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An Investigation the Effect of Auditor Partner Rotation, Auditor Size and Tenure on Investors Expected Rate of Return in Listed Companies of Tehran Stock Exchange (TSE)

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Authors' contributions

This work was carried out in collaboration between all authors.

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ABSTRACT

Aims: The purpose of this study is to determine the impact of Audit quality attributes such as audit partner rotation, auditor size and auditor tenure on Investors Expected Rate of Return in Listed Companies of Tehran Stock Exchange (TSE).

Study Design: This research in terms of purpose is of applied type and in terms of nature is semi-experimental. That its results can be useful for a wide range of corporate stakeholders.

Place and Duration of Study: The used data have been extracted from the companies accepted in Tehran Stock Exchange (TSE) from 2005 to 2010 to determine the relationship between qualitative characteristics of audit and return rate expected by investors.

Methodology: In this Study, cost of equity is the dependent variable and Auditor Partner Rotation, Auditor Size and Tenure as the audit quality characteristics are the independent variables. Also, three control variables of ratio of book to market value, financial leverage and firm size are introduced to regression equations to control the impact of risk factors. In this regard, for measuring Cost of equity was used Gordon growth model. For data analysis and test of research hypothesis, multivariate regression equation has been used. To carry out the research, using Tadbir and Rahavard-e-Novin softwares, the required

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quantitative data and information have been extracted from financial statements and other financial reports of the audited companies.

Results: The results obtained from hypotheses test have shown that there is a positive and significant relationship between size of audit firm and return rate expected by investors. Therefore, the findings indicate that there is a negative relationship between auditor tenure and return rate expected by investors; however, this relationship is not statistically significant. In addition, the results show that there is a positive and significant relationship between the short-term rotation period of audit partner and return rate expected by investors.

Conclusion: According results obtained from hypotheses test, it can be inferred that cost of equity increases by increase of audit firm size. In other words, decreasing the audit quality is resulted in decrease of reliability of financial statements and risk of decision-making for investors. Moreover, the results of this research indicate that investors probably do not care much about audit firm and auditor partner tenure in their decision-makings about expected rate of return.

Keywords: Audit quality; auditor partner rotation; audit firm size; auditor tenure; cost of equity.

1. INTRODUCTION

Presence of transparent and reliable financial information which is the result of a comprehensive and proper reporting system is considered one of the key elements to evaluate a firm's situation and performance and decision-making about investment in the firm. In every economic event, investors need reliable information to make a decision. From investors' viewpoint, that type of information for example financial statements, which are supervised by an independent organization, can be regarded as reliable information. An example of this type of independent organizations is audit firm. Audit creates added value for the reported financial statements, because the results of the study report the relevancy and reliability of the contents of the statements [1].

Considering the position and role of audit firms in users' decisions, audit quality is a key factor for them to prepare audit reports. Quality which determines the function of audit depends on various factors including the auditor's abilities (such as knowledge, experience, ability to adapt and technical efficiency) and professional performance (like independence, objectivity, professional care, conflict of interest and judgment) [2]. Since audit quality is a multi-dimensional structure, but invisible, its measurement is very difficult. Based on extensive studies conducted around the world, including [3-6], effective factors on audit quality are size, variety of clients, reputation, etc. According to prevailing theories accepted in the world, the quality of reports of large audit firms is more than small ones [7].

Auditor as the mechanism detected the important distortions can improve information quality, consequently reduce investment risk and get better optimal extra-organizational decision-makings. Management should try to sustain the commercial unit value, bring the expected return at least to the cost level of capital. On the other hand, shareholders rely on financial statements in determining their expected rate of return. On the other hand, as is explained, reliability of financial statements will be made possible by audit.

The final value of audit activity is to help the users to determine the quality of received reports. Therefore, the users of information must accept the auditor's qualification in order to

trust his statements. If the users' trust is not obtained, the audits goal hasn't completely achieved [7]. On the other hand, the crises of financial reports which lead to destroy the big companies in recent years attract the attention of researchers and professional organizations to increase the reliability and reduce defects of audit reports. Regarding the above cases, it is essential to identify the audit quality and its effect on the return rate expected by investors in the Iranian capital market. This issue will result in a true understanding of the users from financial statements and actual quality of audit reports, and creating a common language in terms of audit quality. Therefore, this study tries to answer this question "can features of audit quality such as rotation partner, size and audit tenure lead to improve and decrease the return rate expected by investors".

