

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter discusses the environmental factors of PSOs, that includes the nature and types, financial reporting system, laws and regulations, governance, auditing, and the municipalities. Moreover, the chapter discusses the theories that used in the prior studies to in explain the relationship between the audit quality and its factors, and give justification why the public interest theory is used in the study to explain the relationships among the study variables. Additionally, the chapter defines and discusses all the study variables. Accordingly, the study hypotheses and the conceptual framework are developed. Finally, the chapter reviews past empirical studies on audit quality and shows the literature gap and explain the differences between the study and the prior studies.

2.2 Environment of the PSOs

This section discusses the nature and types, accounting basis, laws and regulations, governance of the PSOs, as well as municipalities as the most important type of PSOs.

2.2.1 Nature and Types of PSOs

All federal and state governments, statutory entities, municipalities (cities and towns), joint services councils, public universities and hospitals, and state

corporations are considered PSOs. An entity may also be considered as a PSO if it fulfils one or more of the following criteria: its director is chosen by the general public election or by government officials; it has the authority to establish and carry out a tax levy; it has the power to directly issue debt with federal tax-free interest; or the government could unilaterally dissolve it and take over its assets and liabilities (Ives et al., 2004). Government organizations play a vital role in providing essential services like water, electricity, education, health care, and garbage collection (Edmonds et al., 2020; Boex 2010). PSOs' objectives are different from those of for-profit businesses. PSOs prioritize the public's needs while for-profit businesses concentrate on maximizing profits for their owners or shareholders (Rashman et al., 2009). PSOs prioritize services over cost considerations and financial incentives (Goodwin, 2004), and the operating activities of PSOs are not governed by market conditions. In contrast, business organizations must consider market conditions, in addition to sales, expenses, and net income, when making any decisions (Visser & Van, 2016). In general, PSOs typically operate in accordance with political rules, numerous laws, and regulations, and they strive to accomplish policy goals and objectives (Visser & Van, 2016). But hybrid organizations, like municipal corporations, function at the nexus of private and public sector objectives because they possess both public and private sector characteristics (Grossi & Thomasson, 2015).

When compared to business entities, whose ownership interests are divided into tradeable shares or are owned by individual investors, PSOs have less stringent governance and accountability mechanisms because they lack ownership interests (McGowan et al., 2018). The governance body of the municipality includes the mayor and council members, who are chosen by the public or appointed by a higher authority. Those members frequently lack training in management, accounting, and

finance (Axén et al., 2019). PSOs base their operations on striking a balance between available income and expenditures over a specific time frame. As a result, PSOs' function is to provide citizens with public services as a means of wealth redistribution (Eulner & Waldbauer, 2018). PSOs' importance, size, and budgets increased in most countries, particularly between the 1970s and 1980s (Carrington et al., 2019). Furthermore, PSOs have begun to embrace new public management (NPM) techniques (Lonsdale, 2000).

2.2.2 Financial Reporting System in PSOs

According to agency theory, PSO management is in charge of running a suitable financial reporting system (Dewi et al., 2019). Nur (2015) as cited by Dewi et al. (2019) assert that in the reporting system, management performs the role of an agent by providing information to the principals who are relevant stakeholders in order to show accountability and make the best social, economic, and political decisions. According to the stakeholder theory, parties who have an interest in an entity, have a right to obtain information about that entity's performance that may affect their choices. As a result, interested users must receive financial statements from PSO management (Anggriawan & Yudianto, 2018). For decision-makers, these statements must be pertinent and useful, especially in terms of accountability (Dewi et al., 2019). Accountability calls for real, accurate, believable, trustworthy, and comparable (Eulner & Waldbauer, 2018), understandable, and relevant information (Dewi et al., 2019). International Federation of Accountants (2012) stated that a government can only earn public trust if it issues sufficient and truth information related to its financial transactions (e.g., revenues and expenditure). By doing so, it demonstrates accountability, good governance, and reliability (Dewi et al., 2019).

PSOs worldwide may use either cash basis, modified cash basis, modified accrual basis, or full accrual basis accounting, in contrast to the private sector, who employs accrual accounting only. IFAC's 2018 International Public Sector Financial Accountability Index mentioned that around 25 percent of countries (150 countries jurisdictions globally) prepare their financial reports according the accrual accounting, 45 percent use partial cash basis and accrual accounting, while 30 percent remains to use cash basis (IESBA-IFAC 2018). There are differences in the global accounting standards used by PSOs. Though many PSOs use accrual accounting, many variances remain between them due to the timing, content, and the method of adoption of accrual accounting (Christiaens & Reyniers, 2010; Cohen et al., 2019).

Cohen and Leventis (2013) as citing Taylor and Rosair (2000), defined two types of financial statements in PSOs: balance sheet (financial position) and income statement (performance report). Also, certain regulations require publication of these statements in specific period, and consider them as accountability tools (Cohen & Leventis, 2013). Some countries require additional statements, such as budget comparison report, statement of cash flows, statement of changes in equity, and clarification notes (Brusca et al., 2015; Dewi et al., 2019). The implementation of an accounting information system and issuing of financial reports in specific periods according to the regulations are costly, because many services are needed and necessary to accomplish the job of the accounting information system, such as hiring employees and consultants, installing and running an accounting system, appointing internal and external auditors, implementing control procedures, developing regulatory systems and legal procedures, and using different tools to present the financial reports (Cohen et al., 2013). Accordingly, the financial reports quality in PSOs depends on the nature of the regulations in each country. Therefore, there has

been an increase in demand for relevant and standardized financial statements to enhance the accountability and good governance of PSOs, as well as to improve the process of decision-making and avoid corruption (Rossi et al., 2016).

IFAC established in 1986 the International Public Sector Accounting Standards Board (IPSASB) as Public Sector Committee, which became an independent standard setting board in 2004, this board is supported by IFAC. Until 2015, IPSASB has issued 38 standards for public entities (International Public Sector Accounting Standards- IPSAS). These standards and the IFRS, which are used in the private sector, are similar (Brusca et al., 2015). Since 1996, IPSAS, as a unique setter of high quality standards, has played a crucial role in supporting the important qualities of financial statements, such as transparency, credibility, and comparability, to meet the information needs of stakeholders (Rossi et al., 2016).

The International Monetary Fund (IMF) and the World Bank (WB) have played significant roles in encouraging every country to adopt IPSAS. In fact, they set the adoption of IPSAS as a condition for any financial and nonfinancial supports or loans (Rossi et al., 2016). According to IMF (2015), financial data presented in accordance with IPSAS is trustworthy and comparable, and as a result, it can aid users in understanding it and performing accurate financial analyses. Additionally, it can improve risk management and government accountability. IPSASB-based financial reporting systems must be implemented properly, which necessitates the use of competent, knowledgeable, and experienced personnel (Mir & Sutiyono, 2013). The globalization of markets and increased openness require the public sector around the world to agree and adopt harmonized and standardized accounting activities (Christophe et al., 2015; Mnif Sellami & Gafsi, 2019). Because the accounting information system generates the financial statements that serve as the primary input

for the audit process, a high-quality reporting system will generate high-quality pre-audit statements, which will result in high-quality audit statements (DeFond & Zhang, 2014).

2.2.3 Laws and Regulations Governing PSOs

PSOs generally follow pre-established rules and operating procedures rather than acting arbitrarily. The governance and management bodies are guided in their decision-making by political conventions, administrative unit governance, laws and regulations, an annual financial plan that has been approved, emerging events, lobby groups, and uncertain indicators (Rashman et al., 2009; Visser and Van 2016). Public administration is anticipated to be significantly impacted by a more legalized and politicized environment (Spanou, 2008), auditing (Cohen et al., 2013), and accounting (Ballas & Tsoukas, 2004). Although there may be some variations between countries, laws and regulations govern every aspect of PSOs, especially the financial reporting system and the financial report audit. For example, Nurlis (2018) as cited by Dewi and Yusoff (2019) explained that in Sumatra, Indonesia, Government regulations No. 71/2010 must be followed in the preparation and issuance of financial statements. DeFond and Zhang (2014) claimed that government rules both domestically and internationally are tightening controls on accounting and auditing procedures.

The audit quality could be impacted by the varying rules in each country. Chase (1999) as cited by Yebba and Elder (2019), noted that auditors cannot serve PSOs in several states in the U.S. because to variances in the disclosure note requirements for financial statements. The wide-ranging generally accepted accounting principles (GAAP) between U.S. states require highly experienced and specialized auditors (Yebba & Elder, 2019). The PSOs in each country or state represent a distinct market

for external auditors, because they are governed by dissimilar laws and regulations. Accordingly, the determinants of audit contract and reporting quality also vary (Yebba & Elder, 2019).

2.2.4 Governance of PSOs

The effectiveness of the governance determines how social, economic, and political concerns in society turn out. Fukuyama (2015) argues that the state's capacity to deliver basic services and goods has an impact on the effectiveness of governance (Carrington et al., 2019). IFAC (IFAC Public Sector Committee, 2001) defines governance as activities involving organizational structure, decision-making procedures, monitoring techniques, accountability, and top management ethics and conduct. The Chartered Institute of Public Finance and Accountancy (CIPFA) and IFAC (CIPFA & IFAC, 2014) revealed that the governance function ensures that an entity is operated ethically, efficiently, and effectively, and that it achieves its stated goals and the anticipated outcomes for the general public and the users of the company's services. Procedures, policies, norms, and programs used to direct organizational actions and give reasonable confidence that the entity's objectives are achieved accountably and ethically, hence lowering the danger of corruption, are referred to as PSO governance (Rosa & Morote, 2016).

Good governance assures the application of morals, values, ethical principles, code, norms, and rules within a framework of risk management, which includes well defined accountabilities (Khalid et al., 2016). Omar and Bakri, (2019) claimed that effective rules, support values, accountability, clarity and openness, and building abilities are the five principles that make up successful governance. Financial and analysis reports, particularly performance reports, are necessary for sound governance.

An independent auditor must review these reports to increase their transparency and accountability. One of the mechanisms of good governance in PSOs is the internal audit (Maldonado et al., 2019; Rosa & Morote, 2016). In order to ensure the release of high quality financial statements to interested users, the auditors collaborate with other departments of the company and are thus a crucial component of an entity's monitoring system (Khalid et al., 2016).

2.2.5 Audit of PSOs

PSOs are dedicated to achieving their objectives with economy, effectiveness, and efficiency while making appropriate use of public resources (entity assets). The released audited information ensures the entity's transparency and accountability. As a result, audit is a tool that helps public managers meet their need to account for how they use resources (Brusca et al., 2015).

DeFond and Zhang (2014) claimed that PSO audits offer value. For instance, compulsory audits in public schools increase the effectiveness of resource allocation, and mandated audits in public housing authorities decrease overstatements.

It is crucial that the public has faith in the PSOs' financial reports. The primary contributors to producing trustworthy and credible financial accounts are thought to be auditors (Ismail et al., 2019). Auditing is defined by Alvin et al., (2017) as the procedure of compiling and analyzing data pertaining to certain economic entities in order to ascertain and publish an audit report on the degree of correspondence or compliance between the data and the agreed-upon specific criteria. Also, they mentioned that an impartial qualified individual should conduct the auditing. The notion of audit quality varies between the public and private sectors and is dependent on the audit's goal (Watson, 2019).

Due to the sophisticated government accounting systems used by PSOs, the auditor for these entities must be highly specialized in this sort of audit. Additionally, unique state laws that govern financial reporting in US-PSOs may have an impact on the terms of audit contracts (Salehi et al., 2019; Yebba & Elder, 2019). Depending on a country's rules, PSOs are subject to several forms of audits (Rosa & Morote, 2016), such as financial audit, operational audit, compliance audit, or performance audit which includes mixed audit types. According to Goodwin (2004) performance audit and financial audit are appropriate for the public sector. In a financial audit, the auditor looks at how well the company uses its resources to accomplish its goals. In a performance audit, the auditor looks at how well resources are used and how efficiently they are used in relation to the entity's goals. Three categories of auditors, SAI, internal auditors, and external auditors, may carry out these types of audits. All SAIs perform all forms of audits, although other types of auditors differ between countries according to the norms and regulations of each one (Brusca et al., 2015; Carrington et al., 2019; Gustavson & Sundström, 2018; Johnsen, 2019). The European Union's (EU) Council Directive 2011/85/EU states that independent audits and internal controls must be applied to public accounting systems (internal and external audits). Internal controls encompass the oversight of practices including financial oversight, legal intervention, and typically effectiveness controls (Brusca et al., 2015).

Any entity that receives more than a specific amount of federal financial aid (variable depending on related regulations) must be audited by an external independent auditor in accordance with the requirements of Office Management and Budget (OMB) Circular A-133, according to the Single Audit Act of 1984 in the United States. According to the Circular, the financial reports must be audited, all

requirements for federal programs and grants must be met, and the internal control system must be effective (Yebba & Elder, 2019).

Elder et al. (2015) discovered an indirect correlation between improved audit quality and audit firm rotation policies. PSOs must periodically seek audit bids in accordance with entity-specific laws or regulations in order to keep the current auditor in place or to replace him after a technical assessment. In order to provide focused, transparent, and reliable authoritative reports on government performance, auditors utilize audit reports to ensure accountability and make reference to particular criteria in the form of professional audit standards (Rosa & Morote, 2016). The type of an audit, the users who are interested in the information, and the needs of any applicable standards and regulations all influence the nature of the audit reports (Rosa & Morote, 2016). The form of applied audit varies each country, therefore national and international agencies have developed public audit standards. International standards have occasionally been used as a guide in some EU countries (Brusca et al., 2015). The majority of audit standards for PSOs mandate that the auditors report on the efficacy of internal controls, as well as compliance with laws, regulations, and contractual or grant agreement conditions, in addition to the fairness of the financial statements (Cagle & Pridgen, 2015).

2.2.6 Municipalities

This study focuses on municipalities as LGUs with some independence from superior authorities and governed by distinct accounting standards in most countries. The audit system of municipalities varies across the world and includes all types of audits, such as financial statement, operational, and compliance audit, which are carried out by different types of auditors, such as SAIs, internal auditors, and CPAs as

external auditors. The following sections describe the characteristics of municipalities generally and in Palestine.

2.2.6.1 General Characteristics of Municipalities

Municipalities are the main forms of PSOs in any country, and they have a direct relation with their citizens, providing basic needs and solving their problems (Rua & Alves, 2020). The conventional responsibilities of the municipality as a local government authority include the provision of the following services: keeping the local registry, trash collection, infrastructure protection and expansion (e.g., roads, parks, bridges, tunnels, water supplies, sewers, and electricity networks), and encouraging investment and investing in entertainment activities. In addition to these services, the municipality may provide other services such as education, transportation, and health services (Cohen et al., 2013). The services of municipalities are always financed by their own revenues, which mainly come from taxes, services fees, and government contributions (Cohen et al., 2013).

The top management (governance body) of a municipality includes the mayor, municipal council, and council committees, particularly the financial committee, whose members are the mayor, some members of the municipal council (Cohen et al., 2013), and the financial manager. In most countries, the mayor and members of the municipal council are elected by the citizens of the municipality every four years (Cohen et al., 2013). In the U.S., there are two structures of municipal governance body. The first one includes the mayor and council, while in the second type includes the municipal council and municipality manager. There has been a trend to shift towards the second type to ensure more stability and informative disclosure notes on the financial statements (Giroux & McLelland, 2003).

The literature indicates that some countries have adopted accrual accounting based on IPSAS for the public (municipal) accounting system, while others still use the cash basis. Nonetheless, cash basis accounting has become less common because accrual accounting provides more transparency and enables the measurement of the efficiency and effectiveness of the municipality management (Christiaens & Reyniers, 2010). Sometimes the municipalities of a country may use different accounting bases, such as in Austria (Cohen et al., 2019). In general, the application of any accounting system is governed by the requirements of laws and regulations. For example, most European countries use accrual accounting, and the measurement of performance system is legally required (Cohen et al., 2019).

2.2.6.2 Municipalities in Palestine

Palestine is a small country in terms of population and geographic size, but it has around 519 LGUs in the form of municipalities, local village councils, and local committees (Sabri & Jaber, 2010). These units vary in terms of population, area size, and government subsidies. Based on these characteristics, they are classified into four categories: class A (central of district, and A+ central of area includes many districts), class B, class C, and class D (Sabri & Jaber, 2010). All LGUs are governed by Local Authorities Act No. 1 of 1997, which stipulates 27 areas of responsibilities of LGUs: town planning; building licensing and construction control; water supply; electricity supply; sewage; licensing of trades and businesses; public health monitoring; collection and disposal of solid waste; public parks; cultural and sport activities; public transport; disposal of remnants of roads; social services for the poor; cemeteries; precautions against natural disasters; budget approval and management; control of dogs; demolishing dangerous buildings, monitoring of hotels; controlling

the movements and sales of animals; advertising and announcement policies; monitoring of scales; sales of unused roads; prevention of begging and helping poor families; managing the assets of the local unit; and other duties consistent with the laws and regulations, such as providing emergency services and constructing and maintaining schools.

