

Audit Quality in Four Perspectives

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Abstract

This research summarizes several findings from various researchers on the issue of audit quality, aligning them with proxies such as material misstatements, auditor communication, financial reporting quality and perception-based. The research results provide evidence that updated regulations and guidelines are needed to ensure the production of high-quality audit reports. This includes standardizing materiality guidelines, which currently vary among auditors, and providing regulations regarding non-audit services to ensure costs do not exceed standard thresholds.

Keyword: Audit Quality, Misstatements, Auditor Communication, Financial Reporting Quality, Perception-based.

INTRODUCTION

Various researchers, who investigate audit quality, recognize the high value of audits because of the independent assurance they provide regarding the credibility of accounting information. Auditing has become a focal point along with the increasing complexity of business transactions and the development of accounting standards and technological developments. These changes have fundamentally altered the audit market due to significant shifts in supply and demand dynamics. However, consistency of audit quality remains a crucial area of investigation. There are several definitions related to audit quality, (DeAngelo, 1981) states that audit quality is the combined probability that an auditor will discover and report violations in the client's accounting system (Defond & Zhang, 2014) states that higher audit quality offers greater assurance of high-quality financial reporting. This indicates that auditor quality and compliance with audit standards are important markers of high audit quality. Therefore, auditor error and compliance with audit standards are important issues in addressing weaknesses in audit quality, which can lead to poor perceptions of audits in both public and private litigation environments (Asniarti, 2019).

Audit quality as a component of financial reporting quality underlines the importance of researching audit quality. Researchers use various dimensions to compare audit quality proxies (Defond & Zhang, 2014), including proxies for material misstatements, auditor communication, financial reporting quality, perception-based. These dimensions are the basis for categorizing audit quality developments in this research. Material misstatements involve correcting inaccuracies in previously issued financial statements, including examining whether audit quality is related to audit committee characteristics, non-audit services, industry specialization, or enforcement actions related to civil lawsuits filed by the SEC. These examinations cover specific events such as fraudulent financial reporting, which has become a major focus justifying far-reaching legislative and regulatory changes in the wake of high-profile corporate governance failures such as Enron and WorldCom. (Lennox & Pittman, 2010) found that the relatively superior audit quality of Big Five firms has declined in recent years, although larger firms tend to retain Big Five auditors. Some studies indicate misstatements and possible restatements, such as the granting of short-term stock options to audit committee members (Archambeault et al., 2008) and violations of appropriate audit opinions (Rajgopal et al., 2021).

Perception-based reflects investors' perceptions of earnings quality, earnings response coefficient, and

auditor quality. This includes market reactions to changes in auditors in relation to the issuance of going concern opinions, audit committee perceptions, and audit fees (Defond & Zhang, 2014). As an example, (Du, 2017) found that CEO-auditor dialect sharing is negatively correlated with pre-IPO audit quality, which influences investor perceptions. The purpose of this research review is to summarize and provide insight into current research on audit quality, offering directions for future research. We present a descriptive analysis of evolving perceptions of audit quality and their relationship to auditor performance.

Auditor communications reflected in a modified going concern opinion, with managers sometimes intervening to obtain a clean opinion. This manipulation occurred due to managerial collusion with political interference (Malau et al., 2018). Larger auditors are more likely to issue going concern opinions for IPO issuers (Weber & Willenborg, 2003). Greater costs are also associated with receiving a going concern opinion, which undermines auditor independence (DeFond et al., 2002; Li, 2009). Financial reporting quality, although simpler than a restatement or going concern opinion, is often illustrated by earnings management. As former SEC Chairman Arthur C. Levitt put it, earnings management undermines the quality of financial reporting by misleading investors, although usually not to the level of material misstatement (Defond & Zhang, 2014). Preventive measures to limit errors include using earnings management proxies based on the Jones model for firm performance and the Dechow model as alternatives to test the quality of accruals (Hohenfels & Quick, 2018). The aim is to increase the auditor's likelihood of detecting material misstatements due to fraud in financial statement audits (Trotman et al., 2009).

