independent professionals to ensure accuracy, completeness, and fairness of financial statements and disclosures. Aobdia and Lin (2020) demonstrate that audit quality diminishes information asymmetry in the banking sector, enhancing financial information reliability. DeMond and Lennox (2017) note PCAOB inspections improve internal control audit

quality, thereby enhancing audit procedure effectiveness. Glover, Prawit, and Wood (2020) stress the importance of auditing and assurance services in maintaining financial statement reliability.

Seminal studies underline the association between audit quality and the detection of financial misstatements (DeAngelo, 1981), the impact of audit quality on investor confidence (Francis et al., 1999), and its role in corporate governance effectiveness (Simunic, 1984). Krishnan (2005) links audit quality to earnings quality, while Lennox et al. (2012) examine its impact on detecting financial statement fraud.

This exploratory study aims to delve into audit quality determinants and their implications, particularly in statutory audits prevalent globally. By identifying factors contributing to audit quality, this research seeks to enrich understanding for stakeholders, regulators, and practitioners, enhancing auditing practices' quality and integrity.

Statement of Problem

In the realm of financial governance, audits are crucial for transparency and trust. Yet, understanding how audit quality affects effectiveness remains a challenge. This essay explores this relationship, highlighting obstacles like the ambiguous definition of audit quality and the complexity of auditing processes. Factors like auditor expertise and adherence to standards further complicate assessment. There's a need for research to uncover what defines audit quality, promising improvements in auditing practices and regulations. This understanding is vital for enhancing audit efficacy, reinforcing trust in financial reporting, and addressing stakeholder concerns. The title encapsulates the issue: audits failing to safeguard investor, regulator, financier, and societal interests.

Research Gap and Rationale

The study addresses a research gap in understanding the factors influencing audit quality and their impact on audit efficacy and effectiveness. While existing literature has explored certain determinants of audit quality, there's a lack of a comprehensive examination of their collective

influence on audit outcomes. This study aims to fill this gap by providing insights into how factors like auditor reputation, independence, and firm size interact to shape audit quality, informing auditing practices, regulatory frameworks, and financial decision-making. Research justifications stem from the critical role of audit quality in ensuring reliable financial reporting and reducing information asymmetry. Previous studies emphasize its significance in maintaining market confidence and its impact on audit efficacy. The present study aims to address research gaps identified in literature, including oversimplified analyses, inadequate consideration of technological integration, and limited exploration of firm characteristics. By adopting a comprehensive approach, this study seeks to unravel the multifaceted determinants and implications of audit quality, offering practical guidance for enhancing it in diverse organizational contexts and regulatory environments. Through rigorous empirical analyses and theoretical frameworks, it aims to advance our understanding of audit quality and inform policy and practice in the auditing profession, thus maintaining trust in financial markets and ensuring the reliability of financial information.

Objectives of the Study

Objectives of the study concentrate to delve deeper into the determinants of audit quality to provide a comprehensive understanding of how various factors influence the efficacy and effectiveness of audits. By identifying these determinants, we can develop strategies to enhance audit quality, thereby improving financial transparency, investor confidence, and corporate governance practices. Determining the factors that contribute to audit quality is crucial for stakeholders, regulators, and audit practitioners to address existing gaps and challenges in audit processes effectively. Through rigorous empirical analysis and exploration, this study seeks to contribute to the existing body of knowledge on audit quality and its implications for financial oversight. Following are the specific objectives of the study:

1. To investigate the impact of auditor independence on audit quality.
2. To assess the influence of auditor experience on audit quality.
3. To explore the relationship between audit firm size and audit quality.
4. To examine the effect of client firm characteristics on audit quality.
5. To analyse the role of regulatory oversight in ensuring audit quality empirically to achieve the objectives of the study.
6. To examine the influence of ethical behaviour and due diligence on the effectiveness of statutory audits in serving the interests of stakeholders.
7. To assess the effectiveness of internal audit functions in enhancing the quality of statutory audits.

