Effect of Audit Quality on the Investors' Ability to Predict the Future Profits of Companies in Stock Exchange

Mogtaba afsordeh[1*] , Mahmmod Razin[2] and Bahman asefi[2]

1- Accounting department, payamenour University of Ilam, Iran
2- M.A in Acounting,Azad university of shahroud,iran

Corresponding author: Mogtaba afsordeh

ABSTRACT: In this research work, Plug in Hybrid Electric Vehicle (PHEV) is studied how to participate in the energy market, reactive power market and coupled energy and reactive power market. The PHEV capability curve is identified which have been recently presented in the related work in the area. The concept Lost Opportunity Cost (LOC) is explained based on the capability of PHEV and its application is fully taken into consideration. Then PHEV is included in energy, reactive and coupled market. This require to determine objective functions in each market. Finally a 17-node microgrid is taken as case study in which some of PHEVs are placed to take part in these markets.

Keywords: energy market, reactive power market, coupled energy and reactive power market, Plug in Hybrid Electric Vehicle (PHEV), Expected Payment Function (EPF), Total Payment Function (TPF), Lost Opportunity Cost (LOC).

INTRODUCTION

Investors use audit information to predict future earnings and corporate value. Companies duly disclose elections and their accounting changes and what affects the financial statements. In other words, the financial statements have been designed in such a way that it will be an appropriate guide for users and investors, to assess the impact of economic events on current and future earnings. The effect of an economic event on the activities of an enterprise is not limited only to when it happens and affects economic activities of the corporate for a while after the event. Therefore, investors must predict the impact of economic events on future profits of the company. For this purpose, investors make use of the audit quality to enhance the information content of disclosures and reducing earnings management (Brian Lee, 2003).

The role of auditor is providing a reasonable credit for the figures and information contained in the financial statements for appropriate decision-making. Producers and users of information consider the statement of independent auditors as a measure to increase the reliability of the information. As a result, the validity and reliability of accounting information, audited by high quality auditors, can improve the result of user's decision making process (Choi and Young, 2008).

In general, the demand for audit quality is due to numerous role the auditing plays for financial statements. In a supervisory role, when decision-making power is handed to a representative, the owner turn to auditing to monitor representative to prevent opportunistic behaviors and information asymmetry and also reducing agency costs. In informational role, the auditor is valuable as a tool to improve the quality of financial information in terms of investment. High quality of audit increases the reporting reliability by reducing intentional and unintentional errors in historical profit (Becker and Defond, 1998). Since the reliability of financial reporting increases with audit quality and audited information are a basis for investors and other users to predict future profits of companies, thus increasing audit quality and consequently, reliability of information (basis for predictions), the investor's ability to predict future profits will be increased.

Concept of audit quality

A common definition of audit quality is presented by De Angelo (1981). He defined audit quality as the assessment and perception of market from the possibility of the auditor's ability to detect important distortions of financial statements or accounting system of the client and the report of discovered significant distortions. The possibility that the auditor discovers significant distortions depends on the auditor's competence and the probability that the auditor reports the discovered significant distortions depends on auditor independence. In this definition, defect discovery measures audit quality in terms of knowledge and ability of the auditor, while its reporting depends on the auditor motivation to disclose. Although the definition by De Angelo for the financial statements auditing is appropriate, but it could also encompass other types of audit (Yeganeand Azinfar, 2010).

Other researchers have defined audit quality. For example, Titman and Truman (1986) defined the audit quality as the rate of audit data accuracy presented to investors. This definition is similar to the definition by Palmros (1988) of audit quality. Davidson and Neu (1993) consider audit quality as auditor's ability to detect and report significant distortions and finding manipulation in net profit. But Lam and Chang (1994) believe that the quality of audit services must be examined separately for each audit project rather than being examined as a whole.

Audit quality and investor's ability to predict future earnings

Financial statements audited by independent auditors are excellent tools to convey the reliable information. Independent auditor is the most qualified person to comment on accuracy of preparation and submission of financial reports of the corporate. Auditor competence is because he performs the audit in accordance with auditing standards to ensure that the items contained in the financial statements have been prepared in accordance with accounting standards. Therefore, the auditor credits the claims prepared by someone else in the form of financial statements and thereby, increases the reliability of information used in the economic decisions (Nik-khah Azad, 2000).

The inability of investors to forecast and mistake in the forecasts suggest a lack of trust in the corporates' informational environment (Imhoff, and Lobo, 1992). Investors' informational environment, or in other words, information that investors use for their projections include a series of common information (information shared and available to all investors) and their private information (information about their mentality and understanding of the economic situation ...) about companies.

