

LUT School of Business and Management

Bachelor's thesis

Financial Management

Factors affecting audit quality: An auditor's opinion

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Abstract

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Purpose of this bachelor's thesis is to find out what are the main factors that shape and influence the audit quality according to perspective of professional financial auditors. Theoretical part was based on previously conducted research, scientific research papers and relevant literature. Theoretical framework was focused around auditor rotation, audit fees, audit firm size and auditor's industry specialization.

Empirical part and analysis were conducted by using qualitative research method. Qualitative research method was based on semi-structured interviews in which I interviewed 2 experienced professional auditors. Both auditors were from Big 4 audit firms.

Audit quality and factors affecting it have been subject of broader investigation in recent years, particularly as a result of various accounting scandals. Factors affecting the audit quality must be understood in order to maintain high quality. High audit quality is extremely vital from the point of view of stakeholders. Results of this this research indicated that according to both interviewees, auditor's industry specialization was believed to be the most significant factor affecting the audit quality while mandatory audit rotation and audit committee were believed to be one of the least significant factors affecting audit quality. Auditor rotation, which has been generally considered to be vital ensuring high audit quality, was not considered to be important in maintaining high audit quality according to the results.

Tiivistelmä

Tekijä	Armanze Mstoi
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Tämän kandidaatintutkielman tavoitteena on saada selville millä tekijöillä on eniten vaikutusta tilintarkastuksen laatuun erityisesti kokeneiden tilintarkastajien näkökulmasta katsottuna. Tutkielman teoreettinen osuus koostuu muun muassa alan kirjallisuudesta sekä tieteellisistä tutkimusartikkeleista. Yleisesti katsottuna tutkielman teoreettinen viitekehys keskittyy 4 eri tekijän ympärille, jotka ovat tilintarkastajan rotaatio, tilintarkastuspalkkiot, tilintarkastajan toimialaymmärrys sekä tilintarkastusyhtiön koko.

Tutkielman empiirinen osio toteutettiin kvalitatiivisena eli laadullisena tutkimuksena. Laadullisena tutkimusmenetelmänä käytettiin puolistrukturoituja haastatteluja, jossa haastateltiin kahta kokenutta tilintarkastajaa. Molemmat tilintarkastajat olivat Big-4 tilintarkastusyhtiöistä.

Tilintarkastuksen laatua ja siihen vaikuttavia tekijöitä on alettu tutkia entistä laajemmin viime vuosien aikana erityisesti erilaisten talousskandaalien vuoksi. Tilintarkastuksen laatuun vaikuttavia tekijöitä pitää ymmärtää, jotta tilintarkastuksen korkeaa laatua voidaan jatkossakin ylläpitää. Korkea tilintarkastuksen laatu on ensiarvoisen tärkeää sidosryhmien näkökulmasta katsottuna. Tutkimustulosten mukaan kaikkein eniten vaikutusta tilintarkastuksen laatuun on tilintarkastajan toimiala erikoistuminen ja kaikkein vähiten tilintarkastuksen laatuun vaikuttavat tilintarkastajan rotaatio sekä tilintarkastuskomitea. Tutkimustulosten mukaan muun muassa yleisesti tärkeänä tekijänä pidetty tilintarkastuksen rotaatio, ei ollut merkittävässä asemassa tarkasteltaessa tilintarkastuksen laatuun vaikuttavia tekijöitä.

Table of Contents

1. Introduction.....	4
1.2 Research objectives and delimitations.....	5
1.3 Research methodology.....	5
1.4 Theoretical framework.....	6
1.5 Key concepts.....	6
1.6 Structure of the thesis.....	8
2. Basics of Auditing.....	10
2.1 Ethics.....	11
2.2 An auditor and corporate governance.....	12
2.3 Assurance services.....	12
3. Factors affecting audit quality.....	13
3.1 Auditor’s independence.....	14
3.2 Audit rotation.....	15
3.3 Audit fees.....	17
3.4 Audit firm size and auditor’s industry specialization.....	18
4. Empirical analysis.....	21
4.1 Importance of emphasizing audit quality.....	22
4.2 Factors affecting audit quality.....	22
5. Conclusions.....	28
6. References.....	30

1. Introduction

Auditing is one of the most important functions in determining reliability of the financial information and statements and thus it is important to put emphasis on audit quality. Aim of the auditing is to provide reliable and verified information about financial statements that users can utilize (Steiner 2009). Auditing aims to assure the investors and other stakeholders that financial statements have been prepared according to existing legislations and principles. (Steiner, 2009)

Thus, it is reasonable to determine the prospective factors that affect the audit quality overall. Poor audit quality can negatively affect stakeholder's perceptions on audit work and auditor's work ethics. Since the Enron scandal erupted almost 20 years ago, scrutiny on audit work and quality has widened and become even stronger. (Lessambo, 2018)

According to national and international accounting rules and standards, auditors must constantly concentrate on audit quality and assure that audit work is conducted according to relevant standards, principles and rules. (Steiner, 2009) Thus, it could be presumed that audit quality is an important subject among accounting research. As a result, it is fair to suggest that determining the factors affecting audit quality is essential in order to assure the value and quality of audit work. (Lessambo, 2018)

Auditors and accountants play vital and decisive role in contributing to the credibility of financial statements on which they are reporting. It is clear, that good quality audits provide the necessary financial stability. As the international auditing standard-setter, the IAASB (International auditing and assurance standards board) has a strong interest and responsibility to develop standards and guidance for auditors to facilitate high-quality audits being achieved – which in turn builds public trust and confidence in financial statements and financial reporting more broadly. (IFAC, 2018)

1.2 Research objectives and delimitations

The aim of this thesis is to find out the factors that determine the audit quality mainly from the financial auditor's perspective. I will determine that what are the main factors according to auditor's opinions and perceptions that potentially influence and shape the audit quality. In order to focus on finding the potential ways and methods to improve the audit quality, it is of course necessary to find and understand all the major factors that influence the audit quality and have understanding about definition of audit quality.

There has been lots of previously conducted research on audit quality. For example, Francis & Yu (2009) researched the possible relation between Big 4 office size and audit quality suggesting that larger audit firms produce higher quality audits. Blankley, Hurtt, MacGregor (2012) investigated the relationship between audit fees and financial statement restatements. Sutton (1993), also conducted a research that focuses on factors that influence the audit quality and audit process.