2. LITERATURE REVIEW

2.1 Audit Role

Audit plays three crucial roles: supervision on management actions (theory of supervision), creation of better informational environment (theory of information) and providing security for companies against risks (insurance theory). If audit operation lacks a desirable quality and is not able to properly determine reliability of the published information, at micro-economic level, many people lose their capitals and few people will earn immense profit. In addition, decrease of audit quality may be a threat to auditor's credit, reputation and requested commission fee and legitimacy of audit profession [8].

In the Agency Theory, it is argued that audit helps reduce conflict of interest between management and investors. Therefore, large audit firms have stronger motivation for protection of their independence and reputation. Hence, they apply reporting standards much better and quicker [9]. Recently, the issue of managers legal vulnerability has arisen which requires audit as a cover for the loss caused by it. Auditor and management of the business audited unit are jointly and individually responsible against third parties in relation to for the losses arisen from distorted financial statements. In other words, managers are interested in creating an insurance coverage through audit [10].

2.2 Auditor Size

Based on extensive studies conducted around the world, including [3-6], effective factors on quality of audit reports are size, variety of clients, reputation, etc. According to theories accepted in the world, the quality of reports of large audit firms are more than small ones [7].

In many cases, according to the theoretical principles, a large audit firm in terms of size enhances audit quality level. Larger audit firms provide higher quality audit services, because they are interested in obtaining greater reputation in the work market; since the number of their clients is very much, they don't worry about losing them [3].

2.3 Partner Rotation and Audit Firm

Independent auditors play a valuable role in the capital market by reducing information risk through validating the financial statements published by public companies. The significance of this role of audit to a large extent depends on the nature of auditors' attestation [8]. It is argued that auditor's long term relationship with the client may lead to nonchalance and failure of the auditor in fulfillment of one's attestation or certification role. Weakening of

auditor's independence is itself a serious issue which has given rise to much concern. One solution suggested resolving this concern is audit firms rotation.

Nature of firms and auditors partner rotation is a bilateral matter. On the one hand, rotation of audit firms and the auditor partners cuts off the long-term relationship of the auditor with the client, regardless of the repeated audit processes in previous years and elimination of the auditor's unconscious inclination for the client gratification. On the other hand, non-rotation of the auditor improves his efficiency in recognition to better understanding of information changes, replacement and classification learned from previous years [1,11] believe that in the course of time the auditor get better knowledge of the client so as the auditor's ability increases in choosing suitable accounting and reporting procedure. Hence, long-term relationship of the auditor with the client can improve audit quality.

2.4 Audit Quality and Investors' Expected Rate of Return

Cost of capital is the minimum rate of return the firm has to obtain in order to secure investor's expected rate of return. If the expected rate of return is less than cost of capital, the business unit value will decrease. Therefore, for protection of the business unit value, it should try to bring expected rate of return at least to the level of cost of capital. Shareholders expected rate of return is influenced by information risk and information risk in turn depends on personal information, public information and information transparency so as the less the information transparent is, the more the risk premium of ambiguity condition becomes and the higher the investors expected rate of return goes. Shareholders rely on financial statements for determining their expected rate of return. Reliability of the reported financial statements is of influence in estimation of shareholders expected rate of return. On the other hand, as has been explained, reliability of financial statements depends on auditing [12].

In most recent researches at international level, it has been demonstrated that return rate expected by investors is affected by audit quality. [13] Demonstrated that largeness of audit firm significantly reduces cost of capital related to the firms which have not been audited by large audit firms. Based on the information theory, it can be stated that auditors create informational advantages, which provide a basis for economic decision-making, by carrying out audit operation. In other words, auditor as the mechanism detected information distortion improves information quality and consequently reduces investment risk and facilitates optimal decision-making. Thus, audit reduces informational risk for the users of financial statements which eventually results in reduction of return rate expected by investors.

