

The Relationship between Audit Quality and Agency Cost

Mahdi Beshkooh^{1*}, Behnam Gilaniniay Soumehsaraei², Vahid Mahmoudi³,
Farnaz Kazemtabrizi⁴

¹Department of Accounting, Qazvin Branch, Islamic Azad University, Qazvin, Iran

²Department Of Accounting, Rudсар&Amlash Branch, Islamic Azad University, Rudсар, Iran

³Department of Accounting, Qazvin Branch, Islamic Azad University, Qazvin, Iran

⁴Master of Accounting, Kar University, Qazvin, Iran

ABSTRACT

This study investigates the relationship between audit quality, including auditor size and auditor tenure and agency costs. For this purpose, the method of multivariate linear regression model using fixed and random effects by panel data approach is used. Also, to measurement the agency costs was used of free cash flows and the Tobin Q multiplied measure. The study sample is included 61 companies listed in Tehran Stock Exchange during the seven-year period (1382 to 1388). Results shows that relationship between size and agency costs with auditor tenure is not significantly negative and increase tenure period of 3 to 5 years strengthen the auditor's role in reducing agency costs.

KEY WORDS: Quality Audit, Agency Costs, Auditor Size, Auditor Tenure.

1. INTRODUCTION

With the development of capital markets and the increasing separation of ownership from management and increased investment in joint stock companies, accounting and auditing as well as important social role Found. Group Different, to ensure the accuracy of financial information and therefore require a high quality audit, the audit quality is an important one. Agency relationship, a contract that is based on one or more persons (the owner or owners), the person or another person (the representative or representatives) for the operational implementation work and they have taken some decisions are delegated to their representatives [17]. The company has increased the wealth of the owners, but with communicating agents, each of the parties seeking to maximize their own interests and may come on the desirability representatives of owners not in compliance. For this reason, there is a conflict of interest between them and the agency is created. Fees represent a negative relationship with firm value and reducing costs, increasing corporate value. Any additional audit quality is the accuracy of information is more accurate in this case can be estimated more of the value of acquired companies. Care professional auditor, quality information will affect the financial statements but the auditor's reputation, stakeholder understanding of how the information affects [4]. Purpose of this study is representative the effect of audit quality on agency cost. In the next sections literature review and research background, methodology, data analysis, and conclusions are discussed respectively.

2. Literature Review

Spread Business units, the needs resulting from the lack of resources, providing increased competition and financial, administrative and business risks. Financial statements are the most important sources of information that users need them for their decisions and audit quality is important for evaluating the quality of information. De Angelo (1981) defines audit quality by two-dimensional definition: first, detecting misstatements and errors in financial statement and second, reporting these material misstatements and errors [11]. Therefore, according to De Angelo's (1981) definition, audit quality is a function of the auditor's ability to detect material misstatements (technical capabilities) and reporting the errors (auditor independence). Palmerose (1988), audit quality is the probability that financial statements contain no material misstatements [19]. Titman and Trueman, (1986), define auditor quality in terms of the accuracy of information the auditor supplies to investors [20].

Among the most important factors affecting audit quality, audit size and auditor tenure period can be noted. The size of audit Institution reputation is one of the indicators and they are linked; the size of audit institution is large, it will be higher audit quality. The other criteria of the auditor professional care and its ability to oversee is the auditor tenure. Whatever auditor tenure is much more; recognition from employer and his expertise in a particular industry can increase and will enhance audit quality. Recent researches indicate that there is a positive relationship between the type of auditor industry specialization and the quality of audit reports.

*Corresponding Author: Mahdi Beshkooh, Department of Accounting, Qazvin Branch, Islamic Azad University, Qazvin, Iran

Auditors, who are expert in their specific industry, can increase the audit quality, due to their ability in identifying and dealing with special problems of industry. Whatever, the auditor experience in a particular industry is more, it will help to have more fame and then that person will be more interested to perform better quality services [12].

The company's main objective is to increase the wealth of the owners, but with communicating agents, each of the parties seeking to maximize their benefits are desirable and may not be representative for the utility owners. For this reason, there is a conflict of interest between them and the agency is created. Jensen (1986) in the free cash flow theory suggests that managers Instead of distributing free cash flows between the owners tend to re-invest in the company, because the distribution of free cash flows, thereby reducing the resources controlled by managers and their power is reduced. In a sense, no distribution of free cash flows, leading to a reduction in management decisions will be based on market surveillance. Cash flows generated in excess of the total amount of cash needed to finance these new projects, leading to incorrect investment funds is in projects with negative net present value. As a result, firms with high free cash flows and growth opportunities and low investment, agency costs will be high [16]. Jensen and Meckling (1976), agency costs are defined as follows [17]:

1. The Monitoring Expenditures by The Principal: In order to prevent the agent's divergence from the principal's interest and solve the potential moral hazard problem, the principal has to establish incentives, like stock option, to bring the agent's action in line with that of the principal. Moreover, the principal inevitably need to incur some monitoring costs to limit the agent's deviation from the principal's interest.