When it comes to research questions, the main research question is "*Which factors influence the audit quality according to auditor's opinions?*".

I will first introduce the theory behind the audit quality so that the readers of this thesis could gain theoretical knowledge about this subject before looking up to the main research process. Overall, I will present the relevant theoretical aspects and previously conducted research of audit quality that builds theoretical background for this thesis and then after that I will focus on the empirical process because it is highly important to understand the underlying theory and logic behind the audit quality before going to the empirical stage of this thesis.

This thesis will be limited to focus only on audit quality and all the issues concerning the financial statements and different accounting standards will be limited out. Thesis will be focused mainly on general financial auditing, and other topics such as internal audit will also be limited out.

1.3 Research methodology

In this bachelor's thesis the empirical section will be based on the qualitative research methodology. Qualitative research will be conducted as semi-structured interviews. A semi-structured interview is a method in which the interviewer presents the questions to interviewee who then responds to them

in his/her own way. The semi-structured interview allows the interviewee to respond relatively freely without any strict rules. Sometimes interviewee can even suggest his own questions. (Koskinen et.al, 2005) Semi-structured interviews are by far the most widely used qualitative research method that has been used in the data collection especially in the area of the business studies (Hirsijärvi and Hurme, 2004).

Semi-structured interviews are considered highly efficient way to gather relevant information from the subject. Efficiency is primarily based on the fact, that interviewer can basically control the interview without necessarily need to completely guide the process. (Koskinen et.al, 2005) Significance of semi-structured interviews have been increasing since the several decades now. The main reason for this is obviously the simplicity (Koskinen et. al, 2005).

In this thesis I will interview mainly 2 financial auditors who already have several years of work experience in audit firms. The aim is to gain relevant information and necessary answers about the audit quality. After conducting the interviews, I will be drawing conclusions and analyzing the underlying assumptions that have been risen from the interview.

1.4 Theoretical framework

Main aim of the theoretical framework in this bachelor's thesis is to describe key factors, that have impact on audit quality. Theoretical framework will include necessary information about factors that are according to scientific publications most important that affect audit quality. These include for example audit firm rotation and audit firm size (Elder et. al, 2015). Another factor that has been debated are audit fees and auditor's industry specialization (Eschlemann et al. 2014). One important article on auditor industry specialization has been written by Minutti & Meza, (2017), which also deals with auditor's industry specialization and audit quality. Relationship between auditor size and audit quality has been researched by Lennox, (1999) which also deals with auditor reputation and its impact on audit quality.

1.5 Key concepts

Auditing

Auditing is a process where authorized auditor conducts a review on financial statements to find out whether not financial statements have been prepared according to accounting legislations. Aim is to

assure the stakeholders that there are no risks and errors in financial reporting of specific company. Auditing has statutory position (Lessambo, 2018)

Audit quality

Audit quality is generally understood as probability that the auditor will both find and report a violation in the clients financial accounting system (Giroux, Deis, 1992)

Auditor rotation

Rule of rotating audit firms and auditors in specific time. It is a rule which encourages audit firms not to have excessively long tenures with the specific client firm for avoiding intentional mismanagement (Lennox, Wu, Zhang, 2014)

Audit fees

Financial compensation for auditor for conducting an audit engagement. (Blankley et al. 2012)

Financial statement

Financial statement is a formal record where the main purpose is to provide information on financial position of an entity. Financial statement is prepared annually. Financial statement consists of income statement, balance sheet and cash flow statement. Every entity is obligated to prepare financial statements every year. (Leppiniemi, Walden, 2017)

IFAC

International federation of accountants (IFAC) is a global organization that has set ethical guidance for auditing profession. Ethical guidance is developed by IFAC ethics committee who then report their recommendations to IFAC ethics board. (Hayes et al, 2005)

IAASB

International auditing and assurance standards board (IAASB) is a standing committee of the council of IFAC which provides global standards on auditing. Their primary objective is to improve the degree of auditing practices and policies. (Hayes et al, 2005)

ISA

International standards on auditing are professional auditing standards which have been developed by the international federation of accountants (IFAC) with main purpose of creating global technical and educational guidelines for auditors. (Hayes et al, 2005)

Sarbanes-Oxley-act

Financial reporting legislation which was enacted in 2003 in United States. Main purpose to strengthen corporate financial reporting by increasing management accountability and improving public accounting firm independence. (Louwers et al, 2013)

Big 4-auditors

Four biggest audit firms in the world by revenue and personnel. These first-tier international audit and accounting firms are PwC (PricewaterhouseCoopers), Deloitte, KPMG and EY (Ernst & Young) (Louwers et al, 2013)

1.6 Structure of the thesis

This bachelor's thesis includes five main chapters, which are introduction, basics of auditing, theory, methodology and conclusion/results chapters. In the first chapter I introduce the entire thesis. In the second chapter I will focus basics of auditing. Third chapter will be dedicated to theoretical aspects and literature review of the audit quality by reviewing and analyzing the previously conducted research and scientific research papers. In the second chapter I will introduce the main concepts of the auditing so that reader could understand the basic principles of auditing. In the third chapter I will

focus completely on audit quality. In the fourth chapter I will be conducting the empirical qualitative interviews with auditor's and in the fifth chapter I will conclude all the results that have risen from the qualitative research. Sixth and last chapter will be dedicated to the references.

2. Basics of Auditing

In this chapter 2, I will present basic and necessary information about auditing which will be used as a basis for subsequent chapter on audit quality.