Palestine, like any Arab country, is working to improve its government financial reporting system so that it can issue more informative and transparent reports. Such reports fulfil the public's need for information about where the municipality funds are invested and expended, and how the revenues from tax and non-tax resources are distributed and used (Abushamsieh et al., 2013).

Most government organizations use cash basis accounting, but the municipalities are encouraged by the MOLG or donors to switch to modified or full accrual basis. Sabri (2010) pointed out that most local governments in Palestine use cash basis accounting. Numerous efforts have been made since 2004 to encourage PSOs to transition to modern accrual accounting, but they have not been successful. More than 85 percent of municipalities are still using cash basis accounting (Sabri & Jaber, 2010), according to Albuhaici (2013) 100 percent of municipalities in the Gaza Strip used cash basis accounting, but the MOLG Annual Performance Report for 2020 revealed that 30 municipalities of 130 in the West Bank use the accrual basis, this means that the accrual basis is used by 23% of these municipalities (MOLG, 2020), but most Joint Services Councils (JSCs) and all NGOs are using accrual accounting.

All government organizations, municipalities, village councils, and JSCs must provide annual budget using cash basis as required by the Local Authorities Act No. 1 of 1997. The budget statement is prepared based on a standardized format regulated by the MOLG, and includes five sections: operational and capital budget, budget of

profit centers, performance indicators, summary of capital projects, details of budget structure, and credit and debit statements (Sabri 2010). According to the annual budgetary announcement for 2021, the MOLG requires all LGUs to use the Budget Gate Site for preparing and reporting budget. The budget preparers may use accrual basis or cash basis, but in all cases the budgeted cash flows must be prepared according unified accounts of chart. The announcement also recommends the LGUs to audit their financial statements using external auditors (MOLG, 2021). In addition, most municipalities use accounting policies and procedures that are approved by the MOLG. They use computerized accounting software, but a few of them still use the manual accounting system (Sabri, 2010).

2.3 Relevant Theories

The theories can be applied at all stages of the study, including the justification for the study; research objectives and questions; methodology; instrument development; and data analysis and interpretation (Stewart & Klein, 2016). Cooper and Schinlder (1998) as cited by Boakai and Phon (2020) defined the theory as a collection of conceptualizations, definitions, and claims that are suggested to explain and forecast occurrences. Because there is a wealth of literature on audit quality and theories to explain its determinants in the private sector, it is worthwhile to apply some of these theories, in addition to other auditing theories, in the public sector (Hay & Cordery, 2018). Audit quality is not the explicit subject of public sector audit studies (Dwyer & Wilson, 1989). Rubin (1988) demonstrated that findings from private sector research can be used to the public sector entities. Deis and Giroux (1992) confirmed that the theoretical framework built in their study is primarily focused on private sector studies and were empirically tested to assess the merits of

generalizing various findings on the quality of private sector audits to the public sector. In addition, Kurtenbach and Roberts (1994) confirmed that public sector accounting research is largely grounded on the theories of the private sector, for instance applying principal-agent analysis to public sector accounting, auditing, and performance assessment review. Likewise, accounting researchers are investigating control and accountability problems from an economic perspective.

Some studies found the different effects of certain theories on public and private sectors. For example, the effect of the governance theory on the public sector is unlike its effect on the private sector (Jacobs, 2012).

Researchers use different theories linked to audit quality to explain the influence of different factors on audit quality, either in the private or public sector entities. For example Ismail et al. (2019) used the theory of inspired confidence to examine the relationship between auditor competence, auditor independence, and auditor workload in the context of auditing in Malaysian public sector (in Malaysia, public audit is carried out by the SAI, the National Audit Department (NAD)). This theory suggests that auditor competence and independence are related to the ability of the auditor to find errors and fraud in the client's accounting system (Ismail et al., 2019). But sometimes a single theory cannot explain all issues related to the variables of the study. Therefore, researchers may use more than one theory in their theoretical framework. For example, Mnif and Gafsi (2019) used institutional theory and the theory of economic regulation as the underlying theories of their research. Boakai and Phon (2020) used agency theory and stakeholder theory, while Jacobs (2012) confirmed that the most widely used theories are neo-institutional theory and agency theory. Jacobs, (2012) mentioned many theories are used by researchers to explain the audit qualities as the following: the institutional theory, auditing theory, emergency

theory, economic theory, agency theory, signaling theory, insurance theory, management control theory, governance theory, and confirmation theory. The current study indicated that the public interest theory can explain the majority of relationships between the study's variables as main theory.

The public interest theory, which serves as the study's leading theory, is described in the subsections that follow, along with other theories of stakeholder theory and agency theory that serve as supporting theories.

2.3.1 Public Interest Theory

Public interest theory was developed from conventional conceptions of representative democracy and the role of government to enact regulations (Christensen, 2010). Government regulations, according to this theory, are the instruments to resolve the drawbacks of imperfect competition, unbalanced economic activities, missed markets, and unwanted market outcomes (Den Hertog, 1999). In general terms, the public interest theory states that legislation aims to protect and support the public at large (Hantke-Domas, 2003). There are two acceptable concepts of the public interest theory. The first concept states that legislation seeks the security and advantage of the public. The second concept proposes that when market fails, economic regulation should be imposed to maximize social welfare (Hantke-Domas, 2003). Accounting regulations are an effective approach for countries to improve their GAAP to address market vulnerabilities and low financial reporting performance (Kaya & Koch 2015). The regulations also increase social welfare, which is the main priority of each government (Posner, 1974). According to Joskow and Noll (1981) as cited by Den Hertog (1999), the public interest theory is generally used to describe

regulations as a mean to achieve economic efficiency. Therefore, some researchers consider the public interest theory as part of the theory of economic welfare (Den Hertog, 1999; Hantke-Domas, 2003; Mnif & Gafsi, 2019). There are also other theories related to the public interest theory, such as interest group theory and capture theory. Both theories state that regulation is a mechanism by which the state intervenes to respond to the demands of particular groups, and the lobbying efforts and political pressures exerted by these groups are significant motivations for government regulation. For instance, accounting rules could be the result of international financial institutions pressuring states to adopt international accounting standards as a prerequisite for receiving loans and aid from other countries (Mnif & Gafsi, 2019).

According to the theory, as discussed above, the government imposes regulations to realize public interest. This explains the regulations that require municipalities to provide reliable information for the use of all their stakeholders. For example, the EU's Council Directive 2011/85/EU claims that independent audits and internal controls are applied to public accounting systems (Brusca et al., 2015). The MOLG requires all class A and B municipalities through yearly budgetary announcement to hire a CPA firm to audit their financial statements. The CPA firm must be registered with the Palestinian Association of Certified Public Accountants (PACPA). The MOLG also encourages all municipalities to audit their financial statements annually to receive extra government contributions (Rustom, 2018). To aid the municipalities in selecting a competent auditor, the MOLG has issued guidelines document in 2016 on how to select an independent and competent external auditor with reasonable audit fees through tendering process. In addition to this guidelines document, which is directly related to the audit process, there are many laws and

regulations related to internal controls. The MOLG has issued numerous regulations that cover all aspects of operating activities of LGUs, for example, local government financial regulation no. 1 of 1998, which has been superseded by regulation no. 11 of 2019, budgetary procedures, accounting information system manuals, regulations for payroll and human resources procedures, organizational structures for all levels of LGUs, procurement instructions, taxes regulations, and other regulations and instructions. These regulations are important to ensure effective internal control including the external and internal audit.

According to the aforementioned explanation, the public interest theory may account for the majority of correlations between the study's variables. Government action seeks to benefit all parties, including residents, through laws and regulations that allow local government units to accomplish their objectives of providing services to the community in an effective and efficient manner without corruption. These laws and regulations also demand local government units (LGUs) to exhibit openness and accountability by disseminating accurate information for all interested parties. Reliable and credible information can be produced when LGUs adhere to regulations on how to select suitable audit firms that possess all audit quality attributes specified in those regulations, such as auditor ethics, independence, competence, audit fees, and audit firm size. Therefore, Vu and Hung, (2023) confirmed that the literature on audit quality in the public sector points out the relevance of elements defined in each country's present legislative framework. The government also imposes many regulations and instructions to strengthen the internal controls of the LGUs, such as conducting internal auditing, reforming the accounting information system (accounting basis), and updating, interpreting and monitoring the implementation of all laws and regulations applicable to LGUs through GDCG (MOLG - Department)

and FACB (SAI in Palestine). All these actions may influence the audit quality of government units, particularly the municipalities.

This study relies heavily on the public interest theory and other related theories. But to form a comprehensive theoretical framework and support the conceptual framework, the study includes other theories, such as stakeholder theory and agency theory.

2.3.2 Stakeholder Theory

The stakeholders group is defined as any group that has the potential to have an impact on or is impacted by the achievement of the organization's goals (Alvarez & Sachs, 2023). But there is no single framework for the concept of stakeholders common to all organizations, and it is necessary to first understand the sector in which the organization operates, its products, and its ultimate consumers (Matuleviciene & Stravinskiene, 2015).

According to the stakeholder theory, organizations have to identify the interests of all stakeholders (Yamamoto & Kim, 2019). According to Abi et al., (2018) the stakeholder theory states that all stakeholders have the right to obtain information about the performance of the organization that can affect their decision-making. In municipalities, the main stakeholders are the (1) governance body (municipal council), (2) the management and staff, particularly the financial department staff, (3) government regulators, such as the MOLG in Palestine, (4) SAIs, (5) donors, (6) citizens who receive the municipalities' services and pay fees and taxes, and (7) other parties such as creditors and suppliers of goods and services. Every stakeholder has a vested interest in high audit quality, so audit quality assessment is critical. For example, the management, particularly the financial managers, are interested in high

audit quality because it is required by law, to maintain the entity's accountability and transparency towards the citizens and monitoring parties, and to avoid any litigations.

Based on the preceding discussion, the stakeholder theory explains the importance of audit quality of municipalities in its provisions of reliable and credible financial statements for all users. This theory justifies gathering the perspectives of accountants and internal auditors on the effect of audit quality attributes on audit quality, as they are interested in demonstrating accountability and transparency towards citizens and government regulators.

2.3.3 Agency Theory

Jensen and William (1976) defined an agency relationship as a contract wherein one or more people (the principal) hire someone else (the agent) to carry out some tasks on their behalf and give the agent some decision-making authority. They added that the agency relationship exists in all types of organizations, such as universities, cooperatives, bureaus, government authorities, unions, mutual companies, and in all cooperative efforts at every level of management in the firms. The conflict between principals and agents can happen because the latter tends to prioritize their personal interests over the interests of principals. In addition, there is information discrepancy between principals and agents (Chui et al., 2020). According to the agency theory, auditing is one of the main governance mechanisms to minimize conflicts of interests and decrease agency costs. Audit quality is also likely to reduce information asymmetry (Piot, 2010).

The public sector can benefit from agency theory (Dewi et al., 2019; Greenwood & Zhan, 2019; Jensen and William, 1976; Kurtenbach & Roberts, 1994; Zimmerman, 1977). The agency problem exists in LGUs (municipalities) because of the divergent

interests of the electorate (principals) and the elected politicians (agents). The agent may evade, abuse his privilege, or engage in illegal acts. These actions may directly affect the voters' welfare through the agents' power to levy taxes and to decide the combination and quality of services provided by the LGUs to the principals. They may also indirectly affect the voters' welfare through changes that can influence property values. As result, the principals' welfare is linked to the performance of the agents (Kurtenbach & Roberts, 1994). The agency relationships are more complex in the public sector entities than they are in the private sector entities because there are several levels of principal-agency relationships. Politicians are principals, and bureaucrats (managers) are their agents. Bureaucrats are principals, and their agents are those who really provide services to citizens. Citizens are the principals, and politicians are their agents (Hay & Cordery, 2018). In all levels of agency in PSOs, the agents must provide useful reports about their performance to their principals. Financial reporting in PSOs can thus be explained with the agency theory (Dewi et al., 2019). The manager of the government unit assumes the role of an agent who is responsible for giving readers of government financial statements valuable information. Those users act as principals who evaluate the accountability and transparency of the management (Mustapha & Ahmad, 2011).

Agency theory is a typical theoretical framework for examining accountability and efficacy in LGUs. The public sector's accountability system, however, might be better understood as an institutional, complex, multi-principal, multi-agent system as opposed to a straightforward principal-agent connection (Makris, 2006).

The demand for higher audit quality depends on the incentives of voters to monitor agents of PSOs. If the voters have little incentive to monitor the elected officials, they have little demand for audited full accrual financial statements. Such

financial statements are more useful monitoring tools than modified accrual or cash basis statements because they include additional information about the cost of the firm's operations (Zimmerman, 1977).

Based on the preceding discussion, agency theory can support this study's conceptual framework by explaining the needs of different levels of principals of the municipalities for high audit quality. A high-quality audit can provide principals with reliable information and mitigate agency problems.

2.4 Audit Quality

Audit quality remains an unclear concept despite a wealth of research. Researchers have not reached a uniform understanding of audit quality. The concept has many facets, and different stakeholders, such as those who use financial information, auditors, industry regulators, and society, will have different perspectives on it (Masood & Lodhi, 2015; Knechel et al., 2013). Knechel et al. (2013) provided the following summary of each stakeholder's point of view. Users of financial accounts define good audit quality as the absence of major errors and fraud in the financial statements. However, auditors define good audit quality as complying with all standards set by the profession and performing all audit responsibilities. High audit quality, in the eyes of the auditing company, is the capacity to support any claims or objections in a court of law. Profession regulators define it as compliance with professional standards. Society sees it as the prevention of economic problems threaten the presence of the entity or its market. Watson (2019) noted that the notion of audit quality varies across the public and private sectors and depends on the audit's objectives. This situation encourages researchers to suggest many definitions and measures of audit quality. Nonetheless, It's crucial to remember that audit quality is a

trait that is sensed rather than actually observed, hence it is only possible to identify situations where audit quality is at risk (Knechel et al., 2013). Prior research documented some factors that affect the perception of audit quality, for instance, audit firm ethics, sector expertise, audit partner rotation, audit committee oversight, adherence to auditing standards, client awareness, the auditor's financial independence, and audit inspection (Beattie and Fearnley 2012). Researchers must access new and better data on drivers of audit quality, whether it comes from audit firms, clients, regulators, or other sources, to reach a next level of understanding of audit quality (Knechel et al., 2013).

Continuing these studies is important because defining and measuring audit quality enable interested parties to assess whether audit quality has improved over time. They can also help to identify the determinants of low-quality audit, as well as to support and incentivize audit firms to invest and develop audit quality.

2.4.1 Importance of Audit Quality

The primary goal of the audit process is to determine if the financial statements accurately reflect the firm's financial status and operational results for a certain time period (Alareeni, 2019). Users of financial statements, particularly those who are municipal stakeholders like investors, can benefit from independent audit reports (Edmonds et al., 2020).

Research on audit quality has a positive effect on the quality of financial statements, because it stimulates the publication of detailed and accurate disclosure of the financial transactions of the PSOs (Kusumawati & Syamsuddin, 2018). As it guarantees the veracity and integrity of the financial statements, a high-quality audit

boosts the trust of stakeholders and society. On the other hand, a subpar audit will make stakeholders feel more untrustworthy (Alareeni, 2019).

Audit quality is important for the entity's management. It is a valuable monitoring method for assessing and verifying quality-related practices. It is also an impartial examination to see whether the entity's operations follow the specified regulations, and whether the utilized methods successfully and efficiently accomplish the goals and objectives of the entity (Kusumawati & Syamsuddin, 2018). The literature suggests that auditing adds values to the financial statements. For example, the audit process reduces capital cost because of the lower information risk (DeFond & Zhang, 2014). Therefore, studying audit quality of PSOs can ensure that the entities are operated, and the funds are managed well. This way, public confidence in the audit procedures is maintained effectively. Audit quality also enables the PSOs to achieve integrity, accountability, and improvements in their operations (Ismail et al., 2019; Dickins et al., 2018).

Management of PSOs is interested with the public perception about the credibility of their financial statements, therefore, they choose a reliable independent auditor who offers high-quality audit services (Hay & Cordery, 2018). High audit quality decreases agency costs and increases the principal's confidence in the entity's financial reports. Therefore, the agent (the entity's management) incurs the cost of hiring a high quality auditor due to his self-interest to keep a virtuous relationship with the principals and to prevent them from taking unwanted actions against the management, such as decreasing the scope of the agents' activities or terminating their services (Hay & Cordery, 2018). When there is one agent and multiple principals (e.g., share/stakeholders, ministerial cabinet, parliament, or voters), such development

will be expected. Additionally, government agencies that do not conduct any audit will receive smaller amount of resources (Hay & Cordery, 2018).