Common information used by investors to predict include all available information, including audited financial statements, auditing report and detailed information about companies (Abarbanell, and Bushee, 1997 and Zhang, 2008). There is much evidence that audit quality enhances the quality and reliability of the published information (common information) and investors well understand the reliability of information audited by high quality auditors (De chow et al., 2010). Improving the quality and reliability of common information makes the investors to allocate more weight for common information in their predictions (high quality audited information). Thus, there is a direct relationship between audit quality and amount of common information used by investors to predict. Therefore, the quality of audit by increasing the quality of common information of investors and their reliance on this information, can increase the ability of investors to predict.

On the other hand, private information includes data specific to each of the investors like mindset, outlook and their understanding of the economic situation of the companies, optimism, pessimism and subjectivism. Among the subjectivity factors, prejudice is a psychological concept and prevents people from rational judgment and thereby reduce their ability to predict. The results of this research show that one way to reduce its impact is guiding and providing useful information to predict future events. When people want to predict the possibility of an event in the future, use Availability Based Decision Strategy (Khoshtinat, 1999). That is, forecast is done based on recalling memories or personal interpretation of the past important events. Therefore, whatever the contents are presented with more reliability or with valuable description about an event (as a result of audit quality), the ability to predict better about the future events will be increased. Therefore, the audit quality improves both data sets used by investors to predict. It is clear that increasing audit quality, and thus increasing the quality of information used by investors, their ability to predict will be increased.

Although predicting future earnings can be justified by the current profitability, but because of deficiencies in profit measurement such as estimates 'subjectivity, future forecasts and issues arising from the accrual accounting, selecting management in determining the accounting methods and timing of transactions, the possibility of differences in actual earnings and reported earnings would be increased, under these conditions, the ability to predict profit is decreased and application of this element (historical profit) in forecast models will face with difficulty.

When the information used by investors is not reliable, investors fail to accurately predict. Janin and Piot(2005) believe that the quality of auditing could be one way to prevent manipulation and earnings management. According to Becker and Defond (1998), high audit quality increases reporting reliability by reducing unintentional and intentional errors in historical profit. So, companies that benefit from high quality audit have profit with higher quality

and reliability. Therefore, audit quality can increase the ability of investors who use historical profits to predict future earnings by increasing the reliability of information related to historical earnings.

Research background

Schipper (1991) showed that investors use historical earnings information to predict the future earnings. The accuracy of their prediction will be increased by increasing the reliability of this information.

Theo and Wang (1993) showed that clients of large audit institution have greater earning response coefficient than clients of other audit institutions.

Lam and Chang (1994) in a study in Singapore showed that the difference between predicted earnings and reported earnings is not independent of audit quality.

Bushee(1997) stated that the difference between forecasts of investors can be explained by historical earnings.

Lundholm and Lang (1998) in their study found that investors' prediction for companies that are audited by the large audit firms, is more correct and accurate.

Walker et al., (2001) obtained evidence that showed the auditor tenure reduces the likelihood of auditor reduces the likelihood of failure and increases the quality of audit.

Lund holm and Myer in their study in 2002 concluded that the high level of disclosure increases investor's ability to predict future profits. In this research, they used ranking of Association for Investment Management and Research (AIMR) in 2000 (based on the disclosure activities) as a criteria to measure the levels of disclosure. They found that there is a positive relationship between the ranking and predictability of future earnings (in profit - return model).

Eams and Glover (2003) in a study concluded that there is a relationship between different levels of profit and error in forecasting earnings and predictability of earnings.

Behn et al.,(2007) examined the relationship between audit quality and earnings forecast. Their study statistical sample included US companies for a five-year period from 1996 to 2001. In this study, audit quality was measured by two independent variables: industrial expertise of auditor and auditor size. They measured auditor industrial expertise based on the ratio of client companies' assets to total assets of companies in a specific and auditor size based on five large audit institutions or otherwise. The results of their study showed that companies that are audited by auditors with higher quality, have more accurate earnings forecast and companies which are audited by auditors from an institutes other than the Big Five institutes, have more profit prediction deviation.

AlaviTabari, et al., (2007) conducted a study on the effect of audit quality on the profit predictability by taking into account the size of audit firm and auditor specialization in industry as the criteria for audit quality. Their results showed that companies which are audited by auditors specialized in the industry, have higher accuracy of forecasting profits and lower earnings forecast deviation. Also, audit firm size is inversely related to the deviation of earnings forecast.