The role and task of auditing firms is very important to capital markets. Financial information is and has been vital source for the financial markets. For the markets, information must always have trusted measure of reliability. Investor confidence is usually enhanced by the fact that public financial statements have been subjected to the accuracy of independent and unbiased investigation and analysis. (Lessambo, 2018)

Therefore, it is important to understand that auditing is a vital component for the economy. It is an important institution that provides necessary information about financial situation of an entity such as private and public institution. According to IAASB (International auditing and assurance board), the main task of auditing is to increase the trust among the stakeholders on financial statements and financial records (Steiner, 2009). Auditing is needed in order to assure the potential stakeholders that financial statement have been made according to national accounting principles and legislations. (Steiner, 2009)

Generally, there are several types of audit services that are provided by the audit firm in which financial statement audit is perhaps the most important one (Lessambo, 2018). It is well acknowledged that main task of an audit is to provide credibility to the financial statements made and released by corporate executives for their shareholders. Auditors are needed in order to assure all the potential stakeholders that all the financial statements are made according to legal framework (Lessambo, 2018)

In general, according to Finnish accounting laws, all the accounting entities should choose auditor, but of course the smallest companies are not necessary forces to choose auditor primarily due to their size and firm characteristics. (Steiner, 2012) There are always some restrictions and rules concerning auditing. First and foremost, in Finland for example every firm could be exempted from auditing if maximum one of the following three conditions is fulfilled in 2 consecutive financial year; its total balance sheet exceeds 100,000 euros or similar profit is over 200,000 euros or the company has at least three employees. (Horsmanheimo, Steiner, 2012) Smallest companies are totally exempted from auditing.

According to accounting laws, a person generally must be a certified actor to be able to practice auditing. For example, in Finland, a person can be either the KHT, HTM or JHTT- certified auditor to be officially registered auditor. There is also requirement that auditors must not be in financial trouble and he or she must possess relatively good reputation. (Steiner, 2012)

Auditing could be considered an analytical process which has a clear beginning and clear end. Audit process includes gathering and analyzing audit information, which is then given to potential stakeholders. At the start of audit process company leadership provides auditors financial statements (Hayes, et.al, 2005)

2.1 Ethics

Ethics is widely integral and vital part of the auditing particularly from the perspective of audit quality. The behavior of auditors in providing vital auditing services have an influence on the economic situation of the country. Auditors have a responsibility to confirm that their work is conducted according to ethical foundations. It is fair to suggest that the norms of the accounting profession are deeply determined by the public interest. (Hayes et.al, 2005)

As a professional auditor it is very important to follow the prevailing code of conduct throughout the auditing process and work. For example, in the US, the security exchange commission controls the rules about the conduct. This is vital for accountants who work for the SEC-registered companies. It is necessary that every accountant should observe the rules of conduct published by these authorities. (Louwers et. al, 2015)

The auditors should evaluate and investigate the continuation of the client relationship and ethical requirements throughout the audit engagement as the situations and circumstances change. The first steps at the beginning of an ongoing audit engagement will focus on both continuing the client relationship and evaluating the ethical requirements, which means that the preliminary steps must be in place before any other significant steps in that audit engagement (Steiner, 2012)

When auditing multinational companies, auditors and accountants should follow the guidelines created by the IFAC. IFAC's International Ethics Standards Board for Accountants is responsible for the Code of Ethics for Professional Accountants (IESBA Code), which is the code of conduct that controls and governs the audits of multinational companies. (Louwers et. al, 2015)

2.2 An auditor and corporate Governance

Corporate governance is a system that includes structures and processes that are used to direct and manage the corporation for maximizing the shareholder value. Corporate governance includes the relationship between top management, board of directors and other stakeholders such as audit committee and shareholders. (Hayes, 2005)

Generally corporate governance has strong impact on audit work and profession. Auditors play crucial and significant role in enhancing good corporate governance. A relationship between good corporate governance and auditing came into light when financial reporting scandals and collapse of the Arthur Andersen audit firm forced several professional audit institutions to create new practices and legislations to prevent new scandals and challenges from occurring again. (Hayes, 2005)

One example in the US is for example the Sarbanes-Oxley and Public company accounting oversight board (PCAO), which has a task of monitoring audit profession to maintain the investor confidence. One of its main tasks are to establish accounting standards and to conduct investigation and disciplinary proceedings involving accounting firms. (Hayes, 2005)

2.3 Assurance services

American Institute of Certified Public Accountants defines assurance services as independent professional services which aim to improve the quality of accounting information especially for decision makers. According to AICPA, the most important boundaries of assurance services are retaining independence, improving the quality of information and serving the interests of decision makers. Auditing is understood to refer providing an opinion on financial statements and assurance refers more generally to expressing an opinion on all type of information including non-financial information (Louwers et. al, 2016).

Auditing services are highly detailed and aimed to be useful for large groups of decision makers. In addition to traditional audit services, audit firms also offer for example consulting services such as risk services. For example, many corporations and organizations have used public accounting firms to conduct a deep analysis of the prime risks the organizations face. This type of enterprise risk assessment can then be used to show stakeholders that the management team understands and is properly managing the risks, the enterprise faces. It is important to know that accounting firms must choose the services that they wish to provide to the market based on the knowledge and

expertise that lies within the firm. Not all presume that all public accounting firms would be able to provide all types of assurance services. (Louwers et.al, 2016)

3 Factors affecting audit quality

Audit quality has become an increasingly relevant topic during recent years especially as the result of accounting scandals like Enron in which Arthur Andersen committed serious mistakes relating to audit of financial statements. Although there are no official terms that exist for audit quality, it is usually formed by different auditing parts and works. In an effort to improve audit quality in the US capital markets, the Sarbanes-Oxley Act of 2002 initiated several changes that affect the structure of the audit market and the quality of audit services (Louwers et al.) High quality auditing is of course essential for well-functioning capital markets (Skinner, Snirivasan, 2012).

Audit quality is generally defined as the probability that auditor finds and reports an error which could have a potential impact on financial statements and information (Elder et.al, 2015). Generally, Audit quality is a relatively complex subject and there is no exact definition of it that has achieved global recognition (IIASB, 2018). Audit quality comprises the key elements that develop an environment which successfully manages to maximize likelihood of audit quality (IIASB, 2018).

There has been plenty of scientific research about audit quality conducted and published at least for about 4 decades now (Kihn, 2017). In previous scientific research on audit quality, the emphasis has been on the issues such as for example probability for markets to assess that financial statements include errors and how auditors have potential to detect those errors. Other topics have focused on how exact the financial information is from the auditor's standpoint and how is auditor able to reduce the possible noise (disruption) of financial information (Watkins et.al).

There are many rules and standards that normally affect auditor's work. This International Standard on Auditing (ISA) copes with the auditor's overall responsibilities when he or she conducts an audit of financial statements according to ISA. Generally, it creates all the main objectives of the qualified and independent auditor and describes the nature and scope of an audit task to enable the independent auditor to meet those objectives. (ISA, 2009) Thus these standards provide well created framework for auditor's work that controls the audit quality.