In a research, [14] investigate the relationship between auditor's characteristics and cost of capital. Their findings indicate the presence of a significant negative association between auditor's tenure and cost of capital. In other words, cost of capital is reduced by increase of tenure duration. [15] Investigate the relationship between audit quality characteristics and firm size, and cost of equity. In this study, size of audit firm and auditor's expertise had been considered the criteria of audit quality. Results of their research indicated presence of negative and significant association of audit firm size, auditor's tenure and expertise in the industry with cost of equity.

In their research, [16,17] concluded that audit quality is negatively influenced by the policy of auditor's compelled rotation. Moreover, [18] concluded that audit quality is improved by increase of auditor's tenure.

[19,20] took the audit firms which were the members of 4 large audit organizations (previously known as 6 large audit firms and 8 large firms) as the large reputable audit firms and valued their audit works as high quality audits and presented them the benchmark and index of audit quality in their researches. Since the 4 large audit firms in addition to their reputation acted successfully in increasing the quality, employees training and protecting their independence versus the clients as well as other crucial areas. Carcello and Nagy [21] in a research titled "Firm Size, Auditor's Expertise and Fraudulent Financial Reporting" demonstrated that long-term auditor tenure enhances auditor's knowledge and expertise in the respective client's industry and increases the level of audit quality.

In a study, [22] investigated the relationship between audit quality and size of the audit firm from 2001 to 2005. In this research, audit firms which were members of the Association of Chartered Accountants were classified as small ones and the audit organization because of large number of employees and longer precedence were classified as large ones. Their findings indicate that there is a negative and significant relationship between size of the audit firm and audit quality. Nonahal Nahr et al. [23] investigated the relationship of auditor's quality and reliability of liability items from 2001 to 2007. In their study, they used two indices of the audit firm size and auditor tenure to measure the auditor's quality. In addition, in this research, audit organizations were regarded as the large audit firms in terms of size and other audit firms as small ones. The criterion auditor tenure has been set for 5 years. Using multivariate linear regression analysis, their findings indicated that the companies audited by a higher quality auditor have had a greater stability and reliability coefficient in comparison to the companies audited by lower quality auditor.

Considering the research main question, the propositions of the three hypotheses are as follows:

First: hypothesis: there is a significant relationship between size of audit firm and return rate expected by investors.

Second: hypothesis: there is a significant relationship between audit firm tenure and return rate expected by investors.

Third: hypothesis: there is a significant relationship between the auditor partner tenure and return rate expected by investors.

3. METHODOLOGY

This research in terms of purpose is of applied type and in terms of nature is semi-experimental. For data analysis and test of research hypothesis, multivariate regression equation has been used. To carry out the research, using Tadbir and Rahavard-e-Novin software's, the required quantitative data and information have been extracted from financial statements and other financial reports of the audited companies. The data after collection have been linked and classified in the Excel Sheet and eventually using Eviews6 they have been analyzed.

The statistical population in this research includes the listed companies on TSE. Temporal domain of the present research covers the years 2005-2009. However, given estimation of the firms' expected growth rate in each year, using geometrical mean of operational profit, in sum, the research data are for the time interval of 2000 up to 20-03-2010. For sampling, using systematic elimination method the firms which met all the following conditions have been selected as the sample:

For the sake of comparability, their fiscal period ends up to 2-03-2010.

The companies do not belong to the group of banks and financial institutes (investment companies, financial brokerage, holdings, and leasing companies).

The firms do not have a transaction suspension of more than two months from the date of their general ordinary meeting.

The firm has not changed its line of activity or its fiscal year within the research temporal scope.

By application of the above condition, 55 companies were selected as sample companies have a total of 275 years as the research statistical sample.