LITERATURE REVIEW

Audit Quality

Opinion (DeAngelo, 1981) audit quality as the combined probability assessed by the market that a particular auditor detects violations in each client's accounting system, and reports violations if there are violations, it seems that this definition explains the auditor's ability to find violations and report them, while other definitions are often used in explaining quality auditing is (Defond & Zhang, 2014) which states that higher audit quality provides greater assurance of high quality financial reporting as well, this definition of course focuses on compliance with audit standards which is reflected in the importance of the quality of financial reporting that will be produced (Francis, 2004) highlighting the important role of auditors in ensuring the integrity and transparency of financial reports through quality audit practices.

Material Misstatements

An attitude of professionalism places a high emphasis on materiality at every stage of the audit process, from planning to evaluate audit results. As the complexity of national and international audits increases, this issue becomes more urgent, requiring updates to audit standards and other professional guidelines for determining materiality (Glover et al., 2008). According to (Collin, nd), misstatements are statements that are not true or provide incorrect information. Common examples of material misstatements include overstatement of revenues, misstatement of costs, capitalization of costs, and differences across industries and time periods (Dechow et al., 2011). The auditor's level of perception may also vary, because issues that the auditor considers immaterial may be very material to investors and other stakeholders, thereby impacting audit quality. Like (Popova, 2018) although auditors can accurately assess the risk of fraud in assessing the risks of material misstatement, they often struggle to adapt their audit procedures adequately in response to these risks. (Azhari et al., 2020) found that financial distress and CEO duality were significantly correlated with the occurrence of accounting misstatements, indicating that these factors could contribute to these misstatements.

Auditor Communication (Opinion)

Communication is a core component and one of the most important roles in many business practices. (Handoko & Widuri, 2016) Effective auditor communication has a positive impact on the client's response to questions and on the overall success of the audit process. Audit opinion is a form of direct communication between auditors and shareholders regarding the audit process and its results (Defond & Zhang, 2014). Communicating audit results is an important part of the audit process (Coram et al., 2011). The auditor provides assurance that the financial statements are presented fairly in accordance with applicable regulations. This opinion reflects higher audit quality, offering greater assurance of high-quality financial reporting. Misleading opinions, such as modified

audit opinions tailored to the company's wishes, can harm investors. For example, managers may look for a clean opinion to describe the company as a going concern company.

Financial Reporting Quality

Financial Reporting Quality simpler than a restatement or going concern opinion, such as measuring audited financial statements (Defond & Zhang, 2014). This is because financial reports are a combined product of managers and auditors. Conceptually, the quality of financial reports is an appropriate measure for measuring audit quality (Aini et al., 2020). It is also hoped that it can detect earnings manipulation through earnings management, such as meeting earnings targets, which can endanger the quality of financial reporting by misleading investors, even if it does not reach the level of material misstatement (Defond & Zhang, 2014). Discretionary accruals (DAC) are associated with Accounting and Auditing Enforcement Releases (AAER) because earnings management does not directly capture significant misstatements (Dechow et al., 1996). Lower audit quality is associated with greater flexibility in accounting practices (Becker et al., 1998).

Perception-Based,

Investor perceptions, which are indirectly related to earnings quality, include factors such as earnings response coefficient, stock market reaction to audit-related events, and cost of capital (Defond & Zhang, 2014). For example, the stock market reaction to a change of auditor can be positive or negative, depending on whether the change is from a specialist auditor to a non-specialist auditor. Non-audit services (NAS) also influence perceptions of audit quality in various ways. Perception-based proxies are more effective in detecting dimensions of audit quality that output-based proxies may miss. For example, non-audit services may reduce the quality of client footnote disclosures, a factor that is not captured by discretionary accruals or going concern opinions but is detectable through investor perceptions, regardless of which type of non-audit service has the greatest impact (Darmawan, 2023) the importance of auditor independence, competence, and ethical behavior, all of which are perception-based factors that contribute to audit quality.

METHODS

Based on the problem formulation of this study, the research method uses Systematic Literature Review (SLR) with a bibliometric approach, by collecting articles relevant to the themes of material misstatements, auditor communication, financial reporting quality, and perception-based. Analysis is used to see research trends and measure research progress by evaluating relevant articles.

RESULTS AND DISCUSSION

Based on the results of a systematic literature review analysis using a bibliometric approach, a summary of audit quality measurements proxied in material misstatements, auditor communication, financial reporting quality, and perception-based, is as follows.