Today auditing is widely seen as a compact service which main task is primarily to provide and transfer value to the customer and thus satisfy needs of its customer. To be able to compete in a

normal way it is necessary to keep high quality of its auditing services. It is highly vital that for the auditor to understand the legal issues and requirements surrounding the audit work. Especially different legal standards have to be understood from the perspective of high-quality audit and audit work. (Steiner, Horsmanheimo, 2012) So therefore it is necessary and important that auditing is well executed, and it manages to satisfy all the needs of the potential stakeholders such as creditors, investors and customers.

It is relevant for the auditors to maintain audit quality because basically it affects for example international financial markets to function properly. It is important to note that significance of auditing has widely increased for stakeholders who are usually making vital decisions based on these audit reports. So, therefore it is important to assume that this also puts and adds pressure for auditors to pursue higher quality in audit work. (Steiner, Horsmanheimo)

Wang and Wu, 2013, suggest that auditors' individual characteristics and capabilities could most likely impact their final judgments and decisions, ultimately translating into variation in audit quality across individual auditors. Ghebremichael (2010), suggests that from the perspective of functional dimensions, audit process reliability and industry and company are vital determinants of audit quality. From the technical perspectives, integrity of financial reporting is an important factor that influence the audit quality.

According to Yang and Gul, (2013), the impact of independent auditors on the quality of audit reporting and clients' earnings quality are significant and are clear in both large and small audit firms. Yang and Gul (2013) suggest that auditors' individual characteristics can truly affect their judgments and decisions and ultimately affect the audit quality.

3.1 Auditor's independence

An auditor's independence is important for reliable audit work. According to Finnish audit law, it is highly necessary that auditor is fully independent actor in accounting industry. If there are no preconditions for independent audit work, auditor must decline to accept the offer to conduct audit work. On the other hand, if factors that affect auditor's work are relatively insignificant, then working as an independent auditor is usually not a major problem. (Finlex, 2015)

Auditor's task is to ensure that all the possible members of the auditor's team and audit firm meet all the important requirements such as for example investigating the possible personal investments of partners and employees and company contacts with potential audit client. According to IFAC's code

of ethics for professional accountants, auditor's independence may be compromised if there appears to be some unpaid fees of the client. Another major issue that could possibly jeopardize the independence of auditor, is for example if the client is involved in a litigation with the auditor (Hayes et al, 2005). So, overall it is important to note that auditor's opinions must be based on an objective and unbiased viewpoint thus through this, auditor's independence provides value and significance to audit reports (Lavin, 1976).

3.2 Audit Rotation

Auditor rotation has become an increasingly relevant topic in area of audit research, and it has generally emerged as one of the principal methods in many different countries to help to solve the problems concerning audit quality (Carey, Simnett, 2006). The main reason why auditor rotation is needed is primarily because of the fact, that longer audit tenure is believed to have mainly negative impact on audit quality. So, in general, mandatory audit rotation is seen as a very useful way and method to enhance the audit quality and to improve the validity of financial statements which is seen as a core object of the audit work. (Carey, Simnett, 2006).

As mentioned earlier, mandatory audit rotation is normally required to prevent too long audit tenures, because longer audit tenure is strongly believed to have mostly negative influence on audit quality. According to researchers, in order to achieve relatively high audit quality, it is needed to maintain policy of mandatory audit rotation for a long period. It is normally believed that if auditor's tenure is too long, then there could be a serious risk that auditor's independence, which is seen as an important matter, could be possibly weakened, which could then potentially weaken auditor's ability on judgement and unbiased assessment. Auditing profession and financial markets will face potential damages and problems if audit quality is affected negatively for example because of the previously mentioned reasons. (Carey, Simnett, 2006)

In general mandatory audit rotation might be seen as a highly important and valuable tool because it is seen as a systematic method which orders necessary breaks to audit relationships and it helps to avoid too long audit engagements between the same client and audit partner (EY, 2015). Supporters of mandatory auditor rotation generally suggest that ordering compulsory limits on auditor's relationship with the client, improves audit quality by reducing clients' influence over auditors or auditor's self-conceit (Elder et al., 2015). Proponents and recommenders of mandatory audit rotation also believe that a change of audit partner is good and favorable, as it provides a strong and new perspectives on the audit and client (Zhang et al., 2014).

There are multiple countries that require mandatory audit partner rotation but on the other hand some do not put any limitations on audit firm tenure. According to Lennox and Zhang, mandatory auditor rotation has a favorable effect in the auditor's final year of tenure before rotation happens and in the eventual year when the new partner is appointed.

Generally, it has been proven that mandatory rotation could result in higher audit quality. One of the reasons for this is that auditor could be entitled to make necessary readjustments at the time of compulsory auditor rotation at the end of his/her tenure. Thus it could be assumed that whenever audit partner leaves as a result of mandatory auditor rotation policy, he/she would have the authority and desire to finalize client firms' financial statements "in a good way" before other auditor comes in as a result of this rotation policy. This is called a coherent with a positive peer review benefit, which suggests that audit partners perform higher quality audits when they are involved in mandatory rotation. (Lennox et.al, 2014)

For example, in the US there has been legislation called Sarbanes & Oxley-act, which also assumes that mandatory audit partner rotation could potentially improve the audit quality as it enhances auditor's independence especially from the investor's point of view, who basically see mandatory audit partner rotation as refreshing and positive (Chi et.al, 2005). Audit quality is higher when company is subject to mandatory rotation compared to companies not subject to mandatory auditor rotation Chi et.al,2005). On the other hand, it could take some time for mandatory audit-partner rotation to have clear impact on audit quality mostly due to the time needed for new audit-partners to accumulate client-specific knowledge and experience (Chi et.al, 2005).

It could be presumed that new and fresh engagement audit partner is more likely to require an adjustment during the partner's first year of audit engagement due to the mandatory rotation. This is consistent with newly appointed engagement partners bringing completely new perspective to the audit that can identify more financial information and reporting problems. (Lennox et.al, 2014)

Carey and Simnett argue that in the long partner audit tenure there is clearly lower capability and proclivity to issue going concern opinion about financial statements. This clearly indicates that longer the auditor's tenure is weaker the audit quality might eventually appear due to the lack of possible audit partner rotation. On the other hand, Carcello and Nagy suggest that fraudulent financial reporting might be common if auditor's tenure is less than three years. Nevertheless, there is also suggestion that further research is clearly needed on the relation between audit tenure and financial reporting quality especially in cases where auditor changes are mandated rather by audit committee than general management (Carcello, Nagy, 2004).