KhaledHosseini (2010), in a study examined the impact of audit quality (based on four major auditing firms or other than that) on the ability to predict earnings for profitable and non-profitable companies. His study showed that investors better predict the future earnings of companies that are audited by four major institutions. Although these findings was not generalizable to non-profitable firms.

Field of study

The time scope means the time period during which the researcher uses data from the companies surveyed during this period in his study. The present study period is the six-year period 2010-2014. The statistical population of the research are companies that are listed on the Stock Exchange. After applying research terms, the statistical sample consisted of 110 companies listed on the Tehran Stock Exchange.

Definition and measurement of variables
Dependent variable

In this study, the effect of audit quality on the investor's ability to predict future profits of companies is investigated. Thus, the dependent variable of the study is the ability of investors to predict future earnings. In this study, future earnings response coefficient was used to measure and evaluate the investor's ability to predict future earnings in profit –return regression model of Collins (1994). (KhaledHosseini, 2010)

Independent variable

In this research, the audit quality is defined as the independent variable. Due to its multi-dimensional and intangible structure, audit quality has no specific method for measurement. In several studies, different criteria are often used to measure the audit quality.

In this study, three criteria have been considered as indicators for audit quality such as size of audit firm, audit firm specialization in the industry and auditor tenure based on Fernando et al., (2008) model.

The size of audit firm is a dummy variable with Audit symbol. If the company is audited by the Audit Office, the number is one and otherwise, it is zero (Yegane and Azinfar, 2010). In this study, market share is used as an indicator to measure audit firm industry expertise. Because it shows the priority of industry to other auditors. The higher the market share of audit firm is, its industry expertise and experience than other competitors will be more. Auditor tenure is the number of consecutive years that an audit firm is responsible for auditing a company (Meyers et al., 2003).

Explicating research model

Profit and return have every strong statistical reciprocal relationship. However, empirical research do not confirm this relationship. Collins knows that the reason for the different between theoretical foundations and empirical results regarding the link between earnings and returns as the lack of earnings timeliness and believes that lack of earnings timeliness is due to lack of timely information reflection in auditing earnings due to accounting conventions. Because of these accounting contracts (objectivity, provability, conservatism), data are reflected with delay and ultimately in future profits. Therefore, part of the relationship between current returns and profits is due to the delay in reflecting this information in the current profits and future hidden profits. Collins et al., tried a lot in this regard. They showed that lack of timeliness of profit is a very important factor and reason for relationship between profit – returns. Therefore, to better evaluate the relationship between earnings and returns, they designed a new model that is known as future earnings response coefficient (FERC) model.

In this study, earnings, future earnings response coefficient is used to measure and evaluate the investor's ability to predict future earnings in Collins profit - returns model. This model has been used by many researchers (Banghoj and Plenborg, 2008, Dhiensiri et al., 2005, Ettredge et al., 2005, Zarowin et al., 2002; Lee et al., 2007). Thus, in this study, the profit - returns model of Collins (1994) was used as follows:

$R_{i,t} = b_0 + b_1 X_{i,t} + b_2 X_{i,t+1} + b_3 EP_{i,t-1} + b_4 AG_{i,t} + u_{i,t}$

In the formula, R_t is common stock return in year t; $X_{i,t}$ ischanges in earnings per share in year t; X_i is changes of earnings per share in year t+1 and $EP_{i,t-1}$ is the ratio of earnings per share to price at the end of the year t-1; $AG_{i,t}$ is asset growth.

To test the hypotheses, after entering the independent variables, i.e. the size of audit firm, specialization of audit firm and auditor tenure, the following model is used (KhaledHosseini, 2010):

In the formula; Audit is the dummy variable of audit firm size; Spec is the dummy variable of auditor industry specialization; Tenure is auditor tenure variable.

In this model, future changes variable coefficient ($X_{i,t+1}$) is as future earnings response coefficient and a criteria to measure the ability of investors and market to forecast profit growth in the future. The significance and positivity of this variable show that investors can predict earnings future changes through stock returns (KhaledHosseini, 2010).

$R_{i,t} = b_0 + b_1 X_{i,t} + b_2 X_{i,t+1} + b_3 EP_{i,t-1} + b_4 AG_{i,t} + b_5 \text{Audit} + b_6 \text{Audit} * X_{i,t} + b_7 \text{Audit} * X_{i,t+1} + b_8 \text{Audit} * EP_{i,t-1} + b_9 \text{Audit} * AG_{i,t} + b_{10} \text{Spec} + b_{11} \text{Spec} * X_{i,t} + b_{12} \text{Spec} * X_{i,t+1} + b_{13} \text{Spec} * EP_{i,t-1} + b_{14} \text{Spec} * AG_{i,t} + b_{15} \text{Tenure} + b_{16} \text{Tenure} * X_{i,t} + b_{17} \text{Tenure} * X_{i,t+1} + b_{18} \text{Tenure} * EP_{i,t-1} + b_{19} \text{Tenure} * AG_{i,t} + u_{i,t}$

Descriptive Statistics

To better understand the research community and better familiarity with its explanatory variables, econometric index is used. Evaluation of these indicators is the first step to identify the pattern ruling the behavior of the dependent variable and explaining the relationships between variables used in research.

