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FINANCIAL AUDITING IN THE BANKING INDUSTRY – AN EMPIRICAL STUDY

Abstract. *Public confidence in banks is critical to the survival and growth of the banking sector. The audit of banks' financial statements contributes to building this confidence and is thus of great importance. However, most auditing literature excludes financial institutions from samples because unlike other industries, the financial sector has its own and different financial reporting regulations and frameworks. Our paper aims at filling in this literature gap by offering an overview of various characteristics of auditing the banking sector. The data is extracted from the database "Audit Analytics" and spans over the period 2000 - 2021. The various samples analyzed in the present paper comprise bank holding companies around the world that are listed on markets such as NASDAQ, NYSE or OTC. Our objective was to depict the status-quo of several delicate issues in the relationship of banks with their auditors, namely: going concern issues disclosed in the audit report, late filing of financial statements, restatements and auditor change due to resignation or dismissal.*

Keywords*: audit, banks, investor confidence .*

JEL Classification: C02, C11, C45, C46, C63

DOI: 10.24818/18423264/56.4.22.16

1. Introduction

Good governance of the banking sector has a positive impact on society, the economy and, in general, on a wide range of stakeholders. Unlike other industries, the financial sector has its own financial reporting regulations and frameworks. Public confidence in banks is critical to the survival and growth of the banking sector. This confidence depends on the bank's financial position, performance and cash flow. In this context, the audit of banks' financial statements is of great importance. An external audit of high quality is required not only by potential shareholders, but also by the public and regulators. Auditors adhere to applicable auditing and ethical standards such as independence, integrity, objectivity, due care, and confidentiality in conjunction with appropriate planning and oversight. External audits are a control mechanism to protect shareholders from agency risks and thus reduce agency costs. Therefore, the role of the external auditor in the banking sector is undoubtedly of great importance. Auditors are expected to show more scrutiny when auditing the financial statements of banks, as this kind of entities is considered part of the market equity.

Despite the economic importance of the banking sector, there is little effort by researchers to investigate the various relationships that exist between banks and their external auditors. Previous studies that examined audit markets in different regions around the world focused on non-financial firms (Ruiz-Bardadillo et al., 2004; Spathis, 2003). In general, most empirical studies exclude banks from the sample due to their very specific legislative environment and due to their operational characteristics.

Our paper contributes to filling in this literature gap by offering an overview of various characteristics of auditing the banking sector. The data is extracted from the database "Audit Analytics" and spans over the period 2000 - 2021. The various samples analyzed in the present paper comprise bank holding companies around the world that are listed on markets such as NASDAQ, NYSE or OTC. Our objective was to depict the status-quo of several delicate issues in the relationship of banks with their auditors, namely: going concern issues disclosed in the audit report, late filing of financial statements, restatements and auditor change due to resignation or dismissal. The present paper is structured as follows. First, a review of the most relevant research is present. Second, the research methodology is briefly explained. The next subsection describes the results, while the conclusions summarize and comment the findings.

2. Literature Review

The International Federation of Accountants points out several issues that are specific for the external auditing of banks' financial statements and arise because of: the particular nature of the risks associated with the transactions undertaken by banks; the scale of banking operations and the resultant significant exposures which may arise with short periods of time; the extensive dependence on computerized system to process transactions; the effect of the regulations in the various jurisdictions in which they operate; and the continuing development of new products and banking practices that may not be matched by the concurrent development of accounting principles and auditing practices.

Prior literature on external auditing in the banking sector focuses mainly on the US market and examines the following topics: the pricing of audit services for financial institutions (Stein et al., 1994); the audit opinions on publicly-traded savings and loans institutions that subsequently failed (Blacconiere and DeFond, 1997); the effectiveness of bank audit (Siddiqui and Podder, 2002); the loss underreporting and the auditor role of examination of banks (Gunther and Moore, 2003; Fernandez and Gonzalez, 2005); and the impact of accounting and auditing systems on risk-shifting of safety nets in banking.

Our paper focuses on several delicate issues related to financial audits. First, we deal with the going concern issues disclosed in the audit reports drafted for the banks in our sample. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. The going concern audit opinion is a modified opinion according to which, from the auditor's perspective, the company has a significant inability or uncertainty to continue to operate in the foreseeable future.

Relevant for the USA environment is the standard SAS 59. The auditor's task is not only to be aware of the doubts that might arise in the course of the audit work but also to evaluate, in each audit, whether the client is a going concern. If after considering mitigating factors and management's plans, the auditor concludes that substantial doubt remains, the audit report should include an explanatory paragraph to reflect this uncertainty. Alternatively, the auditors may choose to issue an adverse opinion.