Gosh and Moon, (2005), suggest in their research that investors earnings quality could improve by mandatory rotation policy. On the other hand, by imposing mandatory rotation rules on audit and client relationship, this could normally impose unintended costs especially to investors (Gosh, Moon, 2005). According to Lim and Tan (2010), benefits from mandatory audit rotation that improve audit quality mostly originate from auditor's industry specialization and audit fee dependence. In other word's an auditor's industry expertise and knowledge could contribute considerably to audit quality (Lim & Tan, 2010). This practically means it is useful that enough resources are invested in developing an auditor's industry expertise in the industry that client operates in. In other words, the more auditor understands about the specific industry he or she works in, the higher audit quality will be.

According to Arel et.al (2005), mandatory audit rotation is generally a positive thing because long term relationship with the client may create problematic relationships between the auditor and the firm management which then can evolve into conflicts of interests. With no long-term connection to the client, auditor does not face conflict of interest and can act relatively freely. On the other hand, according to one survey conducted by the US government, almost 70 % of top tier CPA-accredited accounting firms did not necessarily believe that long term auditor connections could increase audit failures. (Arel et. al 2005)

3.3 Audit Fees

Audit fee can usually be described as a fee which is charged by the auditor for conducting and completing an audit assignment. Auditors are generally entitled to charge the specific amount of fee for giving an unbiased opinion and statement about specific entity's true financial and economic position. Audit fee could normally be described as the fee charged by a public accountant to the client for providing financial audit services. (Onalapo, 2017) Fitriany et al (2016) researched the impact of abnormal audit fee on audit quality in Indonesia, where negative correlation and relationship was found to exist between abnormal audit fee and audit quality.

Srinivasan et al (2002) models have generally explained and demonstrated that the issues of audit fee and audit quality do generate conflict of interest between auditor and their clients, but this should not in any case make audit fee to have diminishing effect on auditor independence, thus the offer of the amount of the fee has to be offered by client firms. Audit fees are the fees provided to the auditors that usually reflect the cost of the service and effort conducted by the professional auditors and risks of litigation (Choi, 2009). With respect to the factors informing the decision of the appropriate amount

of audit fees, Simunic (1996) argued that audit risks, client size, and audit complexity determine audit fees.

According to Choi, Zang (2010) and Asthana, Boone (2012) there is a positive correlation and relationship between abnormally high audit fees and the magnitude of optional accruals, meaning possibly that auditors receiving high fees tolerated more discretion. However, it is also possible that audit fees are a measure of audit effort, for example, higher fees indicate that the auditor worked more hours, and thus potentially displayed greater effort. Because of the fact, that audit fees are a measure of audit effort, low audit fees could significantly harm audit quality and negatively impact the reliability of financial statements. (Eschlemann, Peng, 2014)

Blankley, Hurtt, and MacGregor (2012) clearly suggest and demonstrate that a negative correlation and relationship between abnormal audit fees and the probability of issuing an auditing restatement. This is purely consistent with auditors receiving low fees performing less thorough audits, thus normally leading to a higher likelihood of material errors and mistakes. (Blankley et.al, 2012)

Clients who tend to pay much higher abnormal audit fees are less likely to use income-increasing discretionary accruals to meet or beat earnings targets. Thus, it could be understood that abnormally high audit fees are an indication of higher auditor effort and as a result affect positively audit quality. (Eschleman, Peng, 2014)

Moreover, audit fees and future restatements are seen to be positively correlated and associated. After controlling for internal control quality, it is suggested that audit fees are negatively associated with future restatements. That is, audit fees are believed to be significantly lower in the periods leading up to the discovery and announcement of the restatement. Yet, evidence is in the line with the belief that restatements reflect lower and weaker audit effort and/or incorrect risk assessment in the periods leading up to the restatement year. (Blankey, et.al,2012)

3.4 Audit firm size and auditor's industry specialization

There is some evidence that large audit firms have enough resources and capability to provide higher quality audits and offer greater credibility to clients' financial statements than small audit firms offer. For example, De Angelo (1981) has argued that bigger auditors with bigger resources have more incentives and better capability to issue accurate reports because they have simply better reputations. There could be one certain reason for this. If large audit firms have higher client-specific rents compared to smaller auditors, the loss of rent is greater for a criticized large auditor than a criticized

small auditor. Therefore, bigger audit firms should have more incentive to issue correct statements. So, the actual logic and understanding would be that, auditors with more wealth at risk from litigation have more incentive to issue accurate reports (Lennox, 1999).

De Angelo, 1981 argues that audit firm size alone alters auditors' incentives in a way that, larger audit firms deliver a higher level of audit quality compared to smaller firms. This generally means that larger the auditor is as measured by number of clients, the less the auditor has to behave opportunistically and the higher the perceived quality of the audit will be. (De Angelo, 1981) It could be simply said that bigger audit firm is, then the better auditor's will finish their work and thus it will impact on audit quality in a positive way. Overall, it has been proven that there is positive correlation between the audit firm size and audit quality (De Angelo, 1981).

According to Choi et. al, 2010, audit firm size is positively correlated with audit quality. Their claim is that large audit firms with deep and "office"-level client base are usually less likely to depend on particular client and therefore they're much better capable of resisting so called "client pressure" on biased financial reporting. Large offices are also able to charge higher audit fees to their audit clients compared to smaller audit firms which basically means that larger offices also have more resources to offer higher quality audit services compared to smaller firms. Larger audit firms charge fee premium in the audit service market. Office size is one of the most important determinant of audit quality and audit pricing. (Choi et. al, 2010)

Regulators and audit firms must pay more attention to the behavior of small offices because they are more likely to be financially dependent on a specific audit client, and therefore to compromise audit quality. Especially, Big four audit firms could need to implement different kind of strategies for providing a consistent level of audit services across offices of different sizes because a poor audit quality by a small office could seriously weaken the reputation of the entire firm. In today's global business environment, it is hugely important to maintaining cohesive and united quality and this issue should be an even more important concern to reputable and respected auditors because their business becomes continually internationalized in terms of locations and client profiles. (Choi et al., 2010)

On the other hand, Al Issa et al. had investigated in Jordan that, the size of the audit firm does not necessarily influence of the audit firm-client relationship length on the quality of audits in Jordan. The longer the audit firm tenure, the lower the audit quality no matter how large audit firm size is (Al Issa et al., 2010).