2.4.2 Definitions of Audit Quality

Researchers have defined audit quality in different ways. For example, Dickins et al. (2018) describe audit quality as the auditor's capacity to identify and disclose misstatements, adhere to ethical and professional standards, and/or satisfy investor needs. DeAngelo (1981) defined the audit quality as the likelihood that an auditor will detect a violation in the financial reporting system and record it in the audit report. This definition is widely used among researchers (Ismail et al., 2019). Despite its widespread use, academics still cannot agree on a single definition of audit quality. The definition essentially returns to the perspectives of different stakeholders of audit quality in audited financial statements (Knechel et al., 2013). Other researchers reason that the difficulty of defining audit quality is because of its nature as a socially constructed concept (Humphrey, 2008; Holm & Zaman, 2012).

Some regulators and standard-setters come to the conclusion that it is impossible for interested parties to agree on a precise definition of audit quality. In its Consultation Report 2009, the International Organization of Securities Commissions (IOSCO) noted that it is challenging to define and specify audit quality to stakeholders, and gaining consensus is challenging.

Knechel et al. (2013) made the suggestion that an effective audit (of high audit quality) entails a well-designed audit process carried out by motivated, competent, trained, and expert auditors who are aware of the inherent uncertainty of the audit and appropriately adapt to the innate characteristics of the client. DeFond and Zhang (2014) defines audit quality as the level of assurance given by the auditor on the

accuracy of the financial statements under review. In other words, better audit quality increases the likelihood of accurate financial accounts. According to the FASB (2010) in Statement of Financial Accounting Concepts (SFAC) No. 8, the relevance and faithful depiction of financial statements are two essential qualitative features that characterize financial statements as being of high quality. Due to these characteristics, all users can benefit from the financial statements.

DeFond and Zhang (2014) added that despite their technical compliance with GAAP, high-quality auditors must consider the financial reporting system and the inherent qualities of the firm to assess how faithfully the financial statements represent the firm's core economics. Therefore, the responsibility of the auditors extends beyond detecting violations against GAAP requirements.

The Statement on Auditing Standards (SAS) No. 90 demands auditors to critique the quality of the company's accounting criteria which they applied in issuing the financial statements. SAS No. 14 requires auditors to analyze the qualitative aspects of the company's accounting procedures, taking into account any potential for management bias (PCAOB, 2010). When assessing the quality of financial reporting, the auditor may also take into account judicial decisions that hold auditors accountable for financial statement faults (DeFond & Zhang, 2014).

From the above arguments, it can be decided that audit quality is a construct that provides a degree of assurance that the firm issues high-quality financial statements. A high-quality audit enhances the credibility of the financial statements. It bears mentioning that the quality of financial reports is determined by numerous factors, among others the accounting system or innate characteristics of the client, auditor, and regulations of the accounting and audit profession.

2.4.3 Measures of Audit Quality

The auditor offers assurance regarding the audited financial accounts, but the level of this assurance is impenetrable, making the measuring of audit quality a cloudy and difficult subject (Chadegani, 2011; Dickins et al., 2018; Knechel et al., 2013). However, this does not dissuade scholars from investigating all aspects and components related to the audit process in order to well understand the idea of audit quality measures.

According to Kusumawati and Syamsuddin (2018), the behavior of auditors during the audit engagement determines how well the audit quality is measured. Alareeni (2019) claimed that numerous aspects and traits of the audit firm that affect audit quality have been covered in various ways by prior studies. Some research looked at the impact of only one feature, while others looked at the impact of a number of attributes on audit quality.

As discussed in the previous section, researchers do not agree on one strict definition of audit quality. Following this, the tools to measure audit quality are still unclearly defined, so researchers use various proxies to evaluate audit quality. There is also no agreement among scholars about the effectiveness of these proxies, seeing that they have mixed effects on the correlations between audit criteria and audit quality (Alareeni 2019; DeFond and Zhang 2014). When examining its determinants, some researchers measured audit quality using a single proxy (Allen & Woodland, 2010), while others used multiple proxies (Alareeni 2019; DeFond and Zhang 2014). According to Lowensohn et al. (2007), both public and private sector research frequently uses the Big 5 audit firms as a stand-in for audit quality. However, they discovered that Big 5 auditors who do not focus on government audits are not related to greater perceived audit quality, and to determine whether these findings are

particular to the Florida market, they recommended additional research on actual and perceived audit quality for Big 5 audits in the public sector.

Hussein and Hanefah (2013) reported that researchers have taken numerous direct and indirect approaches in measuring audit quality. They added that the direct approach is related with the likelihood of discovering and reporting misstatements or breaches in the accounting system under audit, which will be reflected in the contents of the audit process, including the errors of the auditor. On the other hand, the indirect approach concerns the use of proxies of audit quality or assessing audit quality by examining the factors perceived to affect audit quality. Chadegani (2011) listed some indirect and direct measures of audit quality: indirect measures include the audit firm size, auditor tenure, industry expertise, audit fees, economic dependence, reputation, and cost of capital. While the direct measures include financial reporting compliance with GAAP, quality control review, bankruptcy, desk (peer) review, and regulators' performance. Greenwood and Zhan (2019) considered audit adjustments as a more direct measure of audit outcomes. In this case, audit quality is determined by comparing pre-audit and post-audit surplus or deficit.

The proxies of audit quality, perception of the audit quality, and the integrated frameworks of audit quality are discussed in the following subsections.

2.4.3.1 Proxies of Audit Quality

Most studies use the following proxies of audit quality to identify its determinants: modified audit opinion, the auditors' going concern opinion decision, non-Big versus Big 4, discretionary accruals, adjusted discretionary current accruals, accruals quality, reporting of material weaknesses, and audit report timing (Alareeni, 2019; DeFond & Zhang, 2014; Francis & Yu, 2009; Omer et al., 2016).

The qualities of competence (expertise) and independence (objectivity) are crucial to audit quality (Knechel, 2016; Kusumawati & Syamsuddin, 2018) and Watson (2019) asserted that the auditors are in charge of ensuring the quality of the audit. In order to attain audit quality, auditor quality is crucial. The independence, commitment, ethics, competence, diligence, moral courage, reputation, and experience of the auditor are used to estimate their level of quality (Barn, 2023). The audit standards and the profession both demand for all of these qualities.

DeFond and Zhang (2014) classified audit quality proxies into two groups. Each group is divided further into categories, and each category is affected and characterized by several dimensions that give it unique strengths and weaknesses. The first group of audit quality proxies is the outputs of the audit process, such as the auditor's going concern opinion. Material misstatements, auditor communication, financial reporting quality, and perceptions are some of the categories that fall under the first group. The audit process inputs, such as auditor size, make up the second group. Auditor qualities and auditor-client contracting aspects are some of the categories under the second group (e.g., audit fees). DeFond and Zhang (2014) also described several dimensions that affect the categories of the audit quality proxies, whether the proxies capture substantially more extreme audit failures, if they capture actual or perceived audit quality, and whether measurement inaccuracy is particularly problematic are some examples of the direct or indirect ways that the auditor influences the proxies in each category. They discussed the various categories through the influencing dimensions. For instance, the material misstatements category, which are directly influenced by the auditor, captures more egregious audit failures and actual audit quality. DeFond and Zhang (2014) discussed various audit quality proxies, such as restatements of the financial statements, accounting and auditing

enforcement releases (AAERs), auditor's going concern opinion, modified audit opinions, discretionary accruals, accrual quality, conservatism, market reaction, cost of capital, change in market share, Public Company Accounting Oversight Board (PCAOB) inspections, audit firm size (Big N), industry specialization, audit fees, and changes in fees. They concluded that no single category adequately captures the quality of an audit, and that it is preferable to use a number of proxies from other categories to maximize their strengths and minimize their limitations.

Some proxies are more effective for measuring specific factors on audit quality than others, and some proxies may be appropriate in the private sector but inappropriate in the public. A going concern audit opinion is not applicable in the public sector because the survival of PSOs does not depend on its losses, deficits, or risks, but on political and legal decisions. Accordingly, the most suitable proxies of audit quality of PSOs are restatements (i.e., An unqualified opinion on materially misstated financial statements is given by the auditor in error) and modified audit report, but not going concern audit opinion. These proxies are classified by DeFond and Zhang (2014) as output measures of the audit process.

2.4.3.2 Perception of Audit Quality Attributes

According to the earlier section, several researchers utilize audit quality proxies to measure audit quality and its determinants based on how stakeholders perceive the audit process. Audit quality was measured by many researchers through evaluating the perception of different groups as follow: According to Preparers as accountants and internal auditors are two stakeholder groups (Carcello et al., 1992; Warming-Rasmussen et al., 1998); external auditors (Carcello et al., 1992; Davis, 1995; Schroeder et al., 1986), clients (Davis, 1995), audit committee heads (Schroeder and

Ira, 1986), general federal inspectors (Aldhizer et al., 1995), stockholders and financial journalists (Warming-Rasmussen et al., 1998) and users of the financial statement (Carcello et al., 1992).

Some of these studies used the perception of one group of the stakeholders of audit process to determine the audit quality attributes, but others use more than one group, for example, Carcello et al. (1992) conducted a survey of 245 audit partners, 264 controllers (financial statement preparers), and 120 investors and creditors (financial statement users) to investigate the attributes associated with audit quality as perceived by auditors, preparers, and users. The significance of evaluating the three views simultaneously is to identify the characteristics associated with the quality of audit service both overall and among the three categories of financial statement preparers, auditors, and users. However, in an increasingly competitive environment, it is vital to comprehend the viewpoints of both users and preparers on audit quality (Carcello et al., 1992). Any distinctions may assist audit firms in providing more satisfaction to both segments while enhancing audit quality. Audit firms may refer to these perspectives (preparers and users) as a basis to enhance their audit efficiency (Takiah et al., 2010). Carcello et al. (1992) used exploratory factor analysis to derive 12 audit quality components based on 41 attributes discovered in the literature and the authors' experience as audit partners. These 12 components are: (1) audit team and firm experience with the client; (2) industry expertise; (3) audit firm responsiveness to client needs; (4) audit firm compliance with general audit standards; (5) audit firm commitment to quality; (6) audit firm executive involvement; (7) conduct of audit field work; (8) involvement of audit committee; (9) individual team member characteristics; (10) audit firm maintains a skeptical attitude; (11) audit firm's freshness of perspective; and (12) degree of individual responsibility. Carcello et al.

(1992) revealed that the qualities of the audit team members were regarded as being more crucial to audit quality than features of the audit company itself, such as litigation history. And the four most crucial elements in evaluating audit quality were compliance with generally recognized auditing standards (competence, independence, and due care - GAAS), experience of the audit team and firm with the client, industry knowledge, and responsiveness to client needs. However, there were significant disparities in the priority attributed to each component across the three groups. Both preparers and users valued conformity to general standards of GAAS requirements much more than auditors, and the preparers valued auditor responsiveness to client demands more than auditors did. Also, the findings of Al-Dhubaibi, (2020) study shows that there is a discrepancy between Saudi auditors' expectations and those of preparers and users of financial statements with regard to auditors' duties generally and their duty to detect fraud in particular. Auditors believe they have less responsibility for ensuring that financial statements conform with tax regulations, whereas preparers and users believe auditors have more responsibility in this regard. Furthermore, auditors recognize that, while audit procedures are designed to ensure that financial statements are free of intentional and unintentional material misstatements, the test-based nature of the audit process prevents auditors from being confident in their conclusions and providing assurance to users that financial statements are error-free. But the view of the preparers and users that auditors should guarantee audited financial statements are free from material misstatements either intentional or unintentional.

In public and private sector, many researches have studied the perception of accountants and internal auditors on audit quality, e.g., Behn et al. (1997), Pandit (1999), Boon et al. (2008), and Takiah et al. (2010). All these studies adopted the 12

attributes of audit quality which they determined by Carcello et al. (1992) after making some modifications to these attributes, such as replacing the compliance with general audit standards attribute with three components: independence, due care, and technical competence. Therefore, the number of audit quality attributes becomes 14. Behn et al. (1997) asked 434 financial controllers from Fortune 1000 firms to find out which characteristics are linked to the satisfaction of the audit firm and audit team and the client's overall satisfaction. This is considered as an indicator for the validity of the view of the accountants and internal auditors in perceiving audit quality. Pandit (1999) surveyed 359 senior executives from U.S. organizations to learn more about the impact of customer satisfaction on audit service quality, and the influence of performance efficiency and reputation of auditors on the decision to retain or replace auditors. Through a questionnaire survey of 235 local council (municipalities) finance practitioners (including the accountants) and 35 local internal auditors, Boon et al. (2008) inspected the audit quality attributes perceived to be relevant in compulsory audit tendering (CAT) in local councils in New South Wales (NSW), focusing primarily on whether the CAT results impaired auditor independence and audit quality. Takiah et al. (2010) used Behn et al. (1997) instrument, examined the influence of audit quality attributes and client contentment on audit performance at the audit firm and audit team levels. The questionnaire, sent via mail, sought the perceptions of financial controllers of selected companies listed on Bursa Malaysia on audit quality attributes and their level of satisfaction with audit services. Takiah et al. (2010) classified audit quality attributes into two groups. The first group of attributes relate to the audit firm, while the second to the audit team (auditors). The participants were asked to describe their opinions on each attribute of audit quality for the audit team and for the audit firm. The first group of attributes are: (1) audit firm's

experience with client; (2) audit firm's industry expertise; (3) audit firm's independence; (4) audit firm's commitment to quality; and (5) audit firm's responsiveness to client needs. The second group contains ten attributes: (1) audit team competence with approved accounting standards and auditing standards; (2) audit team member's conduct to audit field work; (3) audit team exercises due care; (4) audit team independence; (5) audit firm's executive involvement in the engagement; (6) audit team's experience; (7) audit team's industry expertise; (8) audit team's interaction with the audit committee; (9) audit team members maintain skepticism; and (10) audit team's ethical and knowledgeable in accounting and auditing (Takhiah et al., 2010).

In Palestinian municipalities, accountants are responsible legally on the reliability of the financial accounting reporting process, therefore they interested with the fairness of the financial statements, and to get the trust of the public and the regulators bodies with their financial statements. Independent audit is considered as most important tool to add trustworthiness to these financial statements. Accountants and the internal auditors in the public sectors, particularly in the municipality, may considered at the same time as preparers and users of the audited financial statements, they use them to demonstrate the balance sheet (financial position) and the result of operation (revenues and expenses statement) of the municipalities in front of the regulators or any controlling agency. Accordingly, the current study inspects the attributes of audit quality and their dimensions from the perspective of accountants and internal auditors who are involving in operation of the financial accounting system and preparing of the financial statements.

2.4.3.3 Integrated Framework of Audit Quality in Prior Research

Prior studies have used many proxies to measure audit quality and its determinants. But there is still no agreement among researchers on which measures are best, and there is no proper guidance on how to evaluate them (DeFond & Zhang, 2014). Most studies used one or more factors to understand audit quality, despite the complexity and multidimensionality of audit quality, and despite ongoing debates on its definitions and measures. Some studies provided an integrated, comprehensive framework of the determinants of audit quality to assist practitioners, regulators, and researchers in understanding audit quality research in the private or public sector. While most studies on audit quality are in the private sector, their frameworks can still be adapted for studies in the public sector. The most important frameworks of audit quality in past research are summarized below.

Chadegani (2011) stated that prior studies on audit quality can be classified by outputs of audit engagement, audit processes, and inputs of audit engagement. Outputs include audit opinion, which has a significant effect on audit quality if:

- a. it expresses the audit's findings clearly.;
- b. the stakeholders rely on it in their valuations of the audit quality;
- c. the auditor's judgment is improved when audit tenure increases, issuing the appropriate audit opinion; and
- d. the audit is performed by the Big 4.

Most studies used the proxy of going concern or modified audit report to estimate the effect of the input factors on audit quality.