3.1 Research Variables

3.1.1 Independent variables and their operational definition

In this research, audit quality characteristics have been considered as the independent variables. The most important quantitative indicators for measurement of audit quality are audit quality, audit firm size, audit institutes in membership of the Chartered Accountants Association and auditor partner tenure. To measure the size of the audit firm, the audit firms in membership of the Chartered Accountants Association have been considered as small ones and audit organizations in recognition to the large number of employees and longer precedence have been classified as the large ones. To measure the audit firm tenure, if an audit firm continuously and more than 4 years has been the auditor of the client, the value of the audit firm tenure is defined equal to 1 otherwise it will be considered equal to zero. In this research following the method of [24] the 4-year criterion has been taken as the good quality tenure. In addition, owing to understand more about how audit firm tenure affects return rate expected by investors, tenure is divided into short-term and long-term states. For audit partner short-term tenure, if duration of partner tenure is less than 3 years it is equal to 1 otherwise it is equal to zero. For audit partner long-term tenure, if duration of the partner tenure is more than 6 years, it is considered equal to 1 otherwise equal to zero.

3.1.2 Dependent variable and its operational definition

Return rate expected by investors is the dependent variable in this research. Return rate expected by investors is determined according to cost of equity. In this study, Based on the research results [25] in the country Iran, The model used to calculate the cost of equity is Gordon Growth Model. In this model, cost of equity is calculated using equation (1),

$$K_e = \frac{DPS_{t+1}}{P_t} + g \quad (1)$$

In relation (1), K_e is cost of equity, $DPSt+1$ the profit of expected share in next year for each share. Considering that the past information is used, the firm's next year dividend is used. P_t is the first share price after holding shareholders ordinary meeting, g expected growth rate. Growth rate has been calculated using geometrical mean of operational profit over five last years.

3.1.3 Control variables

In this research, following [15], the effect of financial leverage variables, firm size and ratio of book-to-market value was controlled. Natural logarithm of equity market value the end of

year has been used to measure firm size. Natural logarithm of debt ratio (total debt to total asset) has been used to calculate the financial leverage.

3.2 Data analysis method

In this study, to test the research hypotheses, multivariate linear regression equations have been applied. In these equations, in this Study, cost of equity is the dependent variable and Auditor Partner Rotation, Auditor Size and Tenure as the audit quality characteristics are the independent variables. Also, three control variables of ratio of book to market value, financial leverage and firm size are introduced to regression equations to control the impact of risk factors. The used regression equations are presented in relations (2), (3) and (4).

$$COE_{it} = \beta_0 + \beta_1 AuditSize_{it} + \beta_2 Size_{it} + \beta_3 Lev_{it} + \beta_4 BM_{it} + \varepsilon_{it} \tag{2}$$

$$COE_{it} = \beta_0 + \beta_1 Tenure_{it} + \beta_2 TenureSmall_{it} + \beta_3 TenureLarge_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 BM_{it} + \varepsilon_{it} \tag{3}$$

$$COE_{it} = \beta_0 + \beta_1 Partenure_{it} + \beta_2 Small.Partenure_{it} + \beta_3 Large.Partenure_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 BM_{it} + \varepsilon_{it} \tag{4}$$

In which, COE_{it} is cost of equity, AuditSize_{it} audit firm size, Tenure_{it} auditor tenure. Large.Partenure_{it}, Small.Partenure_{it}, TenureLarge_{it}, Partenure_{it} and TenureSmall_{it}, BM_{it} is book-to-market value ratio, Size_{it} firm size and Lev_{it} firm financial leverage.

4. RESULTS AND DISCUSSION

Descriptive statistics for the variables used in our analysis are given in Table 1. As it is shown in Table 1, the mean cost of equity capital for the entire sample is %35, also, Minimum and maximum expected rate of respectively 10% and 80% with a standard deviation is 17%. Descriptive analysis of the data suggests that the average auditor size 0/31. Average tenure is also equal to 4/33 years.

Table 1. Results of research variables descriptive statistics

Variable	Mean	Median	St. deviation	Minimum	Maximum
Cost of equity	0/35	0/33	0/17	0/10	0/80
Auditors size	0/31	0	0/46	0	1
Auditor tenure	4/33	4	2/17	1	8
Auditor partner rotation	3/5	3	2/5	1	11
Firm size	13/13	13/1	1/5	10/3	16/83
Financial leverage	0/62	0/61	0/17	0/17	0/96
Book-to-market value	0/68	0/56	0/43	0/11	1/8

The average tenure of audit partners also equal to 3/5 years which shows each audit partner on average nearly 4 years to audit any of the Companies has been investigated. Descriptive statistics are presented as well as the validity of research data is indicative of the variety.