Similarly, at international level, the relevant standard ISA 570 states that the auditor's responsibilities are "to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern".

Studies show that auditors are reluctant to disclose going concern uncertainties in the audit report (Citron and Taffler, 1992; Ruiz-Barbadillo et al., 2004). Further, the multiple financial scandals from recent years (WorldCom, Enron, Parmalat, Gescartera, etc.) have been intensively debated at an international level, questioning auditors' attitudes when evaluating clients' going concern status

(Vanstraelen, 2002; Venuti, 2004). In this context, regulators have taken measures that remain controversial and attract public attention. The going concern issues are particularly important in the banking sector, since the (in)stability of the financial institutions also contributes to the (in)stability of the entire economy.

Second, we investigate auditor changes in the banking industry. Audit committees formally decide to approve their auditors on an annual basis and a large percent of companies also seek direct shareholder ratification (Cunningham, 2017). Thus, every year, costs and benefits of an auditor change are considered by auditors and clients, and changes are expected to occur when benefits exceed costs for one of the parties. Auditor changes are divided into resignations and dismissals, reflecting decisions by incumbent auditors and clients. In case of resignation, the auditor is the main decision-making party, while in case of a dismissal, is the client that initiates the auditor change (Cairney and Stewart, 2019).

Auditor changes could be triggered by either behavioral or economic factors or a combination of the two. Literature finds inconsistent evidence of the importance of each category of factors within the auditor-change process. Beattie and Fearnley allege that behavioral factors count most when selecting an auditor. However, various authors contradict this belief and state that purely economic factors (e.g. the audit fee) are the more significant drivers of changing the auditor (Beattie and Fearnley, 1995; Woo and Koh, 2001). Another important factor in deciding an auditor change is audit quality be it real or perceived. Audit quality translates into auditor's ability to identify problems and breaches in the accounting system. Empirical studies show that companies employing non-Big 4 audit tend to change their auditor more frequently than those audited by Big 4 companies. Since larger firms have more resources to provide a certain level of service, many researchers consider that they are synonymous with better quality (Woo and Koh, 2001). Another issue leading to auditor changes could be the disagreements over accounting principles. Income-decreasing accounting choices targeted towards minimizing litigation risk by the auditor often characterize the last year with a predecessor auditor, while such discretionary accruals lose importance immediately in the first year of appointment of the new auditor (DeFond and Subramanyam, 1998).

Third, we look into financial statement restatements. These are important because they might undermine investors' confidence in financial reporting and market efficiency (Badertscher and Burks, 2011; BenYoussef and Drira, 2020). Research showed that earnings restatements are followed by organizational legitimacy threats (Arthaud-Day et al., 2006), stock price decline (Palmrose et al., 2004), increased debt cost (Park and Wu, 2009), and increased equity capital cost (Hribar and Jenkins, 2004). Accounting restatements are usually viewed as the auditors failing to do their job. The archival auditing literature uses accounting restatements as proxy for audit quality (DeFond and Zhang, 2014). Prior studies show that restatements increase auditor's legal liability (Kinney et al., 2004) and audit fees (Feldmann et al., 2009). The research of Liu et al. (2009) revealed that shareholders are less inclined to vote in favor of auditor ratification after restatements, which suggest that restatements damage auditor's reputation.

The US Securities and Exchange Commission (SEC) requires domestic, publicly traded companies to file annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. Form 10-K provides a comprehensive overview of the company's business and financial conditions and includes audited financial statements. Form 10-Q includes unaudited financial statements and provides information regarding the company's business and financial conditions for an interim period of the fiscal year.

The Sarbanes–Oxley Act mandates that SEC requires registrants to disclose information to the public rapidly and consistently. Accordingly, SEC shortened the filing deadline and changed the filing categories for Form 10-K and Form 10-Q. The deadlines for Form 10-K and 10-Q are determined by the company's filing status, and this filing status is based on the company's number of shares held by public investors multiplied by the price per share (the so-called float). There are three types of filers: large accelerated filer, accelerated filer and non-accelerated filer. According to the SEC, companies that are not able to file their annual or quarterly reports before the deadline must file a notification of late filings with the SEC using Form 12b-25.