Audit processes include audit environment, process performance, earning forecast, earnings management, the validity of the audit methodology, the efficiency

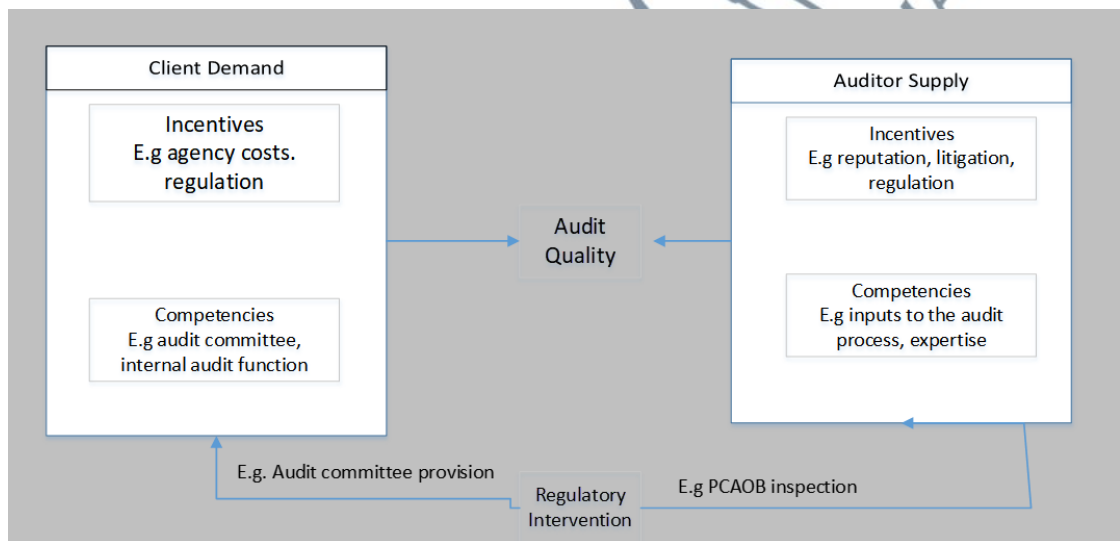
of the audit tools, and the accessibility of appropriate technical assistance. Inputs include auditor perception, compulsory audit tendering, auditing standards, and the auditor's personal characteristics, e.g., skills, experience, ethical values, and mindset.

Francis (2011) highlighted out the fact that audit quality is a multifaceted idea that exists on a continuum, and he thus proposed a framework for comprehending and studying audit quality. The framework comprises six levels of analysis, ranging from audit inputs to outcomes. The units of analysis in audit research are:

1. Audit inputs
 - Test of Audit
 - Engagement team members
2. Audit process
 - Implementation of audit tests by members of the engagement team
3. Accounting firms
 - Engagement teams work in accounting firms
 - Accounting companies recruit, educate, and pay auditors as well as create audit guidelines (testing procedures)
 - Audit reports are issued in the name of accounting firms
4. Audit industry and audit markets
 - Accounting firms constitute an industry
 - Industry structure affects markets and economic behavior
5. Institutions
 - Institutions affect auditing and incentives for quality
6. Economic consequences of audit outcomes
 - The results of audits have an impact on clients and users of audited financial information.

Knechel et al. (2013) suggested an integrated framework to assess the audit quality in the private sector companies, which consists of linkages among the most important attributes of audit (incentives, uniqueness, process, uncertainty, and judgment) and the different aspects of audit engagement, such as inputs, process, outcomes, and context.

DeFond and Zhang (2014) offered a different paradigm for comprehending and assessing the audit quality proxies that are widely employed in the literature. This framework consists of three elements: audit quality demand, audit quality supply, and the intervention of the regulators in both demand and supply of audit quality (Figure 2.1).



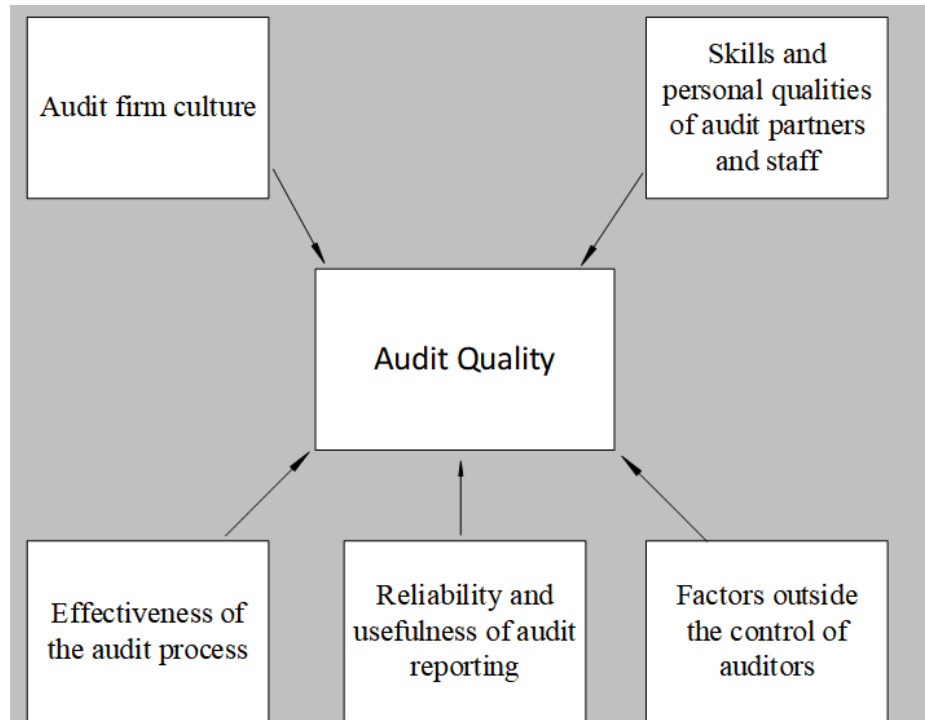
Source: DeFond and Zhang (2014)

Figure 2.1: Audit Quality Framework

DeFond and Zhang (2014) suggested in their audit framework that the client's incentives and competence determine the demand for audit quality. The client's incentives are stated through many factors, for example agency costs and regulations, while client competence is reflected in many factors, for example the audit committee and the internal audit function. The supply of audit quality is determined by the

auditor's incentives and skills. The independence of the auditor is tied to auditor incentives and is influenced by a variety of variables, including litigation, reputation, and regulatory issues. Many other characteristics, including knowledge and engagement-level inputs to the audit process, might indicate an auditor's competency. Regulator action has a substantial impact on these incentives and competencies of client demand and auditor supply of audit quality.

The Financial Reporting Council (FRC) in the UK developed the first official framework for audit quality in 2008 in the U.K. Five factors that affect audit quality are listed in this framework: (1) the culture of an audit firm; (2) the expertise and character of audit partners and personnel; (3) the efficiency of the audit process; (4) the accuracy and value of audit reporting; and (5) elements impacting audit quality that are not under the control of auditors (Knechel et al., 2013) (see Figure 2.2). For each driver, the FRC developed a number of potential audit quality indicators. For instance, establishing a culture where achieving high quality is valued and rewarded; ensuring that partners and employees have enough time and resources to deal with challenging issues; and ensuring strong systems for client acceptance and re-engagement are some indicators under the audit firm's culture. On the other hand, the indicators of the effectiveness of the audit process are the design of audit program and audit procedures, technical support availability, and enforcement of ethical and independence standards (Knechel et al., 2013).



Source: (Robert Knechel et al., 2013)

Figure 2.2: Framework on Audit Quality of the FRC of the UK

Other formal audit quality frameworks have been established by the Australian Treasury (Commonwealth of Australia 2010) and the International Auditing and Assurance Standards Board (IAASB 2011). The investors and the audit committee members' perspectives on audit quality were both discussed. The framework shows that the auditor's attributes, the auditor's report, and contextual circumstances (laws and regulations) influence on audit quality (Robert Knechel et al., 2013).

Measuring audit quality in the public sector is challenging for academicians and practitioners because there is no single model that can explain and define the factors of audit quality. At the same time, the auditor must comply with the Generally Accepted Auditing Standards (GAAS) and relevant ethics and code of profession conduct in the public sector (Ismail et al., 2019).

While there is extensive literature on audit quality in the private sector (Francis 2004), the findings cannot be readily applied to the public sector due to the alterations in both institutional and motivation frameworks that affect both managers and auditors (Greenwood & Zhan, 2019). Previous empirical studies on public sector audit quality are limited (Rosa & Morote, 2016) and are concentrated in North America, particularly U.S. municipalities. The following studies support the dearth of research on audit quality in PSOs, particularly municipalities: Greenwood and Zhan, (2019), Copley, (1991), Deis et al. (1992), McLelland and Giroux, (2000), and Cohen and Leventis, (2013). Moreover, despite extensive research on audit quality in the private sector, there is no framework that can interpret all issues related to audit quality in PSOs generally and municipalities specifically.

2.5 Determinants of Audit Quality

The study aims to improve understanding on the nature of audit quality and its main determinants in municipalities, in addition to providing a framework as guidance in determining audit quality proxies. As discussed in the previous section, the integrated framework of audit quality facilitates understanding on the nature of the audit process, the determinants of audit quality, and how to measure the effects and directions of audit quality factors. This enables researchers, practitioners, and regulators to make improvements to the audit profession and enhance public confidence in the audit profession. Only a small number of studies have provided an integrated framework of audit quality on the public sector, but most of them focus on the private sector. As an example, DeFond and Zhang (2014) used clients' incentives and competencies that drive client demand of audit quality and auditors' incentives and competencies that drive auditor supply of audit quality, as well as the role of

regulatory intervention in shaping the incentives and competencies of both clients and auditors. Other studies used different drivers, indicators, factors, and proxies to understand audit quality. But there is still no agreement among researchers about the proper approach to understand audit quality. Prior studies confirmed that using more relevant and sufficient factors and proxies of audit quality may allow more accurate evaluation of audit quality (DeFond & Zhang, 2014) in audit engagement either in the private or public sector. The current study categorizes the factors of audit quality based on the prior literature of audit quality to three categories: auditors characteristics, audit firm attributes, and the effectiveness of municipal internal controls. The next subsections address the relevance of these factors and their dimensions in assessing audit quality in PSOs, as well as why they were chosen for this study to participate in its audit quality conceptual framework.

2.5.1 Auditor Characteristics

There is general agreement that the key factors of audit quality are the auditor's characteristics (Christensen et al., 2016). Schroeder et al. (1986) and Carcello et al. (1992) suggested that the audit company is less frequently associated with audit quality criteria than the particular audit team (auditor characteristics). From DeAngelo (1981) definition of audit quality, Watson (2019) deduced five qualities of an auditor: competence, conscientiousness, independence, moral bravery, and reputation. Kusumawati and Syamsuddin (2018) divided the characteristics of an auditor into five categories: ethics, commitment, independence, competence, and experience. They added a long list of personal characteristics that auditors must possess, including honesty, diplomatic skill, hard work ethic, objectivity, care and diligence, methodicalness, ability to find data and figures, insatiable curiosity, courage, ability to

keep secrets, communication skills, and common sense. As inputs to the auditing process and potential indicators of the auditor's capacity to carry out a high-quality audit, competence and independence (including ethics) of auditors are taken into consideration (Dickins et al., 2018).

This study discusses three attributes of auditors: ethics, independence, and competence. These factors are regarded as significant drivers of audit quality by scholars, practitioners, and regulators, and they serve as the foundation for additional characteristics and determinants of audit quality.

2.5.1.1 Auditor Ethics

According to Cohen and Wheelwright (2004), ethics is rational and moral considerations that found the activity of a person or a community. Ethics provides a guiding principle for a person or a group to decide whether an action is good or evil. According to Alvin et al. (2017), ethics is a system of moral standards or ideals. They continued by saying that ethical behavior serves as both the glue that holds society together and is necessary for a society to function in organized activities. Valasquez et al. (2010) as cited by Cummings (2020) defined ethics as solid moral principles that outline what people should do and are generally expressed in terms of rights, obligations, benefits to society, fairness, or particular virtues.

According to Alvin et al. (2017) the Josephson Institute identified six basic ethical beliefs that are connected to ethical behavior as the following

1. Trustworthiness (honesty, reliability, integrity, and loyalty)
2. Respect (courtesy, decency, autonomy, dignity, tolerance, civility, and acceptance)

3. Responsibility (self-restraint, leading by example, perseverance, pursuing excellence, and engaging in continuous improvement)
4. Fairness and justice (equality, proportionality, openness, impartiality, and due process)
5. Caring (genuinely concerned for the safety of others, acting altruistically, and showing kindness)
6. Citizenship (voting, serving on juries, obeying laws, giving more than one takes, and conserving resources)

The application of ethics is guided by two principles. The first is the imperative principle, which directs decision-making so that it complies with ethical standards. The second is the utilitarianism principle, which emphasizes examining the effects of each decision made rather than upholding moral standards (Haeridistia & Agustin, 2019).

2.5.1.1.1 Importance of Auditor Ethics

Ethics outlines what is appropriate and inappropriate, acceptable and nonacceptable in perception and action, and provides recommendations for what people should do. It defines moral behavior in terms of a certain group's ideology (Ermasova et al., 2018). Ethical and moral thinking are dispositional traits of auditors (Parsimin et al., 2023), if these traits combined with the trait of professional skepticism, auditors can produce high quality audit (Knechel et al., 2013). Ethics is important for the auditor to perform their tasks in any audit engagement in a professional manner. Therefore, most professional regulators and standard setters regulate auditors' ethics through codes of ethics, for example the Code of Ethics for

Professional Accountants. This code is published by the IFAC through its institution, the IESBA. The IESBA Handbook Code of Ethics (2018) outlines the following five key principles of ethics for accountants:

1. Integrity: to be transparent and truthful in all interactions with colleagues and clients.
2. Objectivity: not allowing bias, conflicts of interest, or improper outside influence to affect one's professional or business judgment.
3. Professional competence and due care: (a) based on current technological and professional standards, applicable laws, and maintaining professional knowledge and competence at the level necessary to ensure that a customer or hiring organization obtains competent professional service, and (b) follow all relevant technical and professional standards with diligence.
4. Confidentiality: must uphold the confidentiality of information obtained through business and professional interactions.
5. Professional behavior: to abide by all applicable laws and regulations as well as refrain from any actions that a professional accountant knows or should know could damage the image of the profession.

In the U.S., the PCAOB and Securities and Exchange Commission (SEC) are empowered to set independence requirements and ethical guidelines for public company auditors. The AICPA has established the Code of Professional Conduct, which is applicable for all its members. This code includes the principles of public interest, responsibility, integrity, objectivity and independence, due care, and scope and nature of services (Alvin et al., 2017). The Institute of Chartered Accountants in Scotland (ICAS) amended its Code of Ethics to include moral courage as a supporter

of the core values of business ethics (objectivity, professional competence, integrity, confidentiality, due care, and professional behavior) (ICAS, 2020).

The auditor usually faces ethical dilemmas when performing audit. Because the auditor provides his services to many users, there may be a conflict of interest between them. In addition, the auditor is hired by the audit committee and receives audit fees from the management (Alvin et al., 2017). When an auditor is presented with an ethical choice, he must have the confidence to acknowledge the choice, adopt a reasonable position, and operate in accordance with those values, and audit quality is enhanced by moral courage, which enables the auditor to turn his ethical decision into an ethical act (Khelil et al., 2016).

Better audit quality results from adherence to and dedication to ethical standards. For instance, it is believed that female auditors are more sensitive and morally righteous than male auditors. Thus, they are less likely to engage in certain practices that can reduce audit quality and auditor independence (Jonnergård et al., 2010; Reheul et al., 2017; Sweeney et al., 2010). Female auditors also have a higher probability of issuing a going concern opinion (Hardies et al., 2016). They are also more conservative, independent, and show greater effort in processing information (Reheul et al., 2017).

The auditor's commitment to adhere to ethics will lead to higher audit quality (ALBeksh, 2016). Nasrabadi and Arabbian (2015) and Anis (2017) as cited by Haeridistia and Agustin (2019) found that audit quality is influenced by professional ethics. Blay et al. (2019) defined two fundamental principles in the auditing profession: responsibility and honesty, and they used both to assess an individual's potential for moral reasoning in auditing.

2.5.1.1.2 Auditor Ethics in the Public Sector

According to Knechel et al. (2013), ethical and moral thinking are personal traits of auditors when combined with professional skepticism, lead to higher audit quality. The judgment of any person is influenced by the events, laws, regulations, and beliefs around him. This means that the auditor's judgment will be different when auditing PSOs versus private business firms. This is because PSOs differ in many aspects from commercial firms, including in the nature of the ownership, governance and management, laws and regulations, nature of services provided, and purpose of establishment. To develop the quality of audits in PSOs, Kusumawati and Syamsuddin (2018) argued that the auditor must have the courage to disclose the truth. The auditor must have a professional commitment to act in the public's interest while maintaining their professionalism. A dedicated auditor will keep professional skepticism to generate superior audit quality (Lord and DeZoort 2001). According to Kusumawati and Syamsuddin (2018), professional commitment is a condition in which the audit firm's members are interested in the firm's aims, values, and goals, and it has a positive impact on performance.