Table 1. Summary of audit quality based on material misstatements, auditor communication, financial reporting quality and perception-based

Audit Quality Measures	Writer	Findings
	(Azhari et al., 2022)	CEO duality, financial distress, and certain corporate governance practices, such as board independence and high debt levels, are positively associated with accounting misstatements.
Material Misstatements	(Beardsley et al., 2020; Hohenfels & Quick, 2018)	A higher Non-audit services (NAS) fee level can result in lower audit quality.
	(Du, 2017)	CADS in the IPO process have greater discretionary accruals and a higher probability of financial restatement in the post-IPO period.

Audit Quality Measures	Writer	Findings
Auditor communications(Opinion)	(Guan et al., 2016)	The relationship between the auditor and the client's directors (managers) results in a higher likelihood of financial misstatements.
	(Hurt et al., 2013)	There is evidence that professional skepticism allows auditors to identify more fraud cues.
	(Schmidt, 2012)	Total nonaudit fees (NAS) and the ratio of NAS fees to total fees are positively related to the likelihood that a restatement results in audit litigation.
	(Lennox & Pittman, 2010)	The incidence of fraudulent financial reporting is consistently lower for Big Five clients
	(Chin & CHI, 2009)	Auditors who have industry expertise are less likely to experience restatements involving material net income
	(Archambeault et al., 2008)	Grant of short-term stock options to audit committee members and possible restatement.
	(Fioleau et al., 2019)	Recommend that auditors adjust their audit committee (AC) communications
	(Malau et al., 2018)	Fraud is committed by management or due to collaboration with political interference.
	(Du, 2017)	CEO-auditor dialect sharing (CADS) is significantly related to discretionary accruals (an inverse proxy of audit quality),
	(Compernelle, 2013)	In a dual accountability relationship, the external auditor is positioned in the middle, and often engages in impression management (IM).
	(Coram et al., 2011)	Communicating audit results is an important part of the audit process.
	(Li, 2009)	
	(Weber & Willenborg, 2003)	In the post-SOX era, companies that incur costs are more likely to receive going concern opinion reports.
	(DeFond et al., 2002)	Larger auditors are more likely to provide going concern opinions to IPO issuers.
		Auditors are more likely to issue going concern

Audit Quality Measures	Writer	Findings
Financial reporting quality		opinions to clients who pay higher audit fees
	(Rahman et al., 2023)	Audit fee engagements significantly reduce real earnings management and improve accrual quality (an alternative proxy for financial reporting quality).
	(Hohenfels & Quick, 2018)	Precautions to limit the effects of errors by using the Jones-based model version of earnings management proxies on company performance and the Dechow/Dichev model as alternative models to test the quality of accruals.
	(Du, 2017)	<i>CAD</i> Sin the IPO process causes collusion between the CEO and the auditor. This collusion results in earnings management before the IPO,
	(Trotman et al., 2009)	<i>Brainstorming treatment</i> and the pre-mortem produced a larger list of potential frauds than groups interacting without brainstorming guidelines
	(Archambeault et al., 2008)	Uncertain rewards received by the audit committee will reduce supervisory motivation and thus, increase the possibility of financial reporting failure.
Perception-based measures	(Becker et al., 1998)	Lower audit quality is associated with more “accounting flexibility”.
	(Darmawan, 2023)	Perception-based factors contribute to audit quality
	(Peštovi et al., 2021)	The multifaceted nature of perception-based audit quality, which is influenced by various internal and external factors.
	(Du, 2017)	<i>CEO</i> -auditor dialect sharing has a negative relationship with pre-IPO audit quality.
	(Kilgore et al., 2011)	The importance of audit team attributes compared to audit company attributes in shaping user perceptions of audit quality.
	(Clinch et al., 2011)	Audit quality is of great value to investors and also plays a role in the quality of financial reporting information and flows through to the allocation of information among traders.
	(Lennox & Pittman, 2010);(Francis, 2004)	Fraudulent financial reporting as strong evidence that the Big Five's relatively superior audit quality has declined in recent years, benefiting from recent reforms such as the Sarbanes-Oxley Act of 2002 in the US.

Audit Quality Measures	Writer	Findings
	(Knechel, 2007)	Consistent with the perception that specialists provide higher quality.