Non-timely 10-Ks and 10-Qs negatively impact the reaction of capital markets and the financial condition of the firms. Late filings could also be conducive of significant drops in stock and bond prices (Bartov and Konchitchki, 2017). Late filings of Form 10-K and Form 10-Q could suggest that the filers have higher potential risks, such as poor internal control processes for financial reporting (Impink et al., 2012).

3. Research Design

The research design is empirical in nature. The analyzed data is provided by Audit Analytics. We have selected only data from the banking industry, irrespective of location or year. Several samples resulted, depending on the criteria of selection. The first sample contains 20 banking institutions for which the audit report contains going concern issues. The second sample includes 274 different listed banking institutions that reported a change in their auditor. The third sample includes 173 companies that are late filers. The fourth sample includes those companies that restated their financial statements as triggered by their auditors. Because the criteria were different, the samples are also different. We were interested to get a picture of these issues in the banking industry (going concern opinions, auditor change, restatements, and late filers). The period covered is 2000 until up to date. The database comprises companies that are listed on Nasdaq Market, on the NYSE, and on OTC markets.

4. Results

Going concern issues

The sample contains twenty (20) banking institutions listed in various markets around the world. Eight (8) companies are listed on the Nasdaq Capital Market, six (6) companies are listed on the Nasdaq Global Market, one company is listed on the NYSE, and the remaining five (5) are listed on OTC markets. Regarding the geographical distribution of the sample, one company is from Argentina, one company is from China, while all the others are located in the United States of America (most of them in the Western United States). The sample includes 3 federally chartered savings institutions, 6 state commercial banks, 8 national commercial banks, one short-term credit institution, one financial services company, and another commercial bank not classified elsewhere.

Although the sample includes twenty (20) banking institutions that report going concern issues in their audit reports, there are 55 observations for the entire period 2000 - 2020, which means that many companies report such going concern issues continuously, several years in a row. For 11 (eleven) out of 20 (twenty) companies, going concern is a one-time event.

The ten most frequent going concern issues mentioned in audit reports of listed entities from the banking industry are enumerated in Table 1. Almost half (47,27%) of the reports mention net/operating loss (including recurring losses); other frequent issues are: regulatory settlements, obligations and contingencies (41.82%), insufficient or limited cash, capital or liquidity concerns (38.18%), regulatory capital - decline or deficiency (32.73%). Most companies have several going concern issues mentioned in their audit reports.

Table 1. Most frequent going concern issues mentioned by the auditors of banking institutions

Going Concern Issue	% of Reports
Net/Operating Loss (including recurring losses)	47.27%
Regulatory settlements, obligations and contingencies	41.82%
Insufficient / limited cash, capital or liquidity concerns	38.18%
Regulatory capital - decline or deficiency	32.73%
Working capital/current ratio deficit/inadequacy	27.27%
Debt covenants/agreements uncertain or not in compliance	23.64%
Assets – inadequate, limited, immaterial or impaired	18.18%
Seeking or needs to combine with existing company	12.73%
Accumulated/retained earnings deficit	12.73%
Notes Payable/Debt Maturity; Balance Due, Past-due, Default	12.73%

Source: Audit Analytics (2022)

From a time perspective, the number of instances where going concerns were mentioned in the audit report of financial statements varies between one (1) and thirteen (13) per year, with peaks in 2020, 2009 and 2015-2016, as shown in figure 1. It must be mentioned that there are instances of multiple audit reports of this kind, for the same year and company.