According to Chang et al. (2007), professionalism and ethical behavior has a substantial effect on public confidence in the accounting and auditing industry. Suraida (2005) as cited by Kusumawati and Syamsuddin (2018) found that competence, ethics, audit risk, and audit experience are positively related to professional skepticism.

According to ISA No. 200, the auditor must design and conduct the audit with professional skepticism, recognizing that the financial statements may contain inaccuracies. In addition to professional skepticism, the audit plan determines the ability of the auditor to accomplish his duties professionally and ethically. An

experimental and survey research confirmed that work overload forces the auditor to adopt dysfunctional behavior and lower audit quality (Ismail et al., 2019). An example of dysfunctional behavior is underreporting time, which is a common ethical dilemma among auditors and has several harmful consequences for audit firms (Emett et al., 2015) and the auditing profession as a whole (Herda & Martin, 2016).

Based on the preceding discussion, auditor ethics significantly influences the quality of audit in the private and public sectors. Ethics is the values that drive the auditor's behaviors and enable the auditor to identify correct or incorrect actions. Ethics can increase the public's trust in the auditor's work and acceptance of audit functions as value-added services. This trust can be improved when the auditor concentrates on their core values of competence, integrity, objectivity, independence, and audit quality (Rezaee et al., 2016). The auditor's ethics includes many attributes that can directly or indirectly influence audit quality. For example, Boon et al. (2008) listed some attributes of auditor's ethics that influence audit quality: audit firm's compliance with general audit standards, due care, audit firm's commitment to quality, individual team member's characteristics, and the degree of individual responsibility. Many researchers have looked at the influence of the auditor's moral traits on audit quality from the perspective of external auditors and the users of financial statement, but few have observed it from the perspectives of accountants and internal auditors, as this study does.

2.5.1.2 Auditor Independence

The auditor is independent when his mental attitude is free from any limitations and constraints; his decisions is not under control of or dependent on others; he considers only the facts and performs his duties with objectivity and honesty with

himself; and he avoids situations that would lead others to question his independence. Otherwise, it is doubtful that his professional skepticism can deliver quality audit (Kusumawati & Syamsuddin, 2018). Auditor independence is higher as his financial and family ties with the client reduce (Dickins et al., 2018).

The following subsections discuss the definition of auditor independence, the significance of auditor independence in the audit quality of PSOs, measures of auditor independence, and the determinants of auditor independence.

2.5.1.2.1 Definition of Auditor Independence

Audit value depends greatly on the public perception of auditor independence. Auditor independence is an important determinant of the readiness of various financial statements users to trust and rely on audit reports. The AICPA Code of Professional Conduct and the IESBA Code of Ethics for Professional Conduct define independence as a notion comprising of two components: independence in appearance and independence of mind (Alvin et al., 2017). The two components of independence are described by IESBA (2018) as follows:

- (a) Independence of mind – the state of mind that allows a conclusion to be expressed without being influenced by influences that damage professional judgment, allowing an individual to behave with integrity, impartiality, and professional skepticism.
- (b) Independence in appearance - the avoidance of facts and situations that are so substantial that a reasonable and knowledgeable third party would be likely to believe that the honesty, objectivity, or professional skepticism of a firm or an audit or assurance team member has been compromised.

IESBA (2018) stated that independence is linked to the fundamental principles of objectivity and integrity. The International Independence Standards requires professional accountants in public practice to hold on both principles when they perform audits, reviews, or other assurance engagements (IESBA, 2018).

Haeridistia and Agustin (2019) confirmed that audit quality and professional value be contingent on auditor independence, and they confirmed that the principle of responsibility requires the auditor to preserve independence in his mental attitude and appearance. In mental attitude means that the auditor is expected to be impartial and does not discriminate, using his professional judgment to evaluate the financial statements. In appearance means that the auditor must demonstrate his independence to the users of financial statements. The auditor must avoid any direct or indirect financial ties with the client under audit. He must also give his opinion without any influence in any part on his independence. Auditor independence can safeguard the auditor's ability to issue independent opinions and remain neutral during the audit process.

2.5.1.2.2 Importance of Auditor Independence for Audit Quality in the Public Sector

Auditor independence in the public sector means that the auditor cannot be easily swayed by the public even if they work for the public's profit; auditors are without support if they support the interest of any given party (Ismail et al., 2019). Auditor independence is essential for providing reasonable certainty regarding the accuracy of the financial statements under audit. It increases the likelihood of discovering misstatements, which outcomes in greater audit quality and enhances public confidence in the audit profession (Ismail et al., 2019). According to Francis

(2011) audit quality emerges when auditors can work competently and independently. Octavia and Widodo (2015) and Bouhawia et al. (2015) confirmed that auditor independence and competence have a significant effect on audit quality. Haeridistia and Agustin (2019) stated that many researchers found that auditor independence influences audit quality, e.g., Soekrisno (2014), Ling (2014), and Jamal and Sunder (2011). Haeridistia and Agustin (2019) concluded that auditor independence has a positive effect on audit quality. An audit is successful when it is carried out in accordance with auditing standards and actual data by an independent auditor (Haeridistia & Agustin, 2019). Francis (2011) mentioned that audit failure occurs when the auditor is not independent. In fact, audit failure has economic repercussions for auditors, clients, and third parties. Gustavson and Sundström (2018) demonstrated that corruption in the public sector at the national level is affected significantly by good auditing, which encompasses three principles of professionalism, independence, and recognizing the people as principal. When the auditor embraces all three principles, he can produce a high-quality audit, which can reduce corruption at the national level. But in PSOs, particularly municipalities, specialized and expert auditors are more important than independent ones. Elder et al. (2015) found that Florida municipalities that appoint specialized audit firms have higher audit quality. Therefore, municipalities should consider specialized, rather than independent, audit firms when selecting audit firms (Elder et al., 2015).

2.5.1.2.3 Measures of Auditor Independence

Competent and objective (independent) auditors can arrive at the correct conclusions when applying professional standards (Knechel, 2016). The literature uses the issuance of a going concern opinion or modified audit report as a measure of

auditor independence because the client's management has an incentive to pressure auditors to issue an unmodified opinion. Other studies used many proxies for auditor independence, such as audit firm size, auditor tenure and rotation, non-audit services, and discretionary accruals (Khurram et al., 2023). Auditors with better competence, lower risk tolerance, greater conservatism, or greater independence are more likely to offer modified audit opinions, ensuring that financial statements are free of misstatements from error or fraud (Ruiz-Barbadillo et al., 2004). Junaidi et al. (2016) reveal that auditor tenure negatively affects auditor independence, but the significance of this effect differs by the length of the tenure. This effect is also measured by the auditor's propensity to give a going concern opinion. In Spain, Kyriakou and Dimitras (2018) found the effect of long-term auditor tenure on discretionary accruals, which in turn indirectly affect auditor quality and independence.

An auditor that offers non-audit services to the client (auditee) may be less independent. This practice is proscribed by the audit profession regulators in the U.S. because it can negatively affect public perception of and confidence in audit quality. Additionally, it can potentially compromise the auditor's objectivity (independence) and skepticism (Francis, 2004). However, Ashbaugh and Mayhew (2003) found no systematic evidence to support that non-audit services violates auditor independence.

2.5.1.2.4 Determinants of Auditor Independence

As mentioned in the previous sections, prior research has discussed many factors that may affect auditor independence (Ashbaugh et al., 2003; Elder et al., 2015; Francis, 2004; Hardies et al., 2016; Junaidi et al., 2016; Knechel, 2016; Kyriakou & Dimitras, 2018a; Ruiz-Barbadillo et al., 2004). Hardies et al. (2016) confirmed that female auditors provide improved audit quality since they are more

independent. Female auditors also have lower audit error rates, implying greater reporting accuracy. Kaplan et al. (2008) demonstrated that competent auditors rely less on inappropriate data or data that aligns with management's self-interest. Their higher selective interest in appropriate information increases their neutrality in dealing with clients. The IESBA Handbook Code of Ethics (2018) stated that the auditor faces many types of pressure that can threaten the compliance with the fundamental (independence) principles, such as pressure to sway information preparation or presentation, pressure to report false financial results to satisfy investor, analyst, or lender expectations, pressure from elected officials on public sector accountants to misrepresent programs or projects to voters, and pressure from coworkers to inflate income are all examples of pressure.. IESBA directly mentioned that its code of ethics is applicable to public auditors and professional accountants in businesses and PSOs. In Section 400, IESBA suggested that a number of factors, such as financial interests, audit fees, compensation and evaluation policies, gifts and hospitality, actual or threatened legal action, loans and guarantees, business ties, personal ties, recent service with an audit client, serving as a director or officer of an audit client, temporary personnel assignments, employment with an audit client, and long association, can affect the independence of audit and review engagements (IFAC, 2018).

Based on the preceding discussion, auditor independence significantly influences audit quality in the private and public sectors. Independence enables the auditor to perform his tasks without bias, thereby improving the perception of users of the audit quality and enhance their confidence in the audited report.

2.5.1.3 Auditor Competence

Competence generally refers to the auditor's capability to do tasks seriously and in accordance with professional standards (Abbott et al., 2016). A thorough understanding of the client's operations and client-specific knowledge, such as knowledge of a firm's internal control structure, procedures and processes, operations, and accounting systems, are necessary for successful audits (Ball et al., 2015).

In the following subsections, the study discusses the definition of auditor competence, auditor competence in the public sector context, and the factors and measures of auditor competence.

2.5.1.3.1 Definition of Auditor Competence

Competence means that the auditor possesses extensive knowledge and practical experience that enable him to perform a high quality of audit and to give proper opinions on the financial statements (Ismail et al., 2019). Competence is a broad concept that includes many qualities of professional auditors to provide effective assurance services to their clients and to enhance the confidence of stakeholders and financial statement users in the audit findings. Therefore, the auditor must be competent, possessing various qualities gained through formal education, practical experience, professional exams, good moral standing, and training. These qualities increase the competence of the auditor (Allen & Woodland, 2010; Kusumawati & Syamsuddin, 2018). However, there is no agreement among regulatory bodies, professional organizations, academia, and practitioners on what constitutes an optimal education level for admittance to the public accounting profession (Allen & Woodland, 2010).

Competence also includes experience in technical and practical aspects. Experience can be divided into two types: generic experience and industry (sector) expertise (Reheul et al., 2017). Past research suggested that the auditor's judgment improves with years of generic experience, as his knowledge base grows and his ability to determine essential information improves (Simnett, 1996). Reheul et al. (2017) found that more experienced auditors are more likely to disclose FS mistakes and uncertainty in the audit report, because they are aware of errors that possibly exist in the financial statements under audit. And they added that auditors who are older or have more experience are less likely to provide a modified opinion. Old auditors always receive a lower audit fee, which may lead to lower audit quality (Hardies et al., 2016) as they become less conservative (Sundgren & Svanström, 2014). Reheul et al. (2017) concluded that current empirical evidence shows a curvilinear relationship between audit partner experience and the probability to issue a qualified (modified) opinion.

Biggs et al. (1993) as cited by Reheul et al. (2017) suggested that industry or sector experience gives the auditor in-depth knowledge about auditing and financial accounting systems, the environment of the organizations, laws and regulations, sector norms, performance indicators, and threats and risks, thus allowing them to make better judgment on the going concern decision of organizations in that particular sector. Such experience can be achieved directly through practice, observation, discussion with colleagues, and review and oversight of supervisors. It may also be gathered indirectly through reading (Kusumawati & Syamsuddin, 2018).

Christensen et al. (2016) confirmed that archival research suggests that audit quality is increased with expertise because of the increased likelihood of discovering errors in the financial statements. A substantial volume of empirical research has

explored this relationship in detail (Alareeni, 2019; Ismail et al., 2019; Minutti-Meza, 2013; Reheul et al., 2017).

For an audit to be successful, Kusumawati and Syamsuddin (2018) argued that the auditor must have full knowledge of accounting principles; accounting theory; accounting procedures; accounting systems; branches of accounting; current issues in accounting; regulations concerning businesses such as companies act; techniques of auditing; developments in auditing standards and principles; computer accounting and other automatic machine devices; commercial and taxation laws; principles of economic and social environment; statistics and mathematics; judgments in audit cases; industrial and business management; financial administration; and the technical details of the business under audit.

IESBA-IFAC (2018) discusses the principles of professional competence and due care in Section R113.1 of its Ethics Code in page 20:

“A professional accountant is required to abide by the professional competence and due care concept, which calls for an accountant to:

- a. Achieve and maintain the professional knowledge and skills necessary to guarantee that a client or hiring organization obtains competent professional service in accordance with current technical and professional standards and applicable laws; and
- b. exercise diligence and conform to the relevant technical and professional requirements”.

The principles of professional competence and due care require auditors to possess the knowledge and technical skills to adhere to professional standards in any audit engagement. They must also continually develop their professional abilities to perform competently within the professional environment. The auditor must also act according to the requirements of an assignment carefully, thoroughly, and on a timely basis. All professional accountants working under the certified public accountants’ authority have suitable training and supervision, and they should clarify to their clients

and other users of their professional services of the restrictions inherent in these services (IFAC, 2018).

2.5.1.3.2 Importance of Auditor Competence in the Public Sector Context

As discussed previously, the nature of PSOs and their regulations are different from the private sector, which means that their reporting system environment is also dissimilar, which may cause some complexities. The complexities in government accounting system requires the client to appoint a specialist auditor with experience in the auditing of PSOs (Hogan et al., 1999).

Yebba and Elder (2019) reported that federal regulators recommend the procurement of specialist external auditors to ensure audit quality. The International Code of Ethics for Professional Accountants requires accountants to comply with the principles of professional competence and due care. These principles are similarly applicable to the external auditors of PSOs because they provide their services as professional public accountants. According to the Code, a professional accountant can be an employee, contractor, partner, director (executive or non-executive), owner-manager, volunteer, or someone who works in the public sector, education, the not-for-profit sector, or in regulatory or professional bodies (IFAC, 2018).

Prior research in the public sector confirms the importance and usefulness of auditor sector expertise. Sector specialist auditors are related to higher compliance with GAAS reporting, fewer audit quality deficiencies, and higher perceived audit quality. Sector specialist auditors are more likely to issue modified audit opinions and higher earnings quality. They are less likely to cause accounting restatements. They have higher expertise, more concern for lawsuit and reputational damage, more conservative attitude and independence, greater reporting of control exceptions, and

shorter reporting lags with disclosure regulation (Chi & Chin, 2011; Chin & Chi, 2009; Deis et al., 1992; Elder et al., 2015; Hardies et al., 2016; Yebba & Elder, 2019).

2.5.1.3.3 Factors and Measures of Auditor Competence

Competence is subjective issue and affected by different factors, hence auditor competence might vary from an auditor to another (Ismail et al., 2019). Most studies used the proxy of issuing going concern or modified audit report to measure the effect of the inputs factors on audit quality (Chadegani, 2011). Auditor competence is the main factor in the audit input (Dickins et al., 2018; Rezaee et al., 2016). And the auditors who have more expertise, lower risk tolerance, and are conservative or independent are more likely to give modified audit opinions, thus giving more assurance that the financial statements are free of mistakes and fraud (Reheul et al., 2017; Ruiz-Barbadillo and Gómez-Aguilar, 2004). There are many indicators for the competence of external auditors, such as a formal education in accounting and related topics, practical experience in the audit profession, passing professional exams, good moral standing, and participating in continuous training programs. These requirements increase the competence of the auditor (Allen & Woodland, 2010; Kusumawati & Syamsuddin, 2018). Auditors that specialize in a specific sector, for example municipalities or other PSOs, are familiar with all contextual factors of the sector, including its laws and regulations, business risks, and accounting standards. These are obtained through years of audit experience in the sector. Ashton (1991) as cited by Reheul et al. (2017) reported that auditors with more years of experience have more ability to explain audit findings because they are aware of errors that possibly exist in the financial statements under audit.

Auditor competence has a significant and positive effect on audit quality (Bouhawia et al., 2015; Octavia et al., 2015). In other words, higher auditor competence leads to higher audit quality.

As discussed in the preceding sections, auditor competence includes many attributes that can directly or indirectly affect audit quality. Boon et al. (2008) mentioned some indicators of auditor competence that can influence audit quality: auditor experience with the client (municipality) under audit; auditor experience with LGUs; auditor knowledge on how to conduct a financial audit (technical competence); and conducting the audit in accordance with accounting and auditing standards.

The above discussion shows that auditor characteristics have significant influences on audit quality and public confidence in the audited financial reports of private and public sector organizations. The outputs of the audit process are directly affected by the auditor's characteristics. Therefore, the auditors should be independent in their judgment; possess a high level of competence; comply with professional standards; gain practical experience; and maintain and develop their capability through continuous professional education and training. All these activities should be carried out according to moral and ethical rules so that the auditor can produce high quality audit.