According to Francis and Yu (2009), there is deep and systematic association and correlation between big four auditors and audit outcomes, partly indicating that larger audit firms are capable in producing higher quality audits.

According to Wooten (2003) auditor's industry specialization is one of the defining factors of audit quality. Audit firms that have many clients from the same industry have deeper understanding and more in-depth knowledge about the audit risks presented by the specific industry. Audit firms that have fewer clients from the same industry do not usually have the critical customer base and resources to focus on industry news and practices. Audit firms that have many clients from the same industry usually produce higher audit quality due to the fact, that they have in some cases more to lose from the relationship (Wooten, 2003).

There has been wide consensus about the fact that industry specific knowledge and expertise does possibly improve the audit quality (Minutti, Meza, 2013). According to a statement issued by United States Government accountability office in 2008, audit industry specialization is considered to be hugely vital component within the context of audit quality suggesting that producing industry specific services to clients could provide substantially higher level of assurance (Minutti, Meza, 2013). According to Solomon et al. (1999), there is evidence that auditors will be able to find and analyze financial statement errors in a more efficient way when they deal with financial statements of the company, which is operating within industry they are specialized in. Specialized auditors do enhance the accuracy of flaw detection which then also affects positively in audit quality (Minutti, Meza, 2013).

Previously conducted research also suggests that specialized auditors are able of generating positive value to clients as well which might for example be noticed in a better financial reporting quality of the clients (Minutti, Meza, 2013). Krishnan and Balsam (2013) suggested in their research that there is positive relation and effect with auditor specialization and earnings surprise indicating that auditor industry specialization might have at least some sort of impact on audit quality and financial reporting. Overall research suggests that industry specialist auditors are in capable of contributing to the earnings quality of their clients. Big four-audit firms will most likely move towards larger industry focus and therefore it could be assumed that this will have positive impact on clients' financial reporting (Balsam, 2013).

4 Empirical analysis

This Bachelor's thesis is about identifying the factors that which factor's matter about the audit quality from the auditor's perspective. Empirical analysis was conducted by utilizing qualitative research methods. As a qualitative research method. I decided to use semi-structured interviews. Semi-structured interview is a qualitative research method which allows interviewer to present the questions to interviewee who then answers the questions in her/his own way (Koskinen et al, 2005). I chose semi-structured interviews because they are one of the most widely used qualitative research method, so it was relevant to use them in my thesis (Hirsijärvi, Hurme, 2004).

Qualitative research method usually operates by specifying single cases. It is important to interact with all the individual cases. Hypotheses are derived from these individual case analyses. Qualitative research method generally specifies individual cases from the point of view of interviewees. Qualitative research proceeds inductively and is usually considered to be conducting propositions. (Koskinen et al, 2005)

In this section I will be presenting and analyzing the interviews I conducted with interviewees. Interviews are based on theoretical framework. Interviews are based on semi-structured interviews. I interviewed 2 professional auditors who were working for Big 4 audit firm. I chose Big 4-audit firms because they're largest (by revenue) and world's most well-known audit firms. Both interviews lasted for about 45 minutes. Interviews were face to face interviews and interviews were recorded in auditors' office.

I allowed Interviewees to respond freely to the questions I had presented them. I first presented them basic questions about auditing and then progressing through relevant issue. They were both qualified authorized public accountants and master's degree holders in Accounting. They both had already nearly 10 years of professional working experience in audit industry. In this empirical analysis I present these two interviewees as interviewee 1 and interviewee 2.

Table 1: Detailed information about interviewees

	Audit firm	Audit experience	Education
Interviewee 1	Big 4	9 years	M.Sc. Accounting
Interviewee 2	Big 4	19 years	M.Sc. Accounting

4.1 Importance of emphasizing audit quality

Audit quality is generally considered to be highly vital issue within the context of financial reporting. Many stakeholders such as regulators, financial statement users and lawmakers have constantly emphasized the importance of audit quality. Audit quality is managed as continuous process that manages important issues that could have effect on audit performance. (Martin, 2013)

Both interviewees consider emphasizing audit quality extremely important. Interviewee 1 believes that it is highly important for international capital markets for functioning properly to invest more resources to enhance the audit quality. He believes that auditing is solely about assuring the stakeholders about confidence and reliability of the information.

“Enhancing the audit quality is important so that capital markets can trust the auditors for having the capability to assure the stakeholders that information is accurate and relevant “. (Interviewee 1)

Interviewee 2 also believes that financial statement information must always be defined in a proper manner. All the stakeholders have the desire that auditors have the ability, to produce high quality of audits that can bring value for them. So, all in all both interviewees consider enhancing the audit quality vital.

4.2 Factors affecting audit quality

According to interviewees it is important to put emphasis on educating the audit professional throughout their professional career, so they can maintain up to date- knowledge for example about legislative issues concerning audit work. It is important that auditors update their knowledge about taxation and accounting laws. It is also vital that auditors follow all auditing and accounting standards diligently and work according to them. One important issue from audit quality perspective is professional skepticism.

Interviewee 1 does not believe that there is at least direct positive relationship between better audit quality and audit firm size. However, there might be some difference within the personnel's skills and knowledge. According to interviewees, bigger audit firms have more resources to invest for example in expensive new technologies that could bring value to audit work and audit quality. There might also be some differences between the audit practices but how much does it affect the audit quality remains a subject of debate according to first interviewee.

“I don’t believe that there is direct positive relationship between the improved audit quality and audit firm size, however larger audit firms have more financial resources to invest for example in technologies such as data analytics that could help to bring value to audit work and even potentially improve the audit quality”. (Interviewee 1)

So, interviewee 1 is not so convinced that there is direct and positive relationship between the improved audit quality and audit firm size. However, interviewee 2 is much more convinced about the idea that that there is indeed positive relationship between audit firm size and improved audit quality.