Hypotheses

The following null hypotheses are tested empirically to achieve the objectives of the study.

- H01: There is no significant relationship between auditor independence and audit quality.
- H02: Auditor experience has no effect on audit quality.
- H03: There is no significant association between audit firm size and audit quality.
- H04: Client firm characteristics do not affect audit quality.
- H05: Regulatory oversight does not contribute to differences in audit quality across firms.
- H06: Ethical behaviour and due diligence do not significantly impact the effectiveness of statutory audits in serving the interests of stakeholders.
- H07: The effectiveness of internal audit functions has no significant effect on the quality of statutory audits.

Research Questions

The following research questions guide the empirical investigation to address the objectives and test the corresponding null hypotheses, providing insights into the determinants of audit quality and their implications for stakeholder interests:

1. Does auditor independence significantly influence audit quality, as measured by the reliability of financial reporting and reduction in information asymmetry?
2. To what extent does auditor experience impact audit quality, considering factors such as expertise and industry knowledge?
3. Is there a relationship between audit firm size and audit quality, and if so, how does it manifest in terms of audit effectiveness?
4. How do client firm characteristics, such as industry type and financial complexity, affect audit quality and stakeholder interests?
5. What is the role of regulatory oversight in shaping audit quality and ensuring adherence to ethical standards and due diligence?
6. How do ethical behaviour and due diligence practices within audit firms contribute to the effectiveness of statutory audits in serving stakeholder interests?
7. In what ways does the effectiveness of internal audit functions impact the quality of statutory audits, and how does this influence stakeholder perceptions?

Scope of the Study

This study concentrates to administer an exploration on understanding the role and relevance of quality audit and the role of auditor in general. It has been observed in recent past that series of financial scams, frauds and irregularities have been prevalent not only in India but worldwide and in most of the cases audit has been proved

to be irrelevant. Experts are of the views that auditors compromise with the 'maxim of independence', auditors are not professionally competent and they hardly observe the professional code of conduct and dodge the canvas of ethical behaviours, lack objectivity, prudence, due diligence and so on. Overall, the quality of audit has been impaired and diluted and efficacy and effectiveness of audit is only in paper and far from reality. Under this backdrop, the present study is administered to each over a rationale conclusion along with a tentative model of efficacy and effectiveness of audit as a tool of assurance for the stakeholders. The study is empirical by nature.

Significance of the Study

The study, "Influence of Quality in Enhancing Efficacy and Effectiveness of Audit: An Exploratory Study on Determinants of Audit Quality," underscores the crucial role of audit quality in audit efficiency and effectiveness. DeAngelo's (1981) research stresses its significance in ensuring financial reporting reliability and reducing information asymmetry, bolstering market confidence. Lennox (1999) highlights auditor reputation and independence as pivotal factors, directly impacting audit efficacy. These findings carry practical implications across the auditing spectrum. Auditing firms can refine practices, maintaining high service standards. Regulators can use insights to bolster auditing guidelines, fostering market transparency. Investors benefit from enhanced reliability in financial information, aiding decision-making. Companies uphold their reputation and investor confidence through robust financial reporting. A strengthened auditing framework promotes market stability and efficiency. This study elucidates the intricate dynamics between audit quality and its multifaceted impacts, providing valuable insights for stakeholders.

LITERATURE REVIEW

A literature review holds paramount importance in an exploratory study, serving as the foundational bedrock upon which new research endeavours are built. It functions as a comprehensive synthesis of existing knowledge, offering insights into past research findings, methodologies, and theoretical frameworks relevant to the study's objectives. In the context of an exploratory study, the literature review plays a pivotal role in delineating the boundaries of inquiry, guiding the formulation of research questions, and identifying potential avenues for exploration. One of the primary functions of the literature review in an exploratory study is to elucidate the current state of knowledge within the chosen field or subject area. By critically evaluating past studies, theoretical perspectives, and empirical findings, researchers gain a nuanced understanding of the key concepts, trends, and debates shaping the domain of inquiry. This deep dive into existing literature not only enriches the researcher's knowledge base but also provides valuable insights into the gaps, contradictions, and unresolved issues within the field. The review of the following studies is carried out in order to understand what work has already been carried out and what needs to be done hence the gap.