2.5.2 Audit Firm Attributes

Audit firms attributes, such as audit fee and audit firm size, are inputs of the audit process that indicate audit quality (Omer et al., 2016). They are also used as proxies for audit quality. Clients can easily determine audit quality based on these observable inputs. Other audit firm attributes are auditor-client tenure, industry specialization, non-audit services (NAS), U.S. and non-U.S. setting, and pre-SOX and

post-SOX setting. These attributes are related to the proxies for audit quality. For instance, specialized audit firms are associated with higher audit quality (Elder et al., 2015).

The next subsections discuss audit fees and audit firm size as the most important characteristics of the audit firm because they mirror the effects of other audit firm attributes. For example, audit fee is related to the level of industry specialization, non-audit services, auditor tenure, independence, and reputation. These and other related attributes have been touched upon briefly in the previous sections.

2.5.2.1 Audit Fees

A going concern opinion is more likely to be issued by audit firms that have a higher audit quality, according to prior research (Omer et al., 2016). And organizations that are more likely to receive a going concern view may pay higher audit fees, because auditors spend more time and money, and hence charge higher rates from clients who are more likely to receive a going concern opinion (Carson et al., 2013; Francis et al., 2009; Geiger et al., 2003). The next subsections discuss the audit fees in PSOs, determinants of audit fees, and the link between audit fees and audit quality.

2.5.2.1.1 Audit Fees in PSOs

Audit fees may reflect the level of audit efforts that the audit firm will expend on the audit engagement. These fees are negotiated bilaterally between the audit firm and the client (Yebba & Elder, 2019). Audit efforts are related to the attributes of the audit firm, the auditor's qualities, market share, level of disclosure regulations, client demand and perception of the audit services, accounting and environmental

complexities, litigation liability, industry specialization, and specific sector requirements. Yebba and Elder (2019) suggested that the mandated disclosure level for state governments (PSOs) requires fee premiums for specialized audit firms. However, the market conditions that determine these fee premiums are unclear. Yebba and Elder, (2019) mentioned that some prior studies revealed mixed results, and audit firms specializing in PSOs may compete on pricing rather than the value added in their services, particularly in a state where there is no regulation for specific disclosure on the financial statements.

Government auditing is a complex process, but the auditor charges a lower fee than audit engagements in the private sector. Therefore, the government audit market is not attractive for international (Big 4) and large national audit firms (Petrovits et al., 2011; Yebba & Elder, 2019). Most audit fees in PSOs are determined by public tender, and the most important determinant of a winning bid is the audit fee (Elder et al., 2015).

2.5.2.1.2 Determinants of Audit Fees

The client demand and auditor supply for audit services and other factors in the context of the audit profession determine audit fees. Alareeni (2019) found that the audit fee is determined by the legal system in a country. If it provides more protection to the stakeholders, such as the ability to sue the auditor, the audit firm would treat its clients more conservatively and it may engage in increased audit activities. The audit firm considers litigation risk during the negotiation of the audit fees with the client, either directly or through the public tender (Axén et al., 2019).

The audit cost is transferred to the clients through audit fees. This cost may include the cost of mandatory education and training for the auditors. Any changes in

the input cost of the audit process may be reflected in the audit fees (Allen & Woodland, 2010).

Audit firms use reported audit time during their negotiation with the client to determine the audit fees, in addition to additional services which are provided to complete the audit engagement effectively. But if the auditors in the audit team underreports time, this can lead to discrepancy between the actual and proposed auditing budget, which has a negative consequence on the audit fee negotiation with the client (Herda & Martin, 2016).

State regulations (GAAP-regulated state) have a vital role in audit pricing. Disclosure regulations directly affects the audit process and forms the client's demands for specialized audit. Moreover, the market positioning of each specialist auditor determines the audit fee. Therefore, the audit fee varies by the market positioning of the audit firm and regulations (Yebba & Elder, 2019). Yebba and Elder (2019) found evidence for lower audit fees in GAAP-regulated states. In non-regulated states, the audit fee is determined by competition, thus the client is interested in audit firms with the lowest audit fee without considering their value added. The audit firms that are considered as market leaders always provide discounts on the audit fees, and accordingly most governmental units are served by local auditors.

Elder et al. (2015) mentioned that Gauthier (2005) and the U.S. Governmental Accountability Office (1987) reported that in appointing audit firms, PSOs may adhere to numerous alternatives and methods recommended by specific procurement policies (e.g., competitive bidding, direct selection from a higher authority or governance body, election by citizens in some countries) to ensure the selection of quality auditors. The procurement staff must also consider an acceptable price range,

which can be gathered from the historical experience of the client or from the recommendations of professional organizations and agencies. Neal and Riley (2004) and Mayhew and Wilkins (2003) as cited by Elder et al. (2015) reported that specialist audit firms and more experienced auditors may be associated with efficiency and lower costs of audit activities, which lead to lower audit fees.

The business risk in PSOs particularly municipal corporations is less than equivalent private corporations. Therefore, the audit fees for PSOs are lower than for private sector organizations (Axén et al., 2019). The conflict and competition between political parties over the control of PSOs may necessitate more monitoring and auditing efforts, which can lead to higher audit fees (Deis & Giroux, 1992; Cohen & Leventis, 2013). The audit firm always considers its reputation risk when it prepares and submits audit tenders for the auditing of municipal entities. It should reflect the amount of potential loss in the audit fees (Axén et al., 2019). Axén et al. (2019) added that accuracy in the audit process needs more time and effort, which increases audit fees. The external auditor can use the report of the internal auditors of the PSOs. However, relying on the work of the internal control of PSOs, which is often less effective than its counterpart in the private sector, may increase audit fees. On the other hand, lower accountability and litigation risk may lower audit efforts and eventually audit fees (Goodwin, 2004). Hay and Cordery (2018) referred many recent studies, including Redmayne, et al. (2010), to argue that the political visibility of a PSO establishes a need for more audit justifications. They also showed that larger political visibility is related to more audit hours and higher audit fees.

2.5.2.1.3 Relationship between Audit Fees and Audit Quality

Auditor can charge higher fees when (i) there is more client demand for further audit efforts, (ii) the auditor has specific industry knowledge, or (iii) the auditor can provide more added value to the client (Yebba & Elder, 2019). In other words, higher fees reflect higher efforts in audit services and more audit experience (Wu et al., 2024), both of which can lead to high audit quality. Therefore, prior research used audit fees to proxy audit quality because they are expected to reflect the level of the auditor's effort in completing his job, therefore higher effort implies higher audit quality (DeFond & Zhang, 2014). The audit effort may be measured by the amount of audit hours spent in the audit process. These hours can also be used to measure audit quality (Deis et al., 1992). In addition to actual audit quality, higher perceived audit quality in the public sector is associated with higher audit effort and audit fee premium (Hardies et al., 2015). For example, female auditors have higher perceived audit quality and higher effort in the auditing process, as evidenced by their higher audit fees (Hardies et al., 2015). DeFond and Zhang (2014) concluded that audit fees are used in both client demand and auditor supply studies. Demand studies often use audit fees to see whether the competencies of the committee are associated with audit quality. Auditor supply studies typically use audit fees to see whether audit quality is related to industry specialist auditors or audit firm size. DeFond and Zhang (2014) cautioned that the researcher should be careful when using audit fees to interpret changes in audit quality, because they cannot capture all factors of auditor supply and client demand.

2.5.2.2 Audit Firm Size

Audit firms are classified into three main classes by size: international firms (Big 4), national or regional firms, and local (small) firms. Alvin et al. (2017) summarized the description of each category in the U.S. context as follows. International firms have offices throughout the world and audit most of the largest companies in the world. National audit firms have offices in most main cities across the U.S. Regional audit firms have a number of offices in the region or state. A local or small audit firm has one office and employs less than 25 professionals. Francis et al. (2013) reported that 61 percent of U.S. public companies are audited by the Big 4, while most government entities are audited by local or regional firms. In general, the audit market concentration in the private sector is higher than that in the public sector. This means that audit firms specializing in the public sector faces less competition, which can lead to better audit quality (Yebba & Elder, 2019). DeAngelo (1981) found a positive relationship between audit quality and audit firm size because larger audit firms can lose more reputation and clients if they fail to report material errors or frauds. Audit firm size is determined by the number of clients, therefore the audit firm with a large number of clients may be more independent, and more specialist auditors who are expected to provide better reporting of control deficiencies in spite of government disclosure mandate (Yebba & Elder, 2019).

Alareeni (2019) reported that many past studies confirmed the positive connection between audit firm size and audit quality. However, some studies did not find this relationship in PSOs (Ali & Aulia, 2015; Lowensohn et al., 2007; Yuniarti, 2011). Deis et al. (1992) suggested that if the audit firm considers its reputation more essential than the retention of any given client, audit firm size has a moderating effect between the reputation and performance of higher quality audit. Habib (2013)

confirmed that Big N auditors provide higher audit quality and are more probable to issue a modified audit opinion. Moreover, the Big4 auditing firms assure the legitimacy and trustworthiness of their auditees' non-financial disclosures, as evidenced by their stringent auditing procedures (Saeed et al., 2024).

Alareeni (2019) concluded that in general, most studies found a positive connection between audit firm size and audit quality, while a few did not find such a relationship. Greenwood and Zhan (2019) confirmed that some prior studies on the determinants of audit quality in the public sector (e.g., Copley, 1991; McClelland & Giroux, 2000; Ballantine et al., 2008) found that auditor size and reputation have small effects on audit quality.

Elder et al. (2015) found a positive association between audit firm size and audit quality in municipalities and other municipal organizations. Larger audit firms are more expected to issue a modified audit report, which is a proxy for audit quality. They added that they cannot predict the direction of this relation due to the mixed results on the influence of audit firm size on audit quality in government entities.

Large, geographically dispersed audit firms are more likely to be decentralized and have a higher degree of individual responsibility. They are also more likely to offer higher-quality audit services because they run the risk of losing their reputation and clientele if they offer lower-quality audit services (Boon et al., 2008). Audit firm size increases the degree of individual responsibility in completing the audit engagement according to the professional conduct approved by the top management of the audit firm. Therefore, audit firm size positively affects audit quality. A larger size allows the audit firm to build a hierarchal organization structure and rank its staff as partners and senior managers. As both conduct visit to the audit site, audit quality is improved (Boon et al., 2008).

Based on the preceding discussion, audit firm characteristics influence audit quality and indirectly affect the outputs of the audit process. Therefore, these attributes are used by many researchers as proxies for audit quality, though some use them as determinants of audit quality. Several studies find that some audit firm attributes have no effect on audit quality, particularly in PSOs. This study chooses audit fees and audit firm size because they are the best representation of other audit firms' attributes. For example, audit firm experience is reflected in both audit fee and audit firm size.

2.5.3 Internal Control

Internal control is typically defined as the management's strategy for ensuring that operations are productive and successful, financial reporting is correct, and laws and regulations are followed (Länsiluoto et al., 2016; Petrovits et al., 2011; Younas & Kassim 2019). Romney and Steinbart (2018) provides the following definition of internal controls and their objectives in page 198:

Internal controls are the processes implemented to provide reasonable assurance that the following control objectives are achieved:

- Safeguard assets: prevent or detect their unauthorized acquisition, use, or disposition.
- Maintain records in sufficient detail to report company assets accurately and fairly.
- Provide accurate and reliable information.
- Prepare financial reports in accordance with established criteria.
- Promote and improve operational efficiency.
- Encourage adherence to prescribed managerial policies.
- Comply with applicable laws and regulations.

COSO issued the Internal Control – Integrated Framework in 1992, which comprises five elements that form an effective internal control, namely control environment, risk assessment, information and communication, control activities, and monitoring. In addition, the COSO framework identified three goals for internal

control: reliability of financial report, effectiveness and efficacy of business, and compliance with applicable laws (Länsiluoto et al., 2016; Romney et al., 2018; Younas & Kassim 2019). According to Ziegenfuss (2001) both public and commercial enterprises in the United States, Europe, and Finland frequently employ the COSO framework. For example, in the U.S., the AICPA, IIA, and the General Accounting Office (GAO) join the COSO framework into their auditing standards. All components of the COSO framework rely on the control environment since it establishes the tone and culture of an organization, which all other activities are built upon (Länsiluoto et al., 2016). Control activities are management practices to ensure that goals are met and that risk mitigation measures in the form of policies and procedures are implemented successfully. Some examples of these practices are the segregation of duties, information processing, physical control, and performance reviews (Aikins, 2011). The main objective of control activities is to make sure that critical responses are given to risks to the firm's goals. The risk assessment procedure, which is heavily weighted in the contemporary control framework COSO Enterprise Risk Management (ERM, 2004) (Länsiluoto et al., 2016).

The last two elements of COSO framework relate to all activities of the organization. While internal and external communication is necessary to supply information needed to carry out daily internal control activities, the information and communication system gathers and exchanges the data necessary to conduct, communicate, manage, and control the operations of the organization. Continuous evaluations are part of the monitoring component's process to make sure every component is there, functioning, and that any defects are reported right away. The board of directors and top management are informed of significant difficulties (Romney & Steinbart, 2018).

The discussion above suggests that the effectiveness of internal controls has an impact on audit quality. The external audit's goals are supported by the accomplishment of internal control goals, which can enhance the effectiveness of the audit. For example, the efficiency and effectiveness of operations facilitate the audit engagement and minimize its costs, particularly when the external auditor depends on the internal auditors' reports. Therefore, this study considers internal audit as a proxy for the efficiency and effectiveness of the organization's operations. Additionally, this study substitutes the accounting basis for the financial reports' dependability, which has a direct impact on the audit process' input by resulting in more accurate financial statements (DeFond & Zhang 2014). According to auditing standards, the external auditor is in charge of finding any violations of laws and regulations that have a direct impact on the organization's financial statements and ability to continue its operations (Alvin et al., 2017). It is obvious that the purpose of internal controls is to ensure that the organization conducts its operations in accordance with all applicable laws and regulations (Lansiluoto et al., 2016). This helps to ensure high audit quality is achieved. Due to the tight relationship between audit quality and internal controls, external auditors are required by audit standards to comprehend and assess the efficacy of the internal controls of the examined organizations.

The next subsections go over internal control in PSOs and how well internal control elements like internal audit, accounting principles, and laws and regulations work.

2.5.3.1 Internal Controls in PSOs

An essential component of public sector governance, the internal control system which aids in enhancing the efficiency, productivity, openness, transparency, and

accountability of public organizations (Reginato et al., 2016; Troupin et al., 2010). A public sector manager will create and execute internal controls to help the organization accomplish its financial goals and priorities while minimizing organizational and financial risks. These procedures include things like authorizing invoices before paying them, dividing up the tasks involved in documenting and paying for financial transactions, and checking reported transactions for consistency and procedural enforcement (Aikins, 2011).

Governmental entities' internal controls and reporting environment are subject to single audit standards and are impacted by relevant laws and regulations (Yebba & Elder, 2019). PSOs conduct internal controls to ensure that the public authorities have determined that the actions taken comply with relevant laws and legal standards, to prevent the performance of tasks in an ineffective or inefficient manner, and to prevent the uneconomic management of public resources and assets owned by government entities (Stášová, 2019). Any form of control aims to prevent future mistakes by teaching people from past mistakes. To achieve credibility and transparency at all levels of the administration, it is crucial to make sure that day-to-day control is a component of governance in public administration (Nemec, 2015). Control in the public sector should continuously offer incentives to enhance all procedures and act as a tool to foster positive interactions between citizens, PSOs, and the public administration (Boyard & Löffler, 2003).

Lansiluoto et al. (2016) proposed that the three components of financial reporting dependability, effectiveness and efficiency of activities, and legal and regulatory compliance make up the internal control effectiveness construct. As a result, three proxies for internal control effectiveness are used in this study. First, internal audit, which checks to see if operating operations, such as internal control

procedures, are carried out effectively and efficiently. The presence of the internal audit indicates the effectiveness and efficiency of activities. Second, accounting basis, which is considered as the foundation of a financial reporting system and directly affects the reliability of financial reports. Third, the existence of adequate and relevant laws and regulations and their proper compliance may support the effectiveness of internal control.

From the above discussion, this study concludes that an active internal control can assist the PSOs in operating and maintaining a high-quality financial reporting system that can produce high quality financial statements and helps the auditor to deliver a high-quality audit. Auditors must comprehend and consider the effectiveness and efficiency of the client's internal control system in their audit plan and other audit processes in order to comply with applicable audit standards, such as the International Standards of Auditing (ISA) and AICPA audit principles.

2.5.3.2 Factors of Effectiveness of Internal Controls

As discussed in the previous sections, the internal control of any entity can only be effective if it complies with COSO's integrated framework and requirements. This study selects three factors related to audit quality and have a significant effect on the effectiveness of internal controls: internal audit, accounting basis, and compliance with laws and regulations applicable to the municipalities. The following subsections discuss each factor and its effect on audit quality.