Results of descriptive statistics of the variables used in this study are in the following table:

		Descriptive Statistics Table1			
Min	Max	Std.deviation	Median	Mean	
−1/54	6/01	0/67	0/30	0/11	Annual return
−1/19	2/68	0/18	−0/01	−0/05	Gain variations
−1/98	1/56	0/21	0/14	0/17	Gain to price
−0/78	2/07	0/27	0/16	0/23	Growth assets

Source: results

Descriptive statistics analysis related to variables include mean, median, standard deviation, maximum and minimum. Examining the quantitative results of descriptive statistics of variables shows that the mean and standard deviation of the dependent variable for the annual stock return are0.11 and 0.67, respectively. Mean of assets growth variable and changes in profit is0.23 and -0.05, respectively showing that the sample firms on average have a positive growth in their assets and negative changes in profit. The mean and median for the variable of earnings-price ratio

is0.17 and 0.14, respectively and 0.23 and 0.16 for asset growth variable. Closeness of the mean and median of variables other than the return on equity show that these variables are well distributed.

Assessing the reliability of variables

Before estimating model parameters, the reliability of variables was examined using Levin, Lin - Chu test. The quantitative results of the reliability test of variables are shown in Table 2.

sig	Levin, Lin - Chu test	variables
0/00	−73/41	Annual return
0/00	−49/87	Gain variations
0/00	−23/31	Gain to price
0/00	−66/24	Growth assets

Source: results

The reliability of variables means that the mean and variance of variables was constant over time and covariance of the variables between different years. As a result, the use of these variables in the model don't result in false regression. As can be seen, 95 percent of research variables were reliable, as a result, its parameters can be estimated without the worry of their being false.

Evaluation of quantitative results of research model

Since the method used in this study is multivariate regression using panel data, so certain tests are used in this method. First Chow test is used. This test determines the use of pooled model or fixed effect model. If statistics of Chow test is significant at the error level 5 percent; the null hypothesis (pooled model) will be rejected and fixed effects model will be accepted. Chow test results are given in Table (3):

Chow test result-table3		
probability	F	
0/11	3/71	Chow test

Source: results

As seen in Table 3, F-statistic is not significant at 95% confidence level, therefore, the Chow test confirms pooled data model.

Table (4) shows the results of the research model estimation where the size of audit firm, audit firm industry specialization and auditor tenure have been considered as standards for audit quality.

Based on model estimation results, it can be concluded that the model is significant, because the value of the possible error level related to F-statistic is zero which is less than 5%. As a result, even at 99% confidence level, the significance of model is accepted. For this model, Durbin - Watson statistics is 1.98, that at 5% error level, self-correlation of the error term is rejected. The value of modified coefficient of determination is 0.36. The statistics show that about 36 percent of changes in dependent variable can be described by the independent variables. According to the fact that the model statistics are not rejected, the research hypotheses are studied.

	Coefficient		variable
sig			
0/00	/41.	b_1	$X_{i,t}$
0/14	0/31	b_2	$X_{i,t+1}$
0/00	1/21	b_3	$EP_{i,t-1}$
0/00	0/76	b_4	$AG_{i,t}$
0/32	–0/11	b_5	Audit
0/00	–0/71	b_6	Audit * X_i,
0/72	–0/36	b_7	Audit * $X_{i,t+1}$
0/54	–0/25	b_8	Audit * $EP_{i,t-1}$
0/11	–0/12	b_9	Audit * $AG_{i,t}$
0/12	0/26	b_{10}	Spec
0/00	0/25	b_{11}	Spec *$X_{i,t}$
0/13	0/16	b_{12}	Spec * $X_{i,t+1}$
0/15	–0/67	b_{13}	Spec* $EP_{i,t-1}$
0/02	–0/43	b_{14}	Spec * $AG_{i,t}$
0/09	–0/05	b_{15}	Tenure
0/05	0/09	b_{16}	Tenure*$X_{i,t}$
0/01	0/07	b_{17}	Tenure* $X_{i,t+1}$
0/02	0/13	b_{18}	Tenure* $EP_{i,t-1}$
0/04	0/11	b_{19}	Tenure * $AG_{i,t}$
26/18	*F*	0/36	R^2
0/00	probabilityF	1/98	Watson dorbin