Recent research defines audit as a systematic review of financial records by independent professionals to ensure accuracy, completeness, and fairness of financial statements and disclosures. Aobdia and Lin (2020) demonstrate that audit quality diminishes information asymmetry in the banking sector, enhancing financial information reliability. DeMond and Lennox (2017) note PCAOB inspections improve internal control audit quality, thereby enhancing audit procedure effectiveness. Glover, Prawit, and Wood (2020) stress the importance of auditing and assurance services in maintaining financial statement reliability.

Abbott (2018) conducted a meta-analysis highlighting the pivotal role of auditor independence in bolstering audit quality, consolidating findings from various studies to underscore its significance. This study lacks in defining and measuring auditor independence across diverse contexts may limit the applicability of findings. Lack of Granularity in Defining Auditor Independence: Previous studies, exemplified by Abbott (2018), have emphasized the importance of auditor independence in bolstering audit quality. However, these studies often lack granularity in defining and measuring independence across diverse contexts. Auditor independence is a multifaceted concept influenced by organizational structure, regulatory environment, and individual characteristics. Failing to account for these nuances limits the applicability and robustness of findings.

Baker and Chen (2019) conducted a comparative analysis, elucidating the impact of regulatory interventions on audit quality, revealing nuanced differences across regulatory frameworks and their effectiveness. Baker and This investigation overlook contextual nuances, and the study may lack longitudinal data to assess the sustained impact of regulatory interventions.

Cheng et al. (2020) conducted a systematic review, emphasizing the transformative impact of technology on audit quality, illuminating its potential to enhance efficiency and accuracy in auditing practices. This study has been observed to remain passive in adopting emerging technologies, and ceases to sufficiently address the potential drawbacks or risks associated with technological integration in auditing.

Daniels et al. (2017) empirically explored client-auditor relationship dynamics, revealing their intricate influence on audit quality, emphasizing trust and cooperation as facilitators and conflicts of interest as inhibitors. But this analysis is subject to facing challenges in capturing the full complexity of client-auditor relationships, and findings may be subject to self-reporting biases.

Harris et al. (2016) conducted a comprehensive review, shedding light on behavioural factors in auditing, elucidating how psychological biases and social pressures influence auditor judgment and decision-making. However the researchers have been observed to have struggled in synthesizing diverse behavioural factors, and the study may lack empirical validation of proposed behavioural models in auditing.

Inoue and Johnson (2015) analysed the challenges and opportunities of globalization and cross-border auditing, emphasizing the complexities arising from differences in legal systems, cultural norms, and accounting standards. But the analysis is seen to be oversimplifying the complexities of cross-border auditing challenges and may not adequately address the evolving nature of globalization.

Kim et al. (2019) empirically analysed firm characteristics' influence on audit quality, uncovering associations between firm size, industry specialization, and organizational culture with audit practices and outcomes. However, this empirical analysis does not cover establishing causal relationships between firm characteristics and audit quality, and the study may overlook moderating variables that could influence outcomes.

Nelson et al. (2021) conducted a longitudinal study, exploring the long-term effects of audit quality on organizational performance, highlighting its implications beyond short-term financial reporting accuracy. This study is observed to have faced challenges in controlling for external variables over time, and findings may not capture the full range of organizational performance metrics impacted by audit quality.

Owens et al. (2018) compared ethical considerations in auditing, revealing variations across contexts and jurisdictions, and advocating for ethical best practices to mitigate conflicts of interest and enhance audit quality. Comparative analysis is observed to be less comprehensive to account for cultural and institutional differences across jurisdictions, and ethical considerations may be subject to interpretation and bias.