2.5.3.2.1 Internal Audit

Internal audit is the process of examining organizational problems or business processes and making organized recommendations for improvements. It provides

guidance to the business on how to better accomplish its goals by controlling risks and enhancing internal controls (Asare, 2009). Auditing Practice Committee of the Institute of Internal Auditors of the U.S. defined the internal auditing as one component of the internal control system implemented by institutions' management for the purpose of evaluating, examining, and disclosing the effectiveness of its internal controls over financial reporting (Chalmers et al., 2019; Dimitrova & Paneva, 2019). The Institute of Internal Auditors defines internal auditing as an objective assurance and consulting process that adds value and seeks to enhance an organization's operations. Internal audit helps the organization accomplish its goals by methodically and systematically evaluating and enhancing the effectiveness of the risk management, control, and governance systems (Goodwin, 2004; Pilcher et al., 2013). The activities of internal auditors in the private and public sectors can be grouped into four categories: (1) risk management, (2) internal controls and financial audit, (3) operational and systems audits, (4) specific and other projects (Goodwin, 2004). Internal auditor competency is linked with the success of internal control over compliance (Chang et al., 2019). Internal audit, according to Romney and Steinbart (2018), looks at the consistency and correctness of financial and operational data as well as the effectiveness of internal controls, employee adherence to management policies and procedures, as well as relevant laws and regulations. They also said that internal audit should report to the audit committee rather than the controller or chief financial officer and should be organizationally distinct from accounting and operations.

2.5.3.2.1.1 Importance of Internal Audit in PSOs

Internal audit is a crucial component of the governance process and can support PSOs (Janse & Coetzee, 2016). Internal auditing is becoming more essential in the public sector as a result of the government's efforts to make sure that all resources are utilized effectively and that public assets are utilized to their fullest capacity. When compared to the citizens' demands for better services, increased openness, and greater accountability, these resources are expanding more slowly (Asare, 2009; Aikins, 2011).

In the private sector, the internal audit is considered as part of the internal control of the firm. The internal audit in a PSO examines the internal control activities on the operating activities to guarantee that the organizational units perform their functions efficiently. The internal audit, in this sense, assists the management of the PSO to control the operating activities of each unit. It provides input to the directors of the PSO in the form of outcomes, obstacles, and irregularities (Sari et al., 2019). Mazza and Azzali (2015) found that there is a correlation between increased internal audit effectiveness and decreased severity and persistence of control weaknesses.

2.5.3.2.1.2 Relationship between Internal Audit and Audit Quality

The internal auditors interact with the external auditors, and the external auditor relies on the work of the internal audit in the private and public sectors. However, in the public sector, this does not lead to reduced audit fees (Goodwin, 2004). The external auditor, in the audit process, must comply with the requirements of ISA 610 (Revised 2013) on using the work of internal auditors (IFAC, 2018).

In general, Aikins (2011) concluded that local government auditors (internal auditors) conduct further audits in operating areas, including fiscal receipts and

expenses. Furthermore, internal auditors have a significant direct and indirect effect on the performance of local government through improvements in internal controls and operational quality.

Research on the internal audit function (IAF) is still nascent, and it is interesting to see whether IAF can substitute or complement the external audit function, or whether outsourcing IAF impairs or enhances audit quality (DeFond & Zhang, 2014). Sari et al. (2019) determined that internal audit has a quality assurance function, which can enable high-quality audit, because the external auditors employ the work of the internal audit function depending on the objective of its core activities (Barr-Pulliam et al., 2024).

2.5.3.2.2 Accounting Basis

When a financial transaction needs to be entered into the accounting records and reported in the financial statements depends on the accounting basis. IFAC Status Report (2018) defines cash accounting basis as the recognition of financial transactions when the cash is received or paid, while accrual basis accounting as the recognition of financial transactions when the underlying economic event occurs, while reporting the assets and liabilities in the financial statements. Based on the accrual accounting basis, organizations must publish a series of financial statements in accordance with IPSAS, including a statement of financial position, a statement of financial performance, and a statement of changes in net assets and equity. A government agency must at least issue the statement of revenues and payments if it employs the cash basis (Zedan et al., 2020). The timing differences between the two bases of accounting have a direct and indirect impact on the goals of the internal controls, particularly when it comes to gauging how well operations are run and how

trustworthy and timely the financial reports are. When a company employs the cash basis, which simply exposes financial assets, it may have an impact on how the audit quality is regarded by the public. The accounting basis in PSOs and its connection to audit quality are detailed in the ensuing subsections.

2.5.3.2.2.1 Accounting Basis in PSOs

Dewi et al. (2019) reported that according to IFAC (2018), in the world, 25% of governments use accrual accounting to publish their financial statements, whereas 30% continue to report on a cash basis. The remaining entities are switching to accrual accounting and publishing their reports on either a modified cash basis or modified accrual basis, which means that their financial statements include a lot of accrual components. The PSOs of some developed countries, for instance member states of the EU, use cash accounting. There is no convincing argument to adopt only accrual accounting, based on the cost-benefit connection, hence the German state authorizes the use of either cash basis or accrual basis in the financial reporting system of the public sector (Eulner & Waldbauer, 2018).

Cash basis accounting generates factual, dependable, and comparable data to fulfill the accountability requirements for public sector earnings and expenditures. Additionally, applying it is not too difficult. PSOs frequently adopt cash-based budgeting since it is simple to understand (Eulner & Waldbauer, 2018). Nevertheless, there are numerous advantages for various users of accrual based accounting. It increases the amount of useful (relevant and trustworthy) information available to decision-makers, promotes public administration's effectiveness and efficiency, promotes transparency by publishing balance sheets based on accruals, offers multiple reporting frameworks, makes it possible for taxpayers and voters to access the same

data, and offers contemporary financial reporting that is appropriate for cross-border comparison (Ademola et al., 2020; Dewi et al., 2019; Eulner & Waldbauer 2018; Interntional Federation of Accountants, 2012; Setyaningrum et al., 2020). In addition to the above benefits, adoption of the accrual basis accounting or IPSAS reduces corruption in PSOs and increases financial reporting quality (Ademola et al., 2020; Cuadrado-Ballesteros et al., 2019).

IFAC issues accounting standards for the public sector based on the accrual basis to harmonize accounting standards around the world and to issue high quality, credible, and comparable financial reports (Ademola et al., 2020).

Through the provision of dependable, excellent financial procedures that result in a reasonable level of accountability and transparency, the implementation of IPSAS promotes good functional performance and the efficient distribution of an entity's resources (Abimbola et al., 2017). IPSASB (2015) stated that the objective of IPSAS is to assist government managers in making decisions concerning public governance in a transparent and creditable manner. The IPSASB favors accrual basis accounting and believes that the cash basis is insufficient to satisfy the needs of financial reporting users. A self-regulatory internal control mechanism is also provided by IPSAS (Ademola et al., 2020).

2.5.3.2.2.2 Relationship between Accounting Basis and Audit Quality

The accuracy and usefulness of financial information generated by a system are indicators of the system's value to a company. The accounting foundation affects the quality of pre-audited financial statements, which are the primary inputs into the audit process (DeFond & Zhang, 2014). As a result, the accounting basis affects audit quality by resulting in accurate financial statements.

2.5.3.2.3 Laws and Regulations

According to Alareeni (2019), the legal environment, auditing standards, and accounting practices all have a significant impact on the accuracy of an audit. The Big Four audit firms are more cautious when dealing with clients in countries with legal frameworks that provide greater protection to users of audited reports. In other words, the legal framework affects the auditor's behavior. The client's investment in reporting systems and assurance tools may expand as a result of the implementation of reporting standards and other disclosure-related laws, as well as government examination of financial reports, leading to more trustworthy financial statements (Yebba & Elder, 2019). Legal enforcement is better in industrialized countries, but it should be recognized that the implementation of laws is just as crucial as their content (Alareeni, 2019; La Porta et al., 2000).

Laws and regulations include all the orders of superior authorities and regulators of the client's industry. The auditor's objectives when responding to non-compliance or suspected non-compliance with laws and regulations are to uphold the standards of professionalism and integrity by notifying the client's management or governance so that they can mitigate the effects of the identified or suspected non-compliance as well as prevent future violations (IFAC, 2018). Some examples of these laws and regulations are accounting standards and procedures, fraud, corruption and bribery, money laundering, terrorist financing and proceeds of crime, securities markets and trading, banking and other financial products and services, data protection, tax and pension liabilities and payments, environmental protection, public health and safety and related regulations, and regulations related to the auditing and issuance of audited financial statements (IFAC, 2018). These laws and regulations are taken into account

as a component of the client's internal controls, and they have an impact on the effectiveness of audits (Alareeni, 2019).

2.5.3.2.3.1 Laws and Regulations in PSOs

Yebba and Elder (2019) compared between the U.S. audit markets of Michigan and Pennsylvania. Both states are quite similar in almost every way, especially when it comes to how their various levels of government—county, city, township, villages, and boroughs—are organized. Both states also mandate that each government entity employ an impartial audit company to review its financial statements. However, because there are certain variations in the regulatory environment, namely with regard to state-level GAAP and the objectives of governmental regulators and standard setters, each state is seen as having its own distinct audit market. Yebba and Elder (2019) found that Michigan, a GAAP-regulated state, has better audit quality because its regulations enhance the reporting environment and require specialist auditors who have practical experience in the applicable regulations. Ahmaro (2014) suggested the necessity to modify the laws and bylaws of municipalities to develop and implement an efficient financial system with clear accounting standards, control principles and procedures, and organizational standards. Governments in Europe are responsible for regulating the external audit function. Central government audits are governed by legislation or decree, and professional auditors occasionally work together to develop the auditing standards (Brusca et al., 2015).

2.5.3.2.3.2 Laws and Regulations in Palestinian Municipalities

In Palestine, most municipal activities are governed by laws and regulations, but most of them were issued by previous authorities before the Israeli occupation in West

Bank and Gaza Strip (Qafishe, 2018). These laws, regulations, rules, and accounting policies and procedures are mentioned as annexes in the Terms of Reference (ToR) for hiring the external auditors in the LGUs. The ToR is approved by MOLG in 2016 as guidelines example for bid documents, and requires the external auditors to consider these laws, regulations, and accounting policies and procedures when they are performing the audit in the municipalities. In addition, the auditors must comply with other laws and regulations that relate to the municipality's activities and affecting its financial performance and are not mentioned in the following list:

- Act No. (1) of 1997 on Local Authorities
- General Electricity Act 2009
- Expropriation Act No. (2) of 1953
- Buildings and Land Tax Act within the Municipalities and Local Council Regions No. (11) of 1954
- Crafts and Industries Act No. (16) of 1953
- Land Tax Act No. (30) of 1955
- Act No. (79) of 1966 on the Regulation of Cities, Villages and Buildings
- Profession Licensing Act No. (89) of 1966
- Public Retirement Act No. (7) of 2005
- Act No. (12) of 2005 for the Election of Local Councils
- Education Tax Regulation No. (1) of 1956
- Financial Regulation for Local Authorities for the Year 1999
- The Regulation of the Joint Services Councils for the year 2016
- Vegetable and Fruit Market Regulation No. (3) of 1997

- The Regulation of Signs and Advertisements in the Local Authority Area No. (5) of 1998
- Slaughterhouse Regulation in the Local Authority Area No. (4) of 1998
- Local Authorities Employees Regulation No. (1) of 2009
- Regulation of Procurement and Executing Works in Local Authorities No. (1) of 1998
- Act of Vehicle Parking in Local Authorities No. (1) of 1998

In addition to the above laws and regulations, the ToR requires the external auditors to adhere the updated International Standards on Auditing (ISA) in their audit process and to consider the following accounting policies and procedures:

- Unified Chart of Accounts
- Accounting Procedures for Cash Basis
- Accounting Procedures for Accrual Basis
- Fixed Assets Valuation Methodology
- Guidance for Transferring from Cash Basis to Accrual Basis
- Annual Budget Preparation Declaration

2.5.3.2.3.3 Relationship between Laws and Regulations and Audit Quality

The auditor may be made aware of non-compliance or suspected non-compliance with applicable laws and regulations while performing an audit service for a client. Such non-compliance can directly affect the computation of considerable amounts and disclosures in a client's financial statements, and indirectly threaten the client's operational elements, its ability to continue functioning, or its ability to avoid material penalties (IFAC, 2018).

The effectiveness of internal control over financial reporting may be improved by more investment in the system to comply with rules, which could reduce the auditor's finding of control inadequacies (Yebba & Elder, 2019). In other words, the audit quality increases when the client complies with all applicable laws and regulations and achieves the goal of an effective internal control. The clients are guided in how to carry out their activities, including how to choose external auditors, the terms of the audit agreements, the scope of the audit process, and its results, by the laws and regulations that are applicable to them. This makes the auditor more cautious when developing audit procedures and methodologies and more determined to complete the audit in the most effective way. The study concluded that laws and regulations significantly affect the quality of audits.

Based on the preceding discussion, municipal internal control is expected to influence the audit quality. The outputs of the audit process are directly affected by the client's internal control components, such as internal audit, accounting basis, and applicable laws, rules, and regulations.

2.5.4 Supreme Audit Institutions

Supreme Audit Institutions (SAIs) are national organizations in charge of conducting compliance, performance, or financial statements audits in government organizations as well as their auditing adherence to legal requirements, relationships with other parties, and the efficacy of various governance techniques, procedures, and policies. Monitoring the use of public funds and the effectiveness and integrity of governmental processes and policies is the main objective of SAIs (Hay & Cordery, 2018).

Since the twenty-first century, there has been increasing awareness about the importance of SAI due to its importance in investigate the spending of government according to the related laws, regulations, accounting applicable framework, and approved budget. It also evaluates the effectiveness and efficiency of public sector programs (Bojkovska et al., 2019; Carrington et al., 2019). This type of audit is delivered by independent governmental agency for all PSOs (Johnsen, 2019), including the federal government (ministries), state governments, local governments, municipalities, state corporations, any business that receives funding from the government or is owned by it, such as hospitals and universities (Desmedt et al., 2017; Zbyslaw Dobrowolski, 2020; Johnsen, 2019). All public organizations and their users of public funds are subject to audits in accordance with the rules governing the budget system, financial transactions, financial statements analyses, and other audit records and data (Bojkovska et al., 2019). Normally, SAIs are granted unlimited power to perform their responsibilities professionally. For example, the Jordanian laws grant Accounting Bureau the authority to conduct auditing without any restraint and reveal all audit findings in the annual report to the legislature's authority, detailing the observations and notes made during the audit (Ahmaro, 2014).

Although SAIs report to parliaments, they are not part of the executive, legislative, or judicial branches of the government. In Greece and Portugal, they are part of the judiciary, but in other countries (e.g., France, Italy, and Spain), they are not part of the judiciary, even if they perform judicial functions (Dobrowolski, 2020). SAIs audit and evaluate public policies and programs for the benefit of their respective parliaments. Therefore, they work only as subordinates of their parliaments. Even so, they do not question the political goals themselves, but rather appraise how

they are being employed by public organizations (Dobrowolski 2020; Dobrowolski & Sułkowski, 2020).

The primary role of SAIs is to provide unbiased reporting on the activities, services, and pursuits of public-funding recipients as well as to provide reliable assurance and evaluation of the performance of the public sector in order to exercise responsible jurisdiction (Bojkovska et al., 2019). Therefore, the effectiveness of SAIs be contingent on the information function, which means that the SAIs perform their audit activities and formulate audit conclusions and recommendations; however, there is no legal requirement to follow these recommendations (Dobrowolski, 2020). Control, prevention, education and training, investigation, standards and regulatory, political, and advising duties of SAIs are derived from their primary function and their laws and regulations (Acker & Bouckaert, 2018; Dobrowolski, 2020; Dobrowolski & Sułkowski, 2020; Hay & Cordery, 2018).

The SAIs try to provide accurate, unbiased, and objective information in the audit reports they produce and make these reports available to the users, as well as all views and findings that are supported by adequate and pertinent audit evidence. The SAIs are responsible for promoting change, advancing knowledge, and making recommendations to enhance the effectiveness of the PSOs. SAIs aim to establish facts, identify the causes and effects of irregularities based on the audit evidence, and provide auditees with advice on how to get rid of irregularities and enhance their operations (Bojkovska et al., 2019; Dobrowolski & Sułkowski, 2020). The tasks of the SAIs can be summarized as follows: (1) to audit, review, and examine the proper use of public funds (revenue and expenditure) in the federal government, regional governments, and provinces; (2) to report the audit findings to the parliament and county council; (3) and to examine the accounts of the public administration and those

financially responsible for the state (Acker et al., 2017). The effectiveness of these tasks depends on the quality of the SAIs' auditors. Octavia and Widodo (2015) found that the quality of financial statements of PSOs is positively related to the competence of government auditors (SAIs). Competent auditors in SAIs can improve external audit quality because external auditors may rely on high quality financial reporting, which leads to high audit quality (DeFond & Zhang, 2014).