Results of testing research hypotheses

According to the estimation results of research model presented in Table 4, the coefficient of variable of earnings variation of next year (b2) is positive and equal to 0.28, however, it is not significant at 95 percent confidence level. This shows that for companies that are not audited by high quality auditors, investors cannot predict earnings variations through the current return on equity. To assess the impact of audit quality on the ability of investors to predict earnings, this coefficient is compared with the coefficients of this variable after the impact of the audit quality indicators i.e. 7b, b12 and b17.

Results of testing first hypothesis

In the first hypothesis, effect of audit firm size on the ability of investors to predict future earnings is studied. For this purpose, the independent variable of audit firm size is multiplied with future earnings changes. Then, to test this hypothesis, the relationship between new variable (Audit * $X_{i,t+1}$) and the current stock returns is investigated. The results show that coefficient of the variables in the model (b7) is negative and equal to -0.36 that is not significant at 95% confidence level. These results suggest that the current stock returns for companies that are audited by audit firms compared to other audit firms, don't reflect more information about future earnings. As a result, auditing by large audit institutions has no effect on the ability of investors to predict future earnings. Therefore, the first hypothesis is rejected.

Results of testing second hypothesis

In the second hypothesis, the effect of audit firm specialization on the ability of investors to predict profits is examined. The results of the research test show that the coefficient of b12 is positive but not significant at 95% confidence level. These results indicate that an increase in audit firm specialization has no significant impact on the ability of investors to predict future earnings.

Results of testing third hypothesis

To test the third hypothesis, i.e. the effect of auditor tenure on the ability of investors to predict future earnings; b17 factor is investigated. According to quantitative results of model estimation, b17 factor is positive and equal to0.07which is significant at 95% confidence level. Based on these results, we can conclude that auditor tenure increases the ability of investors to predict future earnings. So the third hypothesis is confirmed.

Conclusions

In this study, with applying limitations in sample selection, finally, data of 110 companies listed on Tehran Stock Exchange during the period 2010-2014 was used to test hypotheses. Chow test results, to determine the appropriate method of estimating the regression model, confirmed using pooled data method. The results at 95% confidence level indicate the rejection of the first, second and third hypo theses. The auditor tenure, contrary to the size and expertise of the audit firm, increases the investors' ability to predict future earnings.

It can be expected that the size of auditing firm increases the ability of investors to make predictions through a direct relationship with audit quality. But the results didn't confirm such a relationship. In this study, the audit firm is considered as a major audit firm. Audit firm state support has led most large companies operating in different industries, which have state structures, to be audited by the organization. This increases the size of the client of audit firm. Increased number of audit firm clients, because it is state-owned, although caused to consider this firm as a large auditing firm, however, it does not necessarily increase the quality of services provided by these firms. So, it seems that the mismatch of first hypothesis test result with theoretical foundations, on the one hand is due to improper selection of the audit firms as a large audit institution, on the other hand in the eyes of investors, audit firm may not be considered as an audit institution providing high quality audit services.

The results of the second test hypotheses are not consistent with theoretical principles. Auditors specialized in the industry are expected to provide audits with higher quality tannin-experts. Audit firms' specialization in industry, with an understanding of the complexity and specific issues of an industry, play a more obvious informational and surveillance role than other audit firms in the particular industry and can provide reliable information to investors. This reduces the risk of market information, and thereby, it increases the ability of investors to predict. As we have seen, the results of this hypothesis is contrary to theoretical principles and previous research. One of the main reasons is that a large part of the audit profession in Iran is state-owned and also the weakness of the body of audit firms in the private sector, which makes audit personnel training and gaining expertise or creating specialized teams in these institutions not to be economically justified. Auditing of most companies operating in various industries by the National Audit Office, on the one hand, prevents an increase in audit firm specialization in one or more specific industries; on the other hand, it avoid other audit firms from being specialized (due to low volume of clients).

When auditor of a company is constantly changing, due to the creation of the impression that the manager replaces the auditor to reach his desired report, investors' confidence in the company financial statements would be reduced. For this reason, in an analysis and forecast, the financial statements will be less used. Since auditor tenure causes auditor's understanding of the client environment, it highlights the auditor monitoring and informational role and reduces information risk. Providing high quality information to investors through the auditor tenure increases the ability of investors to predict, and finally make right decisions, due to the use of this information. Test results of the third hypothesis confirms this issue.

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