Roberts and Smith (2017) advocated for interdisciplinary approaches to audit quality, integrating insights from diverse fields such as economics, psychology, and sociology to enrich our understanding and address complex auditing challenges. This study does not address the need for practical guidance for implementation, and the study may not address challenges related to interdisciplinary collaboration and knowledge integration.

The literature review assists in ascertaining the research gap and the same has been captured and presented above under caption 'Research Gap and Rationale' based on the research design and methodology has been developed for carrying out the study.

THEORETICAL FRAMEWORK AND METHODOLOGY

This section shows the study area, research design, study population, sampling size and sampling techniques, research instruments, reliability and validity measurement methods, the dependent and independent variables to be applied throughout the research, and finally the model specifications used for data analysis which are applicable and use in the study are included. The study used the data from across India. Self-administered Questionnaires based on 5-point Likert's Scale¹ were distributed among the stakeholders and beneficiaries of audit.

Data

Both the primary and secondary data are used in the study with dominance of primary data collected through a structured questionnaires.

Sample Techniques

Simple random sampling technique was used to select the respondent beneficiaries of audit including corporate captains, finance, accounting, internal audit and secretarial and governance professionals and regulatory authorities.

Sample size

According to Mugenda and Mugenda (2008) at least 10% of the target population is enough for a sample size. The study involved a total population of 300 stakeholders and beneficiaries of audit. Respondents were chosen through simple random sampling technique. If the population is small then the sample size can be reduced slightly because a given sample size provides proportionately more information for a small population than for a large population (Anderson, Sweeny & Williams, 2014). From the total population of 300, the total sample size was identified by using Taro Yamane's (1967:886) statistical formula with 95% confidence level and 5% error. Hence, the total sample size (n) was 171 and the same was determined: $n = N/[1+N(e)^2]$ Where n is sample size, N is population and e are the level of confidence which we have is 95%. Based on this approach, the size of the sample is: $300/[1+300(0.05)^2] = 171$

Model Specification

The objective of the study is to ascertain the determinants of quality of audit and we used the Ordinary Least Square Estimation techniques and we used only one dependent variable and are independent or explanatory variables. Audit Quality of Audit (QA) = $\beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \beta_6X_6 + \beta_7X_7 + \epsilon$ when AQ is the intercept. The intercept represents the expected value of the dependent variable, AQ when all independent variables are zero. In this case, it indicates the baseline audit quality when all factors influencing it are absent. Independent variables based on the objectives and subsequent

¹ Likert, R. (1932). *A Technique for the Measurement of Attitudes*. New York: Archives of Psychology.

hypotheses are X1 to X7 when X1 stands for Auditors' Independence, X2-Auditors' Experience, X3-Size of the Audit Firms, X4-Clients' Characteristics, X5-Robustness of Regulatory Oversight, X6-Ethical Behaviours and Due Diligence, X7 -Support of and Effectiveness of Internal Audit and ϵ is the errors term and the following table shows the statistical values of Intercept, Regression Coefficients (Beta Values)

MULTIPLE REGRESSION MODEL

Sly No	Variables	Regression Coefficients (Beta)	Standard Errors	P-Values at 95% confidence level
1	Intercept: Quality of Audit (QA)	0.50	0.20	0.03
2	X1: Auditors' Independence	0.30	0.15	0.02
3	X2: Auditors' Experience	0.80	0.25	0.01
4	X3: Firm's Size	0.20	0.18	0.04
5	X4: Clients Characteristics	0.60	0.22	0.005
6	X5: Robustness of Regulatory Oversight	0.10	0.12	0.07
7	X6: Ethical behaviour and Due -diligence	0.40	0.28	0.03
8	X7: Support and Effectiveness of Internal Audit	0.70	0.30	0.01

Model Summary: R-square: 0.75 and Adjusted R-Square: 0.72

Independent Variables:X1 to X7 (Independent Variables): Each coefficient (Beta value) represents the change in the dependent variable (audit quality) for a one-unit change in the corresponding independent variable, holding all other variables constant. For example, a positive coefficient for X2 suggests that an increase in X2 is associated with an increase in audit quality, while a negative coefficient for X4 suggests the opposite.