2. The bonding expenditures by the agent: The principal needs to pay the agent to expend resources to guarantee that the agent will not take certain actions which will harm the principal, or to ensure that the principal will be compensated if the agent does take such actions.

3. The residual loss: In spite of the above costs intended to align the principal and the agent's interest, divergences between the agent's decision and the maximization of the principal's welfare may still take place. The reduced welfare of the principal is the residual loss.

To measure the agency costs of the following criteria have been used so far [6]:

A) Efficiency Ratio: This ratio used firstly Ang and colleagues (2000) to measure agency costs include: 1- the ratio of operating expenses to sales which is a measure of discretionary in the management and 2- The asset turnover ratio which is a measure of the quality of asset management companies. Totally this ratio measures the efficiency with which management uses the firm's assets to generate sales. A high ratio shows that assets are generating significant sales and therefore suggests low agency costs. In contrast, a low ratio suggests that management is implementing policies such as poor investment decisions or consuming excessive perquisites. A low ratio therefore indicates high agency costs and inefficient asset utilization.

B) The Number of Acquired Companies: A number of researchers have been acquired a number of companies as a measure of agency costs are considered. Because that the firms acquisition such as power can be considered [16].

C) Interaction between Firms's Growth Opportunities and the Free Cash Flows: In the group, agency costs are function of interaction between the firm's growth opportunities and the free cash flows. to measure growth opportunities can be use criteria of sales growth, operating profit growth and Q-Tobin index and others.

Increased audit quality on two ways can be reducing agency costs. First, by reducing the information asymmetry between companies and investors, reduce agency costs [21]; and second, the quality audit can play an important role in reducing agency problems and it is the main source for shareholders on managers oversee [8]. Therefore, reducing conflicts of interest between shareholders and managers, agency costs are also reduced.

This study examines the relationship between audit quality and agency costs in firms listed in Tehran Stock Exchange in the years 1382 to 1388 has been paid.

Ferdinand A. at el (2009) on their research with the title of Some evidence on the role of auditor tenure and auditors' industry expertise , found that the association between shorter auditor tenure and lower earnings quality is weaker for firms audited by industry specialists compared to non-specialists. They also found auditors with short tenure are associated with lower earnings quality because of the lack of client-specific knowledge and/or low balling [14].

Xin Chang at el. (2008), considered the relationship between quality and reputation of auditors in firm financial decisions. They presented evidences that show, the quality of auditors' reputation has an impact on

corporate financial decisions and high quality of audit reduces the impact of market conditions on the financial decisions of companies and also their capital structure [23].

Louis Henock (2005) found that, the larger audit firms usually offer better services than smaller institutions. But in some cases small audit firms provide better consultant to their employer [15].

The results of Carcello and Nagy (2004) and Fellatah (2006) show that longer audit tenure, enhance the auditor knowledge and expertise in certain industries and also enhance the level of audit quality [9], [13].

Ang et al. (2000), using a sample of 1,708 domestic U.S. companies, they find that agency costs are significantly higher when an outsider manages the firm and are inversely related to the manager's ownership share [7].

Copley and Doucette, (1993) have done an investigation of the relationship between the quality of audit services and auditor tenure. They find that audit quality declines with auditor tenure due to complacency and/or opportunism. This means that the likelihood of receiving a substandard quality audit increases with the length of the auditor – client relationship. In other words, the longer the period of engagement, the higher the risk of lower audit quality [10].

According to Watts and Zimmerman (1983) researches, Auditors have a duty to reduce the cost of agency asymmetric information. Also they have the controlling rule in the problems coming from Separation of ownership and management [22].

Etemadi and et al. (2009), examined the relationship between auditor industry specialization and profit quality of firms listed in Tehran Stock Exchange. They compared discretionary accruals and profit response coefficients in the companies by industry specialist auditors, with companies without industry specialist auditors in their investigation. They used the market share approach to determine industry specialist auditor. Their results show that companies with specialist industry auditor have lower level of discretionary accruals while they have higher profit response coefficients and also industry specialist auditors, provide audit with more quality to their employer [1].