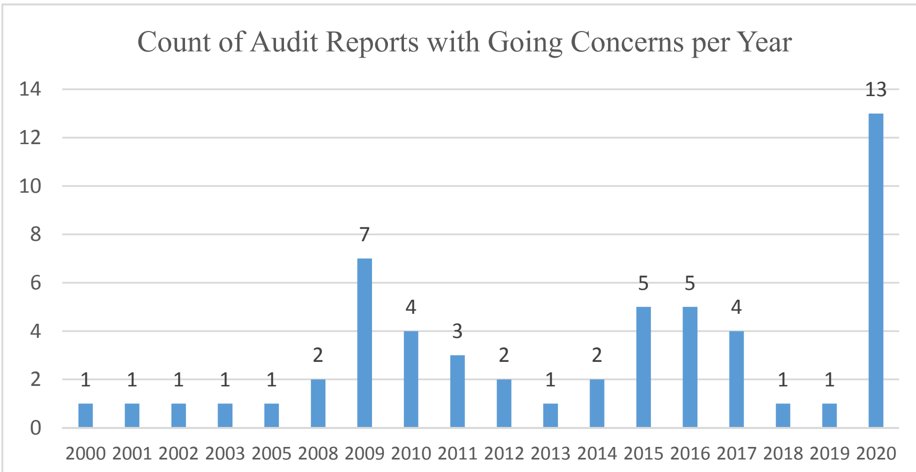

Figure 1. Count of Audit Reports with Going Concerns per Year

Auditor changes

Over the period 2000 – 2021, there were 274 different listed banking institutions that reported a change in their auditor. Fifty-one (51) companies are listed on the Nasdaq Capital Market, one hundred thirty-two (132) companies are listed on the Nasdaq Global Market, fifty-three (57) are on the NYSE, thirty-two (32) are listed on OTC markets, while in case of two the market is not specified.
Regarding the geographical distribution of the sample, four (4) companies are located in Canada, twenty-three (23) are foreign and the rest are headquartered in the United States of America. Foreign locations refer to the following regions: Argentina; Bermuda; Brazil; Colombia; China; Germany; Guam; India; Mexico; Panama; Spain and Switzerland. Regarding their business focus, the sample is structured as follows: two hundred fourteen (214) companies are commercial banks, two (2) institutions belong to the finance services, one is a miscellaneous business credit institution, one belongs to the category "mortgage bankers and loan correspondents", one operates in the real estate, fifty-three (53) are savings institutions, one fits the category "security brokers, dealers, and flotation companies", and one is a short-term business credit institution.

There are four hundred fifteen (415) instances of dismissal, while only eighty-four (84) cases of resignation. There are multiple issues reported in connection to the auditor change, out of which the most frequent are issues related to reportable events (53 cases), internal control (44 cases), accounting (20 cases), lack of independence (11 cases), financial restatement (10 cases), auditor/company disagreement (7 cases), and audit opinion concerns (6 cases) – see Table 2.

Table 2. Issues reported in connection to the auditor change

Auditor changes - reported Issues	Count
Issue - Reportable Event	53
Issue - Internal Control	44
Issue - Accounting	20
Issue - Lack of Independence	11
Issue - Financial Restatement	10
Issue - Other	8
Issue - Auditor / Company Disagreement	7
Issue - Audit Opinion Concerns	6
Issue - Management Not Reliable	1
Issue - Incoming Will Reaudit	1

The disclosure of "reportable events" indicates that the registrant disclosed a reportable condition exists either as referenced to SEC regulations or professional standards (GAAS/GAAP). The mention of "internal control issues" indicates the registrant specifically identifies an internal control issue. This does not mean that a lack of these controls, whether corrected or not, was the cause of the auditor change. Rather, it indicates simply that issues in internal controls were mentioned.

The existence of "accounting issues" indicates issues related to accounting treatments and/or disagreements about accounting principles were disclosed. This instance is flagged even if the company states that they have made the necessary changes for compliance or if they say that there is no longer any disagreement between the registrant and the auditor. In certain situations, the registrant disclosed that there are questions regarding the departing auditor's independence. These issues may include circumstances such as an audit firm losing independence due to an employee having been employed by the registrant. Also such circumstances as the auditor and registrant are in dispute and such dispute impairs the auditor's independence.

Issues related to financial restatements indicate that the registrant reported that a restatement of the financials either occurred or will occur. The instances of auditor/company disagreement indicates that the company and the auditor are or have been in disagreement on a matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure. This was checked even when the filing indicates the disagreement has been resolved. Audit opinion concerns indicate that the registrant disclosed that there are questions regarding the veracity or applicability of previous or upcoming audit opinions. The field covers such areas as companies issuing unauthorized opinions to concerns being raised about the veracity of opinions that have been issued.

Late filers

The sample of late filers comprises 173 companies. Thirty-one companies (31) are listed on the Nasdaq Capital Market, eighty-seven (87) companies are listed on the Nasdaq Global Market, thirty-six (36) companies are listed on the NYSE, eighteen (18) companies are listed on OTC markets and for one company no information is offered. One company is Canadian; four (4) companies are from Argentina, one is from Chile, one from China, one from Colombia, one from Guam, one from South Korea, two are from Spain, two are from Switzerland, while all the rest are located in the United States of America.

About 30% of the companies in the sample have submitted their forms late at least five years in a row and about half of the companies are late filers in at least two periods over the interval 2000 – 2022. The average time to filing is 23 days, with a maximum delay period of 17 months. However, most companies have a time to filling of less than a month.