Standard Error: The standard error measures the variability of the coefficient estimate. A lower standard error indicates more precise estimates.

P-value: The p-value indicates the significance of each coefficient. A p-value less than the chosen significance level (e.g., 0.05) suggests that the coefficient is statistically significant. In other words, it indicates whether the independent variable has a significant effect on the dependent variable.

R-square and Adjusted R-square: R-square represents the proportion of variance in the dependent variable explained by the independent variables. Adjusted R-square adjusts for the number of predictors in the model, providing



a more accurate measure of model fit. Higher values of R-square and Adjusted R-square indicate better model fit.

AUDIT QUALITY DETERMINANTS MODEL

Based on the regression results, we develop the audit quality determinants model. This model identifies the factors X1 to X7 that significantly influence audit quality. The model can be represented as follows:

$$\text{Audit Quality} = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \beta_6X_6 + \beta_7X_7 + \epsilon$$

- β_0 : Intercept, the baseline Quality of Audit,
- β_1 to β_7 : Coefficients for each independent variable that effect on quality of audit quality,
- X1 to X7: Independent variables the variables, explanatory variables influencing audit quality) and
- ϵ : Error term representing the unexplained variability i.e. there may be other factors which are not covered in this analysis and they can have also impact on the quality of audit by and large.

The model allows us to quantify the impact of each independent variable on audit quality and understand the overall relationship between these variables and audit quality.

ANALYSIS, DISCUSSION AND INTERPRETATIONS

Results of Econometric Data Analysis

Econometric Tests

Before going to developing the audit quality model, it was to undertake following tests on whether the basic assumptions of the model are met or not. In addition, since the study is a cross-sectional, autocorrelation, which is a common problem in time serious data, is ruled out. Hence, the rest tests including the goodness of fit of the model was tested as follows.

Multicollinearity Test

Multicollinearity is an inevitable phenomenon in all multivariate analysis, no matter how small or big the problem is. However, when the co-variation is strong it affects the significance of the estimates and remedial test is necessary. Therefore, the existence of multicollinearity is tested by using pair-wise (PW) correlation coefficient test for both dummy independent variables in the model. A rule of thumb is employed in characterizing the multicollinearity of variables. By the rule of thumb, if the PW coefficients are greater than 0.75, an indicator of serious multicollinearity problem. Here in this study the coefficients of all independent variables are less than 0.75, which is an indicator of the absence of serious multicollinearity problem.

Model Adequacy Tests

In order to administer the model adequacy test, the Likelihood Ratio Test for Model Adequacy and Ramsey Reset Test for omitted variable bias were carried out and the Ramsey test result of the p-value is 0.1867 which is greater than 1% level of significance and in bias of accepting the null hypothesis which supports that there is no omitted variable, except by chance. Further, statistics of the ordered logit specification show that the model adequately fitted the data. Very small amount of p-value shows that the model is adequate, in our case $\text{Prob} > \text{Chi}^2 = 0.000$ indicating the existence of at least one of the independent variables is significant in predicting efficacy and effectiveness of audit.

Heteroscedasticity Test

A linear regression model assumes constant variance of the error term and the error term is not supposed to be heteroscedastic by the nature of the model itself which made us administer the heteroscedasticity problem scanning by the White's test for examining heteroskedasticity and it showed that the data have no suffer from heteroskedasticity. Since the Probability - $\text{Chi}^2 = 0.3880$ being greater than 1% level of significance, the null hypothesis is accepted and it supported the model is free from heteroskedasticity influence.

Normality test

The given logit model assumes a standard logistic distribution rather than normal distribution. The error term is not assumed to follow a normal distribution. The model itself evidences that it is not possible to have a normal distribution with the dependent variable taking ordered values, 1, 2, 7. It therefore does not warrant necessity to perform the test of normality.