Noravesh and et al. (2009), investigated the relationship between corporate strategic policies and agency costs of firms listed in Tehran Stock Exchange. They were considered the agency cost as a function of the interaction between growth opportunities and free cash flows. Q-Tobin was defined as a criterion to measure the growth opportunities. The survey results indicated that there is significant negative correlation between the percentage of non-duty members of the board of directors and the ownership percentage of institutional investors with agency costs [5].

Jaffari (2005), believe that the scale of measuring the quality of audit is combination of technical capabilities (detecting misstatements and errors in financial statement) and auditor independence (reporting the misstatements and errors) [2].

Yeganeh and Khaleghi (2003) investigated Expectations gap between auditors and users of accreditation role of independent auditors. Results of their research show that there are significant differences between them [3].

3. The Research Hypotheses

The research hypotheses, according to the proposed theory, include a main hypothesis and three sub-hypotheses can be expressed as follows:

The main hypothesis: there is a significant relationship between audit quality and agency costs.
The first sub-hypothesis: there is a significant relationship between the size of the audit firm and agency costs.
The second sub-hypothesis: there is a significant relationship between the auditor tenure and agency costs.
The third sub-hypothesis: auditor tenure has significant impact on the relationship between audit firm size and agency costs.

4. RESEARCH METHODOLOGY

This research is applicable from the purpose point of view and data gathered by using the ex post facto study approach and also descriptive correlation methodology was used in this research. The main objective is to determine the existence, amount and type of relationship between tested variables. The data sample for this research gathered from the companies involved in Tehran Stock Exchange between the years 1382 to 1388. Only companies with the following specification have been studied in this research:

- 1) The fiscal year date Esfand 29.
- 2) They cannot be a holding companies and banks, insurance, investment and financial intermediation.
- 3) Companies participated in the Tehran Stock Exchange before 82 and also the years from 82 to 88.
- 4) Companies should have stop trading less than 3 months.
- 5) The required information about the company should be available.

4.1. Data collecting

In this research, library research method has been used for data collection with theoretical basis and also in order to access data and for hypotheses processing. Field research method is used.

In the first part, this research investigated on the previous researches in different books, scientific papers and magazines and also web. In the second section, in order to access information for processing hypotheses we used official Tehran Stock Exchange websites (e.g. rdis and irbourse) and also we used some databases such as the Rahavard Novin and Tadbir software.

4.2. Information Gathering Tools

Information gathering tools include financial statements of companies, Tehran Stock Exchange website, Rahavard Novin and Tadbir software and after data collection process, Excel software is used for statistical calculation.

4.3. Methods of Data Analysis

The collected data is entered in an Excel spreadsheet and the primary calculations are done. The final analysis has done by using multivariable regression models with panel data approach in EViews software. For the analysis, Hausman tests, the significant regression coefficients (t), significant regression equation (F) and Durbin-Watson test were used.

5. Definition of Operational Variables

In this study, audit quality considered as an independent variable and agency costs as dependent variable.

5.1. Audit Quality

To measure audit quality following variables are used:

Audit firm Size (AS): It is an artificial variable such that if auditing institution is audit organization, artificial variable of 1 is used, otherwise number 0 is used.

Auditor Tenure (AT): It is an artificial variable so that if auditor tenure of a firm is less than average of auditor tenure of sample firm then artificial variable of 0 is used, otherwise number 1 is used.

5.2. Agency Costs

For measurement agency cost from interaction between free cash flows and Q Tobin has been used. Agency cost can calculate by multiplying two factors of Q-Tobin and free cash flows. Whatever this amount is higher means that the agency cost is also higher.

1) Q-Tobin (growth opportunities): is a measure for management performance. Strong management performance reduces agency costs. According to McCannell and Servaes (1990), this ratio is calculated using the following formula [18]:

$$\text{Tobin's } - Q = \frac{MV + TD}{TA}$$

MV: Market value, TD: total debt, TA: total assets

2) Free cash flows: for the calculation of free cash flows we used polson and lee hen model (1989) as follows:

$$FCF = \frac{(OIBD - CITAXP - INTEXP - DIVP)}{TA}$$

FCF: free cash flow, OIBD: operating income before deducting depreciation, CITAXP: income tax, INTEXP: interest expenses, DIVP: profits paid to shareholders and TA: Total assets.