The most common reasons for late filers are the following, as shown in table 3, are: insufficient time to prepare or review report, meaning that more time is needed to complete the periodic report (45.82% of reports), the registrant states the report cannot be filed without undue to hardship and expense (37.66%) and situations where the auditor was unable to finish review or audit was not complete, which means that the periodic report is late because the audit was not finished as of date of filing the form (10.67%).

Table 3. Common reasons for late filers

Reason for Late Filing	% of Cases
Insufficient time to prepare or review report	45.82%
Insufficient time without undue hardship, expense	37.66%
Auditor unable to finish review or audit not complete	10.67%
Restatement of financials pending	9.41%
Z - Accounts/loans receivable/billing, investments & cash issues	7.32%
Internal Control / Sarbanes Oxley (404 or 302) assessment issues	6.28%
Acquisition, merger, reverse merger, joint venture	5.02%
Waiting on key information - Inability to obtain	4.60%
Auditor (external) retained, changed or resigned	4.18%
Technical problems with Edgar Filing, XBRL conversion Delay	3.56%
Change, newly hired, turnover, reduction or resignation of personnel, management, board, legal staff	3.35%
Act of God (Extreme weather, War, Illness, Even Death, etc)	3.35%

Restatements

We have analyzed those restatements triggered by the financial auditors. First, it may be that companies fail to record audit adjustments, companies fail to gain proper consent, auditors assert an inability to rely on financial records and related audit or auditor initiated issues. Second, it may be that registrants failed to reflect audit adjustments in their financial statements for some period of time. Third, the category of restatements called "audit(or) consent re opinion in financial statements issues" arises when a registrant seemingly includes an auditor's opinion in its financial statement filings with appropriate approval. Such a category could also include problems related to timing, retention and auditor merger or resignation items. Fourth, there are circumstances where an auditor has stated that they do not believe that they can rely on management representations and has indicated that certain of their opinions have to be withdrawn. Lastly, there are issues of the licitness of financial statements that have been filed arising from questions of the independence of or registration with the PCAOB (Public Company Accounting Oversight Board) associated with the company's public accountants.

Among banking institutions, few are those that filed a restatement due to the above-mentioned situations. There are eight (8) such companies, which declared the following issues: audit(or) consent regarding opinion in financial statements issues; audit(or) - defective accounting records; audit or auditor related restatements or non-reliance; audit(or) independence/PCAOB registration issues. All of these companies are located in the United States of America and also failed in applying different accounting rules (as per GAAP/FASB – Generally Accepted Accounting Principles/Financial Accounting Standards Board); table 4 lists the reported accounting rule application failures ordered by their frequency.

Table 4. Accounting rule application failures

Accounting Rule (GAAP/FASB) Application Failures	% of Restatements
Accounts/loans receivable, investments & cash issues	40.9%
Cash flow statement (SFAS 95) classification errors	22.7%
Liabilities, payables, reserves and accrual estimate failures	9.1%
Debt, quasi-debt, warrants & equity (BCF) security issues	9.1%
Tax expense/benefit/deferral/other (FAS 109) issues	9.1%
Revenue recognition issues Foreign, related party, affiliated, or subsidiary issues	4.5%
Lease, SFAS 5, legal, contingency and commitment issues	4.5%
Deferred, stock-based and/or executive comp issues	4.5%
Foreign, related party, affiliated, or subsidiary issues	4.5%

4. Conclusions

Our objective was to depict the status-quo of several delicate issues in the relationship of banks with their auditors, namely: going concern issues disclosed in the audit report, late filing of financial statements, restatements and auditor change due to resignation or dismissal. We found 20 banking institutions that report going concern issues in their audit reports. Most companies report such issues continuously, several years in a row. The most frequent going concern issues are: (a) the existence of net/operating loss (including recurring losses); (b) the regulatory settlements, obligations and contingencies; and (c) decline or deficiency of regulatory capital. Most companies have not just one, but several going concern issues mentioned in their audit reports. Regarding auditor change, over the period 2000 – 2021, there were 274 different listed banking institutions that reported either a dismissal or a resignation of the auditor. Regarding late filers, we have identified 173 companies. The most common reason for delays in filing in the statements is that there was insufficient time to prepare or review report. Restatements triggered by the financial auditors are quite a few, as expected according to prior research. The main contribution of our paper is that it tackles a subject that was more or less neglected in the literature – that of auditing the banking sector. When preparing the data for an empirical study, many researchers chose to exclude financial institutions, due to their highly regulated environment and very specific features. We chose to focus on this specific industry, in the hope of future related research avenues.

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