The first hypothesis suggests a significant relationship between audit firm size and cost of equity. As it is shown in Table 2, coefficient of the variable audit firm size (Audit Size) is

equal to 0.06 and t-statistic is equal to 3.275; according the significance level of 0.001, it can be said that there is positive and significant relationship between audit firm size and cost of equity at 99% confidence. Hence, the first hypothesis is confirmed. Results of this hypothesis are consistent with findings of [15]. Considering significance level of other variables in the model, it can be concluded that firm size variables at 99% confidence have positive and significant effect on cost of equity. However, no significant relationship has been found between book-to-market value ratio and financial leverage, and cost of equity.

Table 2. Results obtained from statistical test of research first hypothesis

$COE_{it} = \beta_0 + \beta_1 AuditSize_{it} + \beta_2 Size_{it} + \beta_3 Lev_{it} + \beta_4 BM_{it} + \varepsilon_{it}$				
variable	Abbreviation	Variable coefficient	t-statistic	Sig.
Constant	β_0	0/44	13/087	0/000
Auditor size	$AuditSize_{it}$	0/06	3/275	0/001
Firm size	$Size_{it}$	-0/02	-5/18	0/000
Financial leverage	Lev_{it}	-0/02	-0/63	0/533
Book-to-market value	BM_{it}	-0/006	-0/245	0/807
Adjusted R2	0/32	F-statistic		14/07
		Sig.		0/000

Regarding the value of F-statistic (14.07) and its respective significance (0.000), all coefficients of the regression are not zero at the same time and there is a simultaneous significant relationship between independent variables and dependent variable. Hence, the fitted model is significant at 99% confidence. Regarding the fitted model's coefficient of determination, it can be claimed that about 32% of changes in cost of equity is explained by the model's variables.

The research second hypothesis suggests a significant relationship between auditor tenure and cost of equity. As is shown in Table 3, coefficient of the variable audit firm tenure (Tenure) is equal to -0.011 and t-statistic is equal to -0.591. Hence, according to the discussed theoretical principles and the findings of [15], there is a negative relationship between Tenure and cost of equity; however, this relationship is not significant. Considering the significance level of the other variables in the model, it can be concluded that there is no significant relationship between variables firm size, book-to-market value and financial leverage, and cost of equity. The adjusted coefficient of determination is equal to 0.54 and it can be stated that about 54% of changes in cost of equity have been explained by the model's variables.

Considering the value of F-statistic (4.532) and its respective significance (0.000), all the regression coefficients are not zero simultaneously and there is a simultaneous significant relationship between all the independent variables and dependent variable. Thus, the fitted model is significant at 99% confidence. Considering the adjusted coefficient of determination, it can be stated that about 54% of changes in cost of equity have been explained by the model's variables.

Table 3. Obtained results from statistical test of the second hypothesis

$$COE_{it} = \beta_0 + \beta_1 Tenure_{it} + \beta_2 TenureSmall_{it} + \beta_3 TenureLarge_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 BM_{it} + \varepsilon_{it}$$

Variable	Abbreviation	Variable coefficient	t-statistic	Sig
Constant	β_0	0/51	1/276	0/206
Auditor tenure	$Tenure_{it}$	-0/011	-0/591	0/552
Auditor short term tenure	$TenureSmall_{it}$	0/039	1/276	0/468
Auditor long term tenure	$TenureLarge_{it}$	0/078	1/484	0/142
Firm size	$Size_{it}$	0/019	0/15	0/881
Financial leverage	Lev_{it}	-0/017	-0/136	0/892
Book-to-market value	BM_{it}	-0/078	-1/361	0/177
Adjusted R ²	0/54	F-statistic		4/532
		Sig		0/000

The third hypothesis shows that there is a significant relationship between auditor partner tenure and return rate expected by investors. As is shown in Table 4, coefficient of the variable auditor partner is equal to -0.006 and the t-statistic is equal to -0.593. Hence, according to the discussed theoretical principles, there is a negative relationship between the auditor partner tenure and cost of equity; however, this relationship is not significant. In addition, coefficient of short-term auditor partner tenure is equal to 0.079 and the t-statistic is equal to 2.294. Thus, there is a positive and significant relationship between short-term auditor partner tenure and return rate expected by investors. Moreover, coefficient of the variable long-term auditor tenure is equal to -0.009 and the t-statistic is equal to -0.152. Hence, there is a negative relationship between long-term auditor partner tenure and return rate expected by investors, however, this relationship is not significant.