6. DATA ANALYSIS

Before testing the research hypotheses, firstly we use the Leamer F test, in order to select the panel data analysis or pooled method. In this test, the null hypothesis means using pooled data method while converse hypothesis means using panel data analysis. Then we use Hausman test, in order to compare fixed effects models and random effects models by considering the power of dependent explanatory variable. The Null hypothesis (random effects method) in this test means that there is no relation between intercept disruption of communication and explanatory variables and they are independent of each other. While the contrast hypothesis (fixed effects method), means that there are correlations between the explanatory variables and intercept disruption of communication. If null hypothesis reject, we will use the fixed effects methods otherwise we will use random effects methods.

Regression models, including the following models:

- 1) $AC_{i,t} = \beta_0 + \beta_1 AS_t + \beta_2 AT_t + u_t$
- 2) $AC_{i,t} = \beta_0 + \beta_1 AS_t + u_t$

In the first model, without considering category of companies, we investigate the relationship between auditor tenure and auditor size with agency cost. In the second model, the relationship between auditor size and agency cost are investigated according to the classification of companies by considering according the auditor tenure. in the second model firstly companies classify to three categories by considering auditor tenure: The first category includes companies with auditor tenure between 1 to 3 years (short term tenure), the second category includes firms with auditor tenure between 3 to 5 years (tenure average) and third category includes companies with auditor tenure between 5 to 7 years (long term tenure). Then the second regression model is estimated separately for each of the aforementioned categories.

7. Variables Research Statistics Descriptive

Descriptive statistics for study variables are presented in Tables 1 and 2.

Table 1: Descriptive statistics for variables in model 1

Variables	AC	AS	AT
Mean	-0.197604	0.346604	0.57377
Median	-0.0817	0	1
Maximum	0.4702	1	1
Minimum	-0.9718	0	0
Standard Deviation	0.524493	0.476447	0.495108

Source: Researcher's findings

Table 2: Descriptive statistics for variables in model 2

Companies classified	Variables	AC	AS
First	Mean	-0.330751	0.142857
	Median	-0.09275	0
	Maximum	0.057743	1
	Minimum	-6.971751	0
	SD	0.910139	0.352029
Second	Mean	-0.087562	0.234694
	Median	-0.041592	0
	Maximum	0.074883	1
	Minimum	-0.559553	0
	SD	0.128476	0.425986
Third	Mean	-0.194979	0.461224
	Median	-0.089608	0
	Maximum	0.470212	1
	Minimum	-4.651783	0
	SD	0.424820	0.499515

Source: Researcher's findings

Table 3: Multiple comparison of dependent variables (AC)

Companies classified	Mean	The mean difference	The difference	P-Value
First	-0.330751	With the second category	-0.243	0.002
		With the third category	-0.136	0.039
Second	-0.087562	With the first category	0.243	0.002
		With the third category	0.107	0.086
Third	-0.194979	With the first category	0.136	0.039
		With the second category	-0.107	0.086
Total	-0.197604	Among the categories	F Statistic	0.007
			4.97	

Source: Researcher's findings

According to the results of Table 3, the probable of F statistic In examining the mean difference between the categories is less than 0.05 and the null hypothesis that the mean of categories agency cost being equality is rejected and opposite hypotheses, not equality mean to be confirmed. Also, the probable of mean difference between the two categories of small ten and less than 0.05 against the hypothesis of mean equality Approval is also here and this difference is significant. As can be seen, the mean cost, mean represents Other categories are more negative and this shows that with increasing tenure, cost companies represented in the latter group, further reduced.

8. Testing the Hypotheses

8.1. Check the Normal Distribution of the Dependent Variable

We used Kolmogorov-Smirnov Test (KS test) in order to investigation of Normal distribution for this research dependent variable. Level of significant (p-value) is 0.88 that shows the distribution of variables is normal.

8.2. First and Second Sub-Hypotheses Test

The first sub-hypothesis: there is significant relation between audit size and agency costs.

The second sub-hypothesis: there is a significant relation between the auditor tenure and agency costs.

The results of the first and second hypotheses are presented in Table 4.

Table 4: Results of the first and second hypothesis test

$AC_{it} = \beta_0 + \beta_1 AS_t + \beta_2 AT_t + u_t$				
Variables	Coefficients	Standard error	t	P-Value
	-0.2607	0.0420	-6.213	0
AS	0.182	0.10 2	1.791	0.0741
AT	-0.0173	0.0789	-0.2196	0.8263
R ²	0.3099	Leamer F Statistics	2.718	0
		Hausman statistic	1.632	0.2015
DW	2.0347	F Statistic	2.688	0

Source: Researcher’s findings

By considering the amount of P-Value less than 0.01 in the Leamer F test in 99% confidence level, the null hypothesis which is using the pooled data is rejected and we use panel data method.