“Smaller audit firms don’t have the ability to reach the same level with bigger audit firms especially in the areas such as audit documentation. In addition, larger audit firms usually have large publicly listed corporations as their clients, which basically means that different auditing standards should perhaps be followed more intensively” (Interviewee 2)

According to interviewee 2 smaller auditors are not capable of reaching the same level for example in documentation compared to larger audit firms. Especially for financial reasons, smaller audit firms may not conduct same audit measures the larger audit firms conduct. This is somewhat consistent with the argument of Lennox (1999) which suggests that larger audit firms provide higher quality of audits and offer more creditability to financial statements than smaller audit firms.

Interviewee 2 statements are also consistent with the argument of DeAngelo, 1981, which also clearly indicates that bigger audit firms have more resources to provide higher quality audits. For example, according to interviewee 1 Big four-audit firms usually have publicly listed clients which at some extend means that international audit standards must be followed more efficiently and therefore he firmly believes that larger audit firms have higher audit quality compared to smaller audit firms. As DeAngelo 1991, suggested, bigger audit firms provide higher quality audits which might be the main reason why large public corporations for example in Finland want to be their clients. Overall both interviewees to agree at some extend that audit firm size is defining factor determining high audit quality. This argument is also supported by Choi et. al, 2010 which suggests that audit firm size is one the most important determinants of high audit quality.

According to interviewee 1, the relationship between audit fees and audit quality is relevant and important. He believes that if audit fee is relatively low it possibly indicates that there hasn’t been much time and resources invested into audit work.

“Issue concerning relationship between audit fees and audit quality is relevant and important. My personal understanding is that lower audit fees indicate that less time and less necessary resources have been dedicated to audit work. If time and resources haven’t been dedicated enough for specific audit engagement it potentially means that audit engagement and report is more likely to be erroneous”. (Interviewee 1)

Interviewee 1 generally believes that if audit fees are for example abnormally low then it could be concluded that audit quality is not necessarily high. Low audit fees mean that auditor has not had enough resources and time to conduct a normal engagement. For example, auditors may not have been engaged in a stock inventory or discussions with the client firm. Audit fees must be at the level which provides enough resources for auditors to conduct their engagement without higher probability of committing errors.

According to Guo and Eshleman (2014), low audit fees could in some cases harm and even dilute audit quality and force the auditors to reduce their work rate and level of engagement. This supports interviewee 1 statements and therefore indicates purely that lower audit fees usually lead to lower audit quality.

Interviewee 2 does clearly agree with the first interviewee suggesting that larger audit firms provide more incentives and higher audit fees than smaller audit firms.

“Larger offices usually offer higher audit fees to auditors compared to smaller audit offices. This in my opinion leads to higher audit quality. In contrast I think that lower audit fees lead to lower audit quality” (Interviewee 2)

This is consistent with argument Blankley et.al (2012) have pointed out. According to Blankley et.al (2012) there is negative relation between abnormal audit fees and probability of issuing an audit restatement. Auditors that receive lower audit fees usually perform less complete audits which then increases the probability of issuing material misstatements.

Both of interviewees agree with the fact that there is positive relation between audit fees and audit quality. Scientific research also supports this claim as we have just mentioned above.

Interviewee 1 agrees with the fact that auditor’s industry specific knowledge does correlate positively with audit quality indicating that more auditor has in depth-knowledge and experience with some specific industry, higher that audit quality will be.

“Auditor’s working for example for financial industry, must possess deep knowledge about industry due to the uniqueness of the industry. Industry specific knowledge surely brings value” (Interviewee 1)

This statement indicates that in order to increase the audit quality it could be useful to hire auditors that have already industry specific knowledge. Interviewee 2 agrees with the first interview suggesting that deep understanding about specific industry is very important that could possibly bring huge value to audit engagement and therefore improve the audit quality. This argument is consistent with argument made by Minutti, Meza, 2013, who suggest that specialized auditor enhance the accuracy of flaw detection. It is also suggested that for example, some benefits arising from mandatory audit rotation that improves audit quality originates from auditor’s industry specialization (Lim & Tan, 2010).

“In general, I believe that auditor’s industry specialization is has lots of positive influence on audit quality. For example, if auditor has deep knowledge in machinery industry, it will have mainly positive impact on audit quality because of his/her industry specialization” (Interviewee 2)

Overall, both of interviewees agree about the fact that industry specific knowledge has a positive correlation with the audit quality. Wooten (2003) supports this claim by suggesting that audit firms that have multiple clients from the same industry, have deep understanding of audit risks presented by specific industry. According to Butar and Indarto (2018) Auditors who have industry specialization tend to bring their own perspective for example to financial statements and industry complexity and therefore improve the audit quality.

Interviewees don’t believe that audit committee could have an influence on audit quality and audit work. Interviewee 1 suggests that there is no direct link between audit committee and audit quality suggesting that directly audit committee cannot have an impact on audit work.

“I don’t think that there is direct relation with better audit quality and audit committee. Audit committee does not necessarily provide any value to auditing and there are other factors that have more significant influence” (Interviewee 1)

Interviewee 2 believes that audit committee could only have a limited influence on audit quality if there is someone in audit committee that has experienced professional who has relevant knowledge about the subject.

But overall, they both seem to indicate that audit committee could have only limited influence on audit quality.

Interviewees are not so convinced that audit rotation automatically affects audit quality. Interviewee 1 clearly did not want to suggest that audit rotation was inevitable element for influencing the audit quality but added that it could potentially bring some extra value. According to him mandatory audit rotation is not so important element but on the other hand could be necessary for some reasons. Interviewee 1 clearly states that if auditor is completely new person and has not been involved in previous audit engagements within the company, it may be possible give provide new findings that could potentially bring some value to audit engagement and therefore impact the audit quality. According to Lennox et.al (2014), mandatory audit rotation could result in higher audit quality because of the different adjustments that are usually involved within departing auditors work and impact on auditor's motivation. Interviewer 1 statements support these theories.

“If we look at this issue objectively, it is fair to suggest that every time new auditor starts an engagement within company with fresh eyes, it is possible that it could for example find something the previous auditors haven't been able to find and also bring new perspectives to audit work and therefore even improve the audit quality.” (Interviewee 1)

Despite these advantages interviewee 1 saw also some disadvantages relating to auditor's rotation. For example, there could occasionally be some concern about new auditor's ability to focus on company's most important issues. Interviewee 2 is more skeptical about audit rotation suggesting that smaller companies may not even need audit rotation due to several reasons.