Table 4. Obtained results from statistical test of the third hypothesis

$$COE_{it} = \beta_0 + \beta_1 Partenure_{it} + \beta_2 Small.Partenure_{it} + \beta_3 Large.Partenure_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 BM_{it} + \varepsilon_{it}$$

Variable	Abbreviation	Variable coefficient	t-statistic	Sig.
Constant	β_0	0/377	7/237	0/000
Auditor partner rotation	$Partenure_{it}$	-0/006	-0/593	0/554
Short-term auditor partner rotation	$SmallPartenure_{it}$	0/079	2/294	0/023
Long-term auditor partner rotation	$LargePartenure_{it}$	-0/009	-0/152	0/879
Firm size	$Size_{it}$	-0/027	-6/465	0/000
Financial ratio	Lev_{it}	0/002	0/04	0/968
Book-to-market value	BM_{it}	0/028	1/203	0/231
Adjusted R ²	0/43	F-statistic		14/578
		Sig		0/000

Considering significance of other variables in the model, it can be concluded that firm size has a negative and significant relationship with return rate expected by investors, but the variable book-to-market value and financial leverage have no significant relationship with

cost of equity. Considering the value of F-statistic (14.578) and its respective significance (0.000), all regression coefficients are not simultaneously zero and there is a simultaneous relationship between all the independent variables and the dependent variable. Thus, the fitted model at 99% level is significant. Regarding the adjusted coefficient of determination, it can be stated that about 43% of changes in cost of equity have been explained by the model's variables.

5. CONCLUSION

This research attempts to find an answer to this question "Are auditor quality characteristics resulted in reduction of cost of equity?" In order to do this, the indicators audit firm size, audit firm tenure and auditor partner tenure have been employed as audit quality characteristics. In addition, Gordon Growth Model has been applied to measure cost of equity,. Research findings suggest a positive and significant relationship between audit firm size as one of the audit quality indicators and cost of equity. As was discussed in the theoretical background section, larger audit firms, because of their interest in maintaining their reputation in the work market and no fear of losing their clients in recognition to the large number of their customers, provide higher quality audit services. However, prior research done in Iran by [22] has indicated a negative and significant relationship between size of audit firm and audit quality. Hence, regarding that Iranian economic environment differs from that of other countries and considering the results of this hypothesis and results of the research carried out by [22], it can be inferred that cost of equity increases by increase of audit firm size (decrease of audit quality). In other words, decreasing the audit quality (increase of audit firm size), is resulted in decrease of reliability of financial statements and risk of decision-making for investors.

Moreover, the results indicate a negative relationship between audit firm tenure as another indicator of audit quality and cost of equity; however, this relationship is not significant. This result suggests that in Iran audit firm tenure has no effect on return rate expected by investors. In regard to auditor partner rotation, the results indicated that short-term auditor partner leads to increase of return rate expected by investors but long-term auditor partner has no significant effect on return rate expected by investors. Further, the results of this research indicate that investors probably do not care much about audit firm and auditor partner tenure in their decision-makings about expected rate of return.

Suggestions based on the research results:

1. Board of directors and managers are recommended to take care in choice of audit firm in order to increase audit quality and to reduce return rate expected by investors.
2. The potential investors are suggested to pay attention to audit quality of the audit firm in their decision-makings on determining expected rate of return.

Suggestions for future researches:

1. Taking other indicators into account for measurement of the impact of audit quality on cost of equity (e.g. auditor partner rotation, auditor expertise in the industry, ...)
2. Taking account of other criteria for measurement of cost of equity such as O'Hanlon and Steel Model, Capital Assets Pricing (CAPM), ...

COMPETING INTERESTS

Authors have declared that no competing interests exist.

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