

**Department of Accounting
College of Commerce
National Chengchi University**

**Ph.D. Qualifying Exam- Auditing
March 18, 2005**

PART 1

1-1: (19%)

Audit quality is an important element of corporate governance – although it's unclear whether audit quality and other aspects of corporate governance (e.g. director knowledge and independence) are fundamentally *complements* or *substitutes*. The notion that audit quality (defined as the probability that financial statements are fairly stated when an unqualified opinion is given) varies systematically across classes of audit firms (now Big 4 vs. non-Big 4) has been a very productive research hypothesis since early 1980's.

- (1) What is the *product differentiation hypothesis*? What is the association between this hypothesis and audit quality? Please cite prior studies (empirical, analytical, and experimental) to justify your answers. **(3 points)**
- (2) Based on what you have learned from your Ph.D. seminar courses in Auditing and Financial Accounting, is there any “theory” underlying the *product differentiation hypothesis*? What are the potential problems of this hypothesis? **(3 points)**
- (3) Much of the previous empirical evidence has shown that audit quality of the Big 4(6)(8) firms is significantly higher than that of the non-Big 4(6)(8) firms. Please discuss this finding in the areas of: ① audit pricing, ② auditors' legal liabilities, ③ market reactions to audit reports, and ④ earnings management. **(8 points)**
- (4) Given the voluminous amount of studies you have discussed in (3) above, it seems that issues related to audit quality has been well addressed and documented. Why, however, many auditing researchers are now beginning to revisit audit quality as an important topic? **(5 points)**

1-2: (19%)

Independence requires the auditor to act with integrity and objectivity both in mental attitude and in appearance. In operational term, independence ensures that those who perform an audit engagement should be mentally objective when collecting, investigating, and reporting on information. The Public Oversight Board's *Panel on Audit Effectiveness* emphasizes that independence is "fundamental to the reliability of auditor's reports." Because auditor independence not only increases the likelihood that firms' financial statements are in conformity with the generally accepted accounting principles (GAAP), but also encourage investors to rely more on the financial statements, auditor independence has long been regarded as a cornerstone to the public accounting profession. However, since many recent audit failures have been attributed to a lack of independence (e.g., Arthur Andersen vs. Enron), a call to restore public trust through improving auditors' independence has been emphasized by regulators, practitioners, and auditing academic.

- (1) How do auditing researchers measure auditor independence empirically? **(2 points)** What are the potential problems associated with these measurements? **(2 points)** Please cite prior studies to justify your answers.
- (2) What are the possible mechanisms that may be used to enhance auditor independence? Please discuss prior studies that have examined these mechanisms. What are their key conclusions? What are the potential research design problems in these studies? Please organize your answers using your own categorization scheme. A simple duplicate of the lecture notes is not acceptable! **(8 points)**
- (3) What is the key argument between lowballing and auditor independence? **(2 points)** What are the major findings of prior studies that have addressed the relation between lowballing and auditor independence? **(5 points)**

1-3: (12%)

Section 301 of the Sarbanes-Oxley Act of 2002 rules that all public companies establish effective *audit committees*. Among the most important requirements, (a) each committee member shall be a member of the board of directors of the company and shall otherwise be independent (defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the company, and as not being an affiliated person of the company, or any subsidiary thereof), (b) the committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company, (c) the committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the company regarding accounting, internal controls, and auditing, (d) the committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

Find an issue related to the audit committee and write a research proposal. Please note that your research proposal should *at least* include the following: (1) main research motivation and purposes, (2) possible literature review, if any, (3) methodology to be used, (4) research design (include data source and statistical method, if necessary), and (5) possible contribution(s).