The amount of P-Value in Hausman test is over 0.05. Consequently, the null hypothesis which is using the random effects method accepts and we use this method for data estimation. R squared is about 31%. This means that 31% of agency costs are explained by the independent variables. Durbin-Watson statistics with the amount of 2.0347 shows there is no correlation between the error components.

According to this table, by considering that the probability of the F statistic equal to 0 is less than 0.05, and in the 99% confidence level, the regression model is generally confirmed. According to this point that the results of the coefficient of regression are significant (as it can be seen in table) therefore the probable of AS variable (auditor size) in the 99% confidence level is more than 5 %. As a result the null hypothesis can be confirmed based on this variable is not significant. The Significant coefficient of AT variable (auditor tenure) is also more than 0.05 and the null hypothesis can be confirmed for this variable as well. So, according to test results, the first and second sub-hypothesis is rejected.

8.3. The Third Sub-Hypothesis Test

The third sub-hypothesis: auditor tenure has significant impact on the relationship between audit firm size and agency costs.

The results of the first and second hypotheses are presented in Table 5.

Table 5: Results of the third sub-hypothesis test

$AC_{it} = \beta_0 + \beta_1 AS_t + u_t$					
Companies classified	Model variables	Coefficients	Standard error	t	P-Value
First	$\beta.$	-0.3756	0.0994	-3.777	0.0003
	AS	0.2832	0.2924	0.96848	0.3361
	R ²	0.294	Leamer F Statistics	2.683	0.0061
			Hausman statistic	2.332	0.1268
	DW	1.843	F Statistic	2.46	0.0096
Second	$\beta.$	-0.121	0.02124	-5.695	0
	AS	0.114	0.0486	2.355	0.0214
	R ²	0.35	Leamer F Statistics	1.639	0.09
			Hausman statistic	1.417	0.234
	DW	2.031	F Statistic	2.438	0.0066
Third	$\beta.$	-0.247	0.11345	-2.178	0.0305
	AS	0.113	0.2401	0.471	0.638
	R ²	0.296	Leamer F Statistics	2.578	0
			Hausman statistic	0.121	0.728
	DW	2.346	F Statistic	2.514	0.00003

Source: Researcher's findings

The results of third sub-hypothesis test are presented in Table 5. As can be seen in this Table, the amount of P-Value in the Leamer F test for all the three categories is less than 0.01. Therefore in the 99% confidence level, the null hypothesis which is using pooled method (pooled) is rejected and we use the panel data method. In addition in all three categories the amount of P-Value in Hausman Test is more than 0.05. Consequently, the null hypothesis which is using random effects method is confirmed and we use this method for the estimation. Coefficient of determination in all groups indicates that about 29%, 35% and 30% of the agency cost variation is determined by the audit firm size respectively. Durbin-Watson statistics in all three groups indicates there is no correlation between the components of the errors. In addition Probability of F statistics in all three categories shows regression is generally linear and significant.

Coefficients of the audit firm size variable in all three groups are 0.283 2, 0.114 And 0.113 respectively, that show the positive effect of the audit firm size which by increasing tenure, then agency costs are reducing. Significant coefficients of audit firm size variable in second group is less than 5% that shows the its coefficient is significant.

6. Conclusions and Suggestions

In this Research, the relationship between audit quality components, including the audit size, audit tenure and agency costs in available firms in Tehran Stock Exchange over a period of 7 years are listed. The importance of this research is that a few researches have done on the effect of audit quality in agency costs in Iran. For this purpose we used the multiple linear regressions with random effects method and panel data approach.

The results of first and second sub-hypothesis tests show that there is no an inverse relationship between the size and audit tenure with the agency costs.

The third sub-hypothesis test shows that increasing audit tenure between 3 to 5 years has a positive effect on the relationship between audit firm size and agency costs and makes this reverse relationship more strength.

But tenure period between 1 to 3 years due to less expertise and auditor tenure period between 5 to 7 years due to World Wide Web, and greater recognition of the close relationship with the auditor cannot reduce the agency cost. These results were consistent with Copley and Doucette [9] and with the Finds of Carcello and Nagy [8] and Fallatah [12] is in conflict.

6.1. Suggestions for Future Research

1. This research categorizes Industries in Tehran Stock Exchange in order to investigate the impact of industry on the relationship between variables.
2. Future researches can be done on the other methods of measurement of audit quality such as auditor expertise.

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