Source: processed data (2024)

Involving specific events, such as fraudulent financial reporting, which has become a major focal point for justifying far-reaching legislative and regulatory changes in the wake of high-profile corporate governance failures such as Enron and Worldcom, regulations continue to be adapted and developed, as many emerging issues related to fraud display the low quality of the audited financial reports, so that it is necessary to correct the financial reports. An accounting restatement is a correction of a misstatement in a previously issued financial report (Defond & Zhang, 2014). Restatements are used in a variety of research settings, including testing whether audit quality is associated with non-audit services (NAS) fees, audit committee characteristics, and industry specialization. (Hohenfels & Quick, 2018) Higher levels of Non-audit services (NAS) fees can result in lower audit quality; this negative effect is derived from economic and social ties, which can damage auditor independence. (Beardsley et al., 2020) emphasis on Non-audit services (NAS) can divert attention from the audit function and the need for careful management of NAS within the audit firm, a distraction also not solely caused by independence issues but also due to a broader diversion of resources and attention within audit office. The regulations imposed regarding NAS fees in the European Union are still too loose in an effort to avoid reducing audit quality, although a total ban on NAS from auditing clients will not result in higher audit quality compared to a moderate level of audit quality. Researcher (Chin & CHI, 2009) found that companies audited by auditors who have industry expertise are less likely to restate financial statements. This is because companies are less likely to experience restatements involving material net income, the use of industrial auditors has greater incentives for companies to pay. Industrial auditors are generally trained in audit conditions that are the same or not much different from previous audits, this will of course have a positive impact on the auditor's level of skepticism. (Hurt et al., 2013) Professional skepticism allows auditors to identify more fraud cues, increase budgeted audit time, identify more contradictions, generate more alternative explanations, and negotiate more forcefully with clients. Contrary to existing circumstances, the SEC and PCAOB have consistently found a lack of professional skepticism in practice. Another factor of restatement is related to the audit committee, such as (Archambeault et al., 2008) where the granting of short-term stock options to audit committee members will result in the possibility of restatement. This is due to the uncertain rewards received by the audit committee, if the rewards do not match expectations it will reduce supervisory motivation and thus, increase the possibility of financial reporting failure, the risk of fraud will increase because management can exploit the opportunities created by the lack of monitoring and control.

Communicating audit results between auditors and shareholders regarding the audit process and results is an important part of the audit process (Coram et al., 2011), which ultimately contributes to their evaluation of the quality of financial reporting. A modified opinion based on needs, will communicate the auditor's evaluation of substantial doubt regarding the client's ability to maintain its business continuity. Manager intervention in pressuring the auditor to issue a clean opinion, (Malau et al., 2018) The fraud was carried out by management or due to collaboration with political interference. Like the need for a pre-IPO opinion, there is pressure related to the pre-IPO, so the information communicated through opinions must describe going concerns and be more able to predict post-IPO stock performance. (Weber & Willenborg, 2003) Larger auditors are more likely to provide going concern opinions to IPO issuers. (Fiolleau et al., 2019) Policymakers have identified effective communication between auditors and audit committees as an indicator of audit quality, although little is known about the factors auditors consider when deciding what to communicate about significant accounting matters.(Compernelle, 2013) External auditors often engage in impression management where the audit committee expects transparency, auditors are also expected to help managers maintain a consistent image.

As a proxy for the quality of financial reporting, is simpler than a restatement or going concern opinion. As noted by former SEC Chairman Arthur C. Levitt, although earnings management damages the quality of financial reporting by misleading investors, it does not reach the level of material misstatement. (Defond & Zhang, 2014) earnings management proxies do not directly capture very large misstatements, DAC is associated with AAER (Dechow et al., 1996) and thereby capture the increased likelihood of more extreme misstatements.

(Hohenfels & Quick, 2018) Earnings management versions of the Jones-based model with a stronger focus on company performance and the Dechow/Dichev model as an alternative model for examining the quality of accruals take various precautions to limit the effects of misstatement errors. (Becker et al., 1998) Lower audit quality is associated with more flexibility in accounting. Various other studies are related to the quality of financial reports with audit quality such as, (Trotman et al., 2009) Brainstorming treatment guidelines and the pre-mortem produced a larger list of potential frauds than groups that interacted without brainstorming guidelines. This is because the meeting is likely to increase the auditor's level of skepticism and alert them to various possibilities of fraud. (Rahman et al., 2023) revealed that auditors with audit fee engagements significantly reduce real earnings management and improve the quality of accruals.