“In my opinion, the first thing that comes to my mind is that could the new coming auditor be able to focus on the most critical and vital issues in the company? I think it would even be better that smaller companies should even be exempted from mandatory auditor rotation because I don't see any real value from it” (Interviewee 2)

This is somewhat consistent with the suggestions made by Carcello & Nagy, 2004, who suggest that fraudulent financial reporting might become more common if auditors are rotated intensively. It is also consistent with the view of Chi et.al, 2005, who suggests that it could take plenty of time for new audit partner to accumulate client specific knowledge about the client.

According to interviewees, auditor's independence is considered the single most important thing and issue that influence audit quality.

“Auditor's independence is the single most important aspect when talking about auditing and audit quality. Auditors must independent professionals who must look at relevant issues objectively. More independent auditor is the better the audit quality will be. If we auditors cannot work independently,

then it is presumed that our role as quality assurance is seriously harmed. I personally cannot imagine the situation where auditor is not independent but at the same time tries to keep audit quality high". (Interviewee 1)

Interviewee 2 also agrees with the fact that auditor's independence is vital element when discussing about audit quality.

"Auditor's independence affects the audit quality and it must be always ensured that every incoming auditor is as independent as possible. For example, it must be ensured that auditor does not have any inner circle involved in company's activities in which he/she is auditing" (Interviewee 2)

These statements are consistent with suggestions made by Lavin, (1976), who argues that auditor's independence is essential and can bring value to audit reports only when auditor's opinions are based on an objective and unbiased perspective.

So, overall both interviewees consider auditor's independence one of the most important elements that influence the audit quality. Interviewees think that it is very important to educate themselves and always follow the important auditing standards which are very important in audit industry.

"It is important that auditors have up to date-knowledge and education and can always perceive all the critical changes that occur within audit industry". (Interviewee 2)

Below table 2 displaying and summarizing the results of this research.

Table 2: Results

	<i>Factor</i>	<i>Relevance</i>
1.	Auditor's industry specialization	Important
2.	Auditor's independence	Important
3.	Audit fees	Slightly important
4.	Audit firm size	Slightly important
5.	Mandatory audit rotation	Less significant
6.	Audit committee	Less significant

5 Conclusions

In this bachelor's thesis I have focused on audit quality and its factors. The main purpose of this thesis was to find out what kind of opinions and perceptions experienced auditors have about the factors shaping audit quality. In theoretical part I presented basic and necessary information about auditing in order to provide readers basic picture about auditing as a subject. Theoretical part was written by using literature, scholarly articles and previously conducted scientific research. Theoretical part was primarily focused on topics such as audit firm size, audit rotation and audit fees and auditor industry specialization. Empirical part was done using qualitative research method. As a qualitative research method, I used semi-structured interviews where I interviewed two professional auditors.

The research question in this bachelor's thesis was to find out which factors shape the audit quality and it could be concluded that according to empirical research the most important factor was regarded to be auditor's industry specialization and expertise. Audit fees and auditor's independence were also considered playing major role in shaping audit quality. These conclusions are of course consistent with the previously conducted research such as Wooten (2003) who argues that audit firms that have various clients from the same industry tend to have more in depth-knowledge about risks presented by the specific industry. This clearly gives an indication that audit firms should focus on industry specialization for improvement of audit quality.

Both interviewees agree somewhat that there is relationship between audit firm size and audit quality. They believe that larger firms have more resources to invest in technologies that could possibly help to improve the audit quality. Both also believe that higher audit fees lead to better audit quality. This is consistent with the argument of Eshleman & Peng (2014) who suggest that higher audit fees indicate greater audit effort and thus impact positively on audit quality.

One of the auditors/interviewees did not even consider audit rotation to be important in maintaining high audit quality but other one believed that auditor rotation does have at least some minor impact on audit quality. But overall it could be concluded that auditor rotation does not have significant influence on audit quality which of course is very surprising given its current status in maintaining high audit quality. Audit committee was not believed to have significant influence on audit quality either according to both interviewees. Empirical analysis also suggested that auditor's independence is of course also vital element in assuring that auditing is conducted objectively and in an unbiased manner. Auditor's independence was considered to have important role in maintaining high audit quality.

Overall it is fair to suggest that according to empirical analysis I conducted the most important factors that shape the audit quality according to professional auditors are auditor's industry specialization, auditor's independence and audit fees. Audit firm size also has an influence on audit quality, but it was not regarded to be as important as two previous one. Audit rotation plays minor role according to the interviewees but could bring some extra value. This might then partly indicate that mandatory audit rotation does not produce the value it was originally meant to produce.

As a result of the analysis I conducted it could be useful in the future to focus on issues which deals with improving auditor's industry specific knowledge and for example designing new audit fee system. The further research could for example focus on issues that deals with how audit firms could for example produce functions and methods that enhance the auditor's industry specialization because according to Lim & Tan (2010) auditors industry specialization clearly improves the audit quality.

Another further research topic could possibly focus on audit fee system because the higher audit fees clearly indicate higher audit quality and better work effort (Eschleman, Peng, 2014). Another further research could focus on mandatory audit rotation law amendment.

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Appendix: Interview questions

1. How audit work has been changing over time?
2. Why emphasizing the audit quality is so important?
3. What does good audit quality mean for the financial markets and for your work?
4. How is good audit quality defined?
5. What are the main factors that could possibly affect audit quality?
6. Why some factors impact and shape the audit quality more than others?
7. Is there relationship and connection between the audit firm size and audit quality?
8. Does higher audit quality mean higher audit fees and vice versa?
9. Does auditor's industry experience affect the audit quality? How and why?
10. What are the most important ways and methods to improve the audit quality in general?
11. Does audit committee have an influence on audit quality?
12. Can improving the audit quality make it possible to avoid audit and accounting scandals? How and why?
13. Role of auditor's rotation? How does rotation policy affect the audit quality?
14. Do you recommend audit firm rotation? Are there advantages and disadvantages?
15. Does auditor's independence have positive impact on audit quality?