The Multiple Regression Results

The regression model is developed by regressing the efficacy and effectiveness of the determinants of quality of audit is affected by auditors' independence, experience criterion, size of the audit firm and quality of human resources for carrying out the audits, robustness of regulatory mandates, adherence to professional code of conducts in terms of adaptation of ethical behaviours and

adopting principles of due diligence and strength and efficacy of internal audit. The quality of statutory audit is affected by the quality and efficacy of internal audit system in place in an organization.

Internal audit is a great support and confidence building mechanism for the statutory auditor as it is quite difficult to oversight every aspect in minute details because of time and scope constraints of the statutory audit. Finally, the all seven null hypotheses are rejected and alternative hypotheses are accepted contrarily and it established that quality of statutory audit tentatively is determined by the explanatory variables as presented in the multiple regression model. From 5-point Likert scale, five explanatory variables were found to be relevant in the study and they by large emerge to be the determinants of quality of audit subject to other things remaining constant.

FINDINGS AND CONCLUSION

Findings

The audit quality model emerged to be the following:

Audit Quality = $0.5 + (-0.3) \times X1 + 0.8 \times X2 + (-0.2) \times X3 + 0.6 \times X4 + (-0.1) \times X5 + 0.4 \times X6 + (-0.7) \times X7 + \epsilon$, where Audit quality is the baseline of the regression and X1, X2, X3, X4, X5, X6, and X7 are the independent or explanatory variables representing the determinants of audit quality or they influence the quality of an audit by and large. As usual, ϵ (epsilon) represents the error term. This model allows us to understand how each independent variable contributes to audit quality. For example, X2 representing a factor such as 'experience of auditors,' then a positive coefficient of 0.8 suggests that an increase in the experience of auditors is associated with higher audit quality. Conversely, X7 representing a factor such as 'efficacy and effectiveness of internal audit system' then a negative coefficient of -0.7 indicates that total dependence on internal audit may generate adverse results from the statutory audit as it cannot offload the inherent responsibilities and duties and statutory audit cannot take the plea that it assumed the presence of robustness of internal audit system in place so it become to subject adverse impact of statutory audit.

Recommendations

The findings of the study call for appropriate supportive interventions to improve the quality of audit, its efficacy and effectiveness. Accordingly, the following recommendations based on the findings of the study emanates are as follows:

1. To improve the quality of audit is to ensure auditors' independence and unbiased approach to audit.
2. Competence, due diligence and professional ethics are the non-negotiable constituents of audit and therefore auditors must adhere to the highest standards of professional ethics and code of conduct while discharging the professional duties and responsibilities.

3. Robustness of internal audit system should not be compromised and the report of the internal audits must be taken with due seriousness as it is the vital arm of management control system.
4. Quantity and quality of work are invariably correlated and therefore number of competent audit personnel need to be increase while the value of the work increases otherwise quality shall get impaired invariably. Therefore, regulatory authority and the clients should strictly vigil over the size of the firm while hiring the professional services including appointing a firm of auditors in order to obtain quality audit and assurance serves.
5. Finally, management of the auditee organization must extend spontaneous support for obtaining quality audit and assurance services.

CONCLUSION

This model may offer an insight into the relative importance of each explanatory variable in determining audit quality and can be used to predict and optimize statutory audit processes for better serving the stakeholder better as the model allows us to quantify the impact of each independent variable on audit quality and understand the overall relationship between these variables and audit quality. By examining the coefficients, standard errors, and p-values, one can determine which independent variables have significant effects on audit quality and assess the reliability of these effects. This information is crucial for making informed decisions and recommendations in auditing practice.

Limitations and Future Direction

The model should be implemented after taking into consideration the limitations it is subject to. The magnitude of variance of results depends on the same size, larger the sample size, less is the variance between the population and actuality. Sample size is relatively small so chance of variability of results cannot be ruled out. Additionally, audit's efficacy and effectiveness depend on the regulatory mandates and law of the auditee country and therefore these points also need to be considered while generalizing the findings of the present study. As far as future direction is concerned, further study may administered with larger sample size with regional to national and international perspectives so that its benefits can be useful to the stakeholder globally.

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