Investor perceptions that have an indirect relationship to earnings quality such as; , earnings response coefficient, stock market reaction to audit-related events and cost of capital (Defond & Zhang, 2014). (Clinch et al., 2011) Audit quality is of great value to investors and also plays a role in the quality of financial reporting information and flows through to the allocation of information among traders. Perceptions regarding CEO-auditor dialect sharing (CADS),(Du, 2017)CEO-auditor dialect sharing has a negative relationship with pre-IPO audit quality. (Knechel, 2007) Consistent with the perception that specialist provides higher quality. Other perception-based actions are also found in inspections which are based on the examiner's factual assessment of the auditor's actual procedures, such as (Sulaiman, 2018) Recurrent problems in the inspection process, such as a lack of challenges from external auditors and a lack of evidence and documentation, are a separate note and are expected to have implications for regulators and audit practitioners in terms of monitoring and improving audit quality. (Gonthier-besacier et al., 2016) further highlighting the role of professional expertise and shared values in shaping their perceptions of audit quality. (Kilgore et al., 2011) emphasizes the importance of audit team attributes compared to audit company attributes in shaping user perceptions of audit quality. This will of course give investors their own perception who will give positive or negative reactions, especially in the largest developing countries in the world.

CONCLUSION

After the SOX era, many people wanted to research audit quality, such as its development both before and after the SOX era, the strengths and weaknesses of the audit quality proxies used and others. Various frauds committed in accounting, an auditor's ability to detect these frauds, as well as the trust of investors or other parties in audit quality and the regulations that participate in influencing this trust, are the main attraction for researching audit quality. Apart from detecting the quality of financial reports with earnings management (Hohenfels & Quick, 2018) earnings management as a preventive measure to limit the effects of misstatement errors. Earnings Management (DAC) is always associated with Accounting and Auditing Enforcement Releases (AAER) (Dechow et al., 1996). An effective governance structure is also important in mitigating risks, including financial difficulties, board independence, CEO duality, and significant debt to avoid material misstatements in accounting (Azhari et al., 2022). An increase in the likelihood of more extreme misstatements may occur. Audit procedures introduced by SAS No. 99 such as Brainstorming treatment which is carried out on each assignment so that the quality of the inspection can be carried out well. Different from (Trotman et al., 2009) found the brainstorming treatment and the pre-mortem had more potential for cheating than groups interacting without brainstorming guidelines.

Auditors should adapt their communications to the audit committee's oversight approach, the audit committee's industry and accounting knowledge, and the audit committee chair's preferred communication style (Fiolleau et al., 2019), because CEO-auditor dialect sharing has a negative relationship with pre-IPO audit quality (Du, 2017). This can only happen due to factors such as collaboration with political interference (Malau et al., 2018), or even external auditors are positioned in the middle, and often engage in impression management (Compernelle, 2013), which is tricky because it can strain the relationship with the CFO. Regardless of the importance of an IPO, various countries or regions have their own reasons, such as a limited number of accountants, countries with poor governance ratings, geography, cultural influences, and so on. (Becker et al., 1998) Lower audit quality is associated with more flexibility in accounting. This will of course provide a different perception for investors, apart from that there is a differential incentive to favor client interests rather than public interests (Weber & Willenborg, 2003), such as the use of non-audit services, which are still large in number and can reduce audit quality(Beardsley et al., 2020; Hohenfels & Quick, 2018; Schmidt, 2012) Moreover, those who

most often receive large incentives are high-quality auditors.

Highly qualified auditors are more likely to detect questionable accounting practices and reject their use or qualify audit reports (Becker et al., 1998). Emphasizes the importance of audit team attributes compared to audit company attributes in shaping user perceptions of audit quality (Kilgore et al., 2011). Other perception-based actions are also found in inspections which are based on the examiner's factual assessment of the auditor's actual procedures, (Sulaiman, 2018) recurring problems in the inspection process such as lack of challenge from external auditors and lack of evidence and documentation, (Gonthier-besacier et al., 2016) the role of professional expertise and shared values in shaping their perceptions of audit quality. It is hoped that this will be a separate note and provide implications for regulators and audit practitioners in terms of monitoring and improving audit quality. It is important to update regulations related to audit quality, such as the level of materiality which is still different in each auditor's view in order to find a point of uniformity in determining the level of materiality in the audit process and also regulations for non-audit services.

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