Ahmaro (2014) explained that every Arab state has its own mechanism for performing municipal audits. In Lebanon, municipalities are under the authority of the General Controller, not a ministry. In Jordan, the municipality's accounts are audited by the Ministry of Municipal Affairs and Accounting Bureau. In Iraq, the Ministry of Finance audits some municipalities, while the Bureau of Financial Control audits others. The Accounting Board is the body in Algeria that conducts municipal audits. Municipalities in Egypt are audited by the Ministry of Finance.

Financial and Administrative Control Bureau (FACB) is the SAI of Palestine, but there is another body does as SAI in the Palestinian municipalities established by MOLG at the name of the General Department of Control and Guidance (GDCG). Both agencies perform compliance and performance audit for LGUs. The following subsections discuss each agency.

2.5.4.1 Financial and Administrative Control Bureau (FACB)

The Palestinian National Authority (PNA) was established in Palestine in 1993, and following it was the creation of many PSOs. The audits of PSOs commenced in 1994 under Presidential Decree 22/1994, which was later amended by Act 17/1995. Both acts relate to the establishment of the General Audit Institution (GAI), which was later replaced by the Financial and Administrative Control Bureau (FACB) Act

no. 15/2004. This law is based on Palestinian Basic Act of 2003 and passed in 2005. The FACB is one of the SAIs of Palestine. It is also known as State Audit and Administrative Control Bureau (SAACB), as stated on its official website. This study uses its name as it appears in the law, FACB. The FACB is a statutory body whose activities are planned by its own statute. It has a budget that is included in Palestine's overall budget, independent legal personality, and complete legal competence to exercise the duties and exercising the authority granted by the FACB Act and other relevant laws and regulations. FACB's main goals are to ensure that the financial and administrative operations of Palestine's executive, judicial, and legislative entities are sound and sustainable, to reveal any financial or administrative fraud or material errors, including the abuse of public positions, and to make sure that public performance is carried out in a reasonable, efficient manner in accordance with applicable laws, regulations, bylaws, instructions, standards, and procedures (FACB, 2021).

The FACB works to improve its professional and transparent relation with PSOs under audit and stakeholders to enhance audit quality, improve performance, and conserve public funds. The FACB adopts the standards of the International Organization of Supreme Audit Institutions (INTOSAI) standards and international standards on audit. It is committed to improve its conduct to fulfil with all INTOSAI standards (FACB, 2010). The FACB releases quarterly and annual reports that include overall operations carried out in accordance with the pre-established plan or emergency issues, in addition to the individual audit reports of public bodies. The Palestinian president, the legislative council, and the council of ministers are all given these reports as proposed laws. All PSOs subject to financial and compliance audit are

allowed to use control processes under the FACB's legislative mandate. It just began performing performance audits as part of a development program (FACB, 2021).

Article 3 of the FACB Act No. 15 of 2004 states that the main objectives of the FACB are as follows:

1. Ensure the financial activity is sound and that public funds are used for the intended purposes.
2. Conduct administrative inspections, ensure performance effectiveness, assure proper authority application, and disclose any deviations when they are discovered.
3. Verify that financial and administrative operations comply with relevant laws, rules, regulations, and resolutions.
4. To guarantee public performance is fair, unbiased, and transparent as well as to reinforce the PNA's financial, administrative, and economic policies' dependability and trustworthiness.

Article 31 of Act No. 15 lists PSOs that are under the jurisdiction of the FACB. They include LGUs, i.e., municipalities, village councils, and others, as specified in item 10 of Article 31. The PSOs in Article 31 are as follows:

1. The presidency of the PNA and its related institutions.
2. The prime minister, cabinet members, and officials of equivalent offices.
3. The legislative council and all of its divisions and institutions.
4. The judicial authority, the prosecution, its members (prosecutors), and its staff.
5. The ministries and the bodies of the PNA.
6. The police, security forces, and all military and security bodies.

7. Public and private bodies and institutions, trade unions, associations, and federations of all kinds and levels and their equivalent.
8. Organizations and companies that are owned or contributed by the PNA, or receive assistance from the PNA or from its donors to the PNA.
9. Institutions and companies licensed to operate or manage a public facility.
10. Local government units, - municipalities, village councils, and other units.
11. Unless there is a special provision regarding it, the requirements of this law shall apply to the entities that contain laws, regulations, bylaws, or decisions issued in respect of them with special rules.
12. The bodies, departments, and units to which the provisions of this law apply are called "administrative bodies".

The FACB has developed the Palestinian Government Auditing Standards based on INTOSAI standards, code of ethics as amended by the ISA, and ARABOSAI membership requirements. The FACB, as Palestine's SAI, is mandated by law to accomplish the national audit development goals:

- Increase transparency and accountability: Audits are conducted to determine whether regulations are in place, whether financial/administrative procedures followed are in accordance with applicable laws/regulations/decisions, to ensure proper use of power, to disclose deviations in order to ensure efficient performance, to avoid corruption, and to increase transparency/accountability of the State of Palestine's public performance.
- Increase local government response to citizens: Through audit reports on local government entities, the FACB guarantees the compliance of local government

entities with relevant laws and regulations, as well as efficiency and economy in resource management (FACB, 2017).

On October 2010, the FACB issued Ordinance No. 1 of 2010 on the Adoption of Palestinian Government Auditing Standards (PGAS). According to Article 4 of the Ordinance, licensed Palestinian auditors shall disclose their compliance in the auditor's report in accordance with the law on the practice of the auditing profession when auditing any entities subject to the mandate of the Bureau. When auditing entities subject to the Bureau's mandate and its procedures, the auditor must comply with the code of ethics adopted in the Standards according to Article 5. According to Article 14, "the auditor shall promptly and within a period not to exceed two weeks from the date of the discovery of the violations notify the Bureau of any financial and regulatory violations at entities subject to the mandate of the Bureau. The other articles of the Ordinance relate to the relationship between the external auditors, FACB, and their clients (FACB, 2010).

In 2019, the FACB issued 125 audit reports, 63 of which are related to LGUs. There are 571 LGUs (including joint service councils) under the jurisdiction of the FACB, which means that it has not been able to audit every LGU. In fact, some municipalities have not been audited for many years. The FACB's auditors also visited 91 LGUs during 2019 to investigate various complaints (FACB, 2019)

2.5.4.2 General Department of Control and Guidance (GDCG)

The General Department of Control and Guidance, a separate department in the MOLG, performs assurance and advising activities to LGUs. Therefore, the department's auditors investigate and evaluate the efficiency and effectiveness of the

operating activities of the municipalities and other LGUs, and examine the extent of their obedience with wide-ranging laws, regulations, policies, budgetary announcement, procedures, and instructions issued by the MOLG related to the financial and operational activities of municipalities.

The MOLG states that the main objectives of the GDCG are:

1. Assuring the security of financial transactions and the correct use of public funds for the purposes for which they were intended.
2. Ensuring effective results, proper delegation of authority, and the detection of anomalies wherever they occur.
3. Examining the degree to which the financial and administrative operations of LGUs comply with applicable laws, rules, and decisions, as well as approved circulars.
4. Increasing public results' transparency, fairness, and accountability to increase public results' trust in and reputation for financial and administrative policies (MOLG, 2011).

GDCG auditors visit each LGU twice a year and provide a primary audit report to the LGU council at the conclusion of each visit (MOLG, 2013). The focus of this report is on compliance audits and substantial changes that occur between two visits; in some situations, the Department follows up on citizen complaints and audit reports provided by the FACB and external auditors (MOLG, 2011). It also joins in the evaluation of external auditor procurement bids and ensuring the external auditors' conformity with the ToR (MOLG, 2013).

The above discussion indicates the importance of SAIs (FACB or GDCG) in the auditing of municipalities. Their audit can affect external audit quality. additionally,

based on the public interest theory, the SAIs' activities reflect the government's interference in the direction of municipalities. The public interest theory can explain the relationship between most variables of the study. Government involvement strives to benefit all parties by implementing laws and regulations that allow local governments to achieve their goals of providing community services in an efficient and effective manner. These laws and regulations also allow management to demonstrate openness and responsibility by providing trustworthy information to all stakeholders.

2.6 Hypotheses Development

This section presents the research hypotheses, which are developed based on the above discussions. The main variables and their dimensions are (1) auditor characteristics (ethics, independence, and competence); (2) audit firm attributes (audit fees and audit firm size); and (3) effectiveness of municipal internal control (internal audit, accounting basis, and laws and regulations). In addition, the study examines the effect of SAIs as a moderator between audit quality and those main variables.

2.6.1 Auditor Characteristics

As discussed in Section 2.5.1, numerous studies have shown the positive relationship between auditor characteristics and audit quality. This study expects auditor characteristics to be positively associated with audit quality. Thus, the following hypotheses are proposed:

H1: There is a positive relationship between auditor characteristics and audit quality.

H1a: There is a positive relationship between auditor ethics and audit quality.

H1b: There is a positive relationship between auditor independence and audit quality.

H1c: There is a positive relationship between auditor competence and audit quality.

2.6.2 Audit Firm Attributes

As discussed in Section 2.5.2, many studies have found a positive relationship between audit firm attributes and audit quality. This study expects audit firm attributes to be positively related to audit quality. Thus, the following hypotheses are proposed:

H2: There is a positive relationship between audit firm attributes and audit quality.

H2a: There is a positive relationship between audit fees and audit quality.

H2b: There is a positive relationship between audit firm size and audit quality.

2.6.3 Effectiveness of Municipal Internal Control

As discussed in Section 2.5.3, many studies have found a positive relationship between the effectiveness of municipal internal controls and audit quality. This study expects that the effectiveness of internal control positive related to audit quality. Thus, the following hypotheses are proposed:

H3: The effectiveness of municipal internal control has a positive influence on audit quality.

H3a: Internal audit has a positive effect on audit quality.

H3b: Accrual basis accounting has a positive effect on audit quality.

H3c: Laws and regulations have a positive effect on audit quality.

2.6.4 Supreme Audit Institutions

As mentioned in earlier sections, audit quality is positively related to auditor characteristics, audit firm attributes, and the effectiveness of municipal internal controls. Do SAIs moderate the relationship between audit quality and its

determinants (Auditors Characteristics, Audit Firms Attributes, and Effectiveness of Municipal Internal Control)? To answer this question, the study develops three sub-hypotheses relating to the effect of SAIs on the relationships between audit quality and its determinants. The determinants chosen for this study are auditor characteristics, audit firm attributes, and the effectiveness of municipal internal control.

The FACB issued the Palestinian Government Auditing Standards (PGAS) in October 2010, which are based on the INTOSAI and the code of ethics as updated by the ISA (FACB, 2010). In the financial reporting system of PSOs, the PGAS place a strong emphasis on strong internal controls, including internal audit, an appropriate accounting information system, and compliance with relevant laws and regulations. In 2016, the MOLG issued the Terms of Reference (ToR) for the procurement of external audit services as guidelines for Palestinian municipalities. The ToR listed a few qualities of auditors and audit companies, including audit team size, auditor independence, competency, and ethics. It also explained how to choose the best audit services charge. The MOLG has also published a number of regulations to activate internal control in municipalities over their activities, particularly the financial reporting system. As another SAI for municipalities, GDCG keeps an eye on these rules.

The PGAS and ToR of the MOLG mandate that municipal external auditors adhere to the Code of Ethics and uphold the following principles: trust, confidence and credibility, independence, objectivity and impartiality, professional secrecy, competence, professional development, political neutrality, conflict of interests, and professional skepticism (FACB, 2010). Moreover, Supreme Audit Institutions (SAIs) play an important role in the operation of governments by informing legislators and

other stakeholders through independent audit reports. They support strong government, accountability, and openness (World Bank, 2020). This means that the role of the SAIs is assistant in the effective of external audit process and influence indirectly on the audit quality. Accordingly, the study formulates the following hypothesis:

H4a: SAIs moderate the relationship between auditor characteristics and audit quality.

Some characteristics of the audit firm, including audit fee and audit firm size, are included in the ToR of the MOLG. Along with the specialty and rating of the auditors in the audit engagement team, it also mentions the number of auditors in the team based on how LGUs are categorized. The MOLG requires the municipalities to comply with the public Purchase Act in procuring audit firms, which means prioritizing those with the lowest audit fee. Accordingly, the study develops the following hypothesis:

H4b: SAIs moderate the relationship between audit firm attributes and audit quality.

Internal control should be investigated and evaluated in accordance with the type of audit being undertaken, according to the PGAS, which mandates that auditors analyze and assess the dependability of the client's internal controls. Internal control assessments, for instance, may help to preserve assets and resources and to guarantee the accuracy and completeness of accounting records. In addition, the auditor must check for compliance with applicable rules and regulations to give a reasonable assurance of finding mistakes, irregularities, and unlawful activity that could materially affect the financial statements (FACB, 2010). The MOLG mandates that class A and class B municipalities set up an internal audit division to assess the efficacy and efficiency of their operations. To oversee all of the towns' financial

activities, each municipality is required to form an audit committee that is comprised of members of the local council. The MOLG has additionally published guidelines and instructions that describe how to switch from cash basis accounting to accrual basis accounting. It also encourages the municipalities to adopt the accrual basis, because it is more reliable method of accounting. Accordingly, the study develops the following hypothesis:

H4c: SAIs moderate the relationship between the effectiveness of municipal internal controls and audit quality.

The following Table 2.1 summarizes the study hypotheses and the codes of the variables and the path of each hypothesis.

Table 2.1: Research Hypotheses Codes and Descriptions

Code	Description	Path
Direct or Causal Effect Hypotheses		
H1 ⁺	Auditor Characteristics (ACH) has significant positive effect on Audit Quality (AQ)	ACH→AQ
H1a ⁺	Ethics (ET) has significant positive effect on Audit Quality (AQ)	ET→AQ
H1b ⁺	Independence (IN) has significant positive effect on Audit Quality (AQ)	IN→AQ
H1c ⁺	Competency (CM) has significant positive effect on Audit Quality (AQ)	CM→AQ
H2 ⁺	Audit Firm Attributes (AFA) has significant positive effect on Audit Quality (AQ)	AFA→AQ
H2a ⁺	Audit Fees (AF) has significant positive effect on Audit Quality (AQ)	AF→AQ
H2b ⁺	Audit Firm Size (AFS) has significant positive effect on Audit Quality (AQ)	AFS→AQ
H3 ⁺	Effectiveness of Municipal Internal Control (EMIC) has significant positive effect on Audit Quality (AQ)	EMIC→AQ
H3a ⁺	Internal Auditing (IA) has significant positive effect on Audit Quality (AQ)	IA→AQ
H3b ⁺	Accounting Basis (AB) has significant positive effect on Audit Quality (AQ)	AB→AQ
H3c ⁺	Laws and Regulation (LR) has significant positive effect on Audit Quality (AQ)	LR→AQ

Table 2.1, continued

Code	Description	Path
Moderation Effect Hypotheses		
H4a	Supreme Audit Institutions (SAI) moderates the relationship between Auditor Characteristics (ACH) and Audit Quality (AQ)	ACH*SAI→AQ
H4b	Supreme Audit Institution (SAI) moderates the relationship between Audit Firm Attributes (AFA) and Audit Quality (AQ)	AFA*SAI→AQ
H4c	Supreme Audit Institutions (SAI) moderates the relationship between Effectiveness of Municipal Internal Control (EMIC) and Audit Quality	EMIC*SAI→AQ

Source: Author

2.7 Conceptual Framework

Based on its theoretical foundation and the definitions of the audit quality attributes as discussed in earlier research, this study developed its conceptual framework. As discussed in Section 2.3.1, the public interest theory is able to explain most variables in the study. According to this theory, superior authorities impose some rules on the organizations to prevent unwelcome results and to achieve specific goals, such as obtaining credible and reliable information on the municipalities operations. This goal can be achieved if the external auditors produce a high-quality audit of the municipalities. To achieve this goal, the MOLG has approved and issued in 2016 the ToR for the procurement of external audit services as guidelines for Palestinian municipalities. This ToR defined several independent factors associated with the traits of auditors and audit companies, including audit team size, auditor independence, competency, and ethics, also, it described how to choose the most appropriate cost for audit services. Additionally, the MOLG has released a number of regulations to implement internal controls for the municipality's activities, particularly the financial reporting system. Class A and B municipalities must have an internal audit department in order to assess the efficacy and efficiency of their operations to be according to the MOLG standards. To oversee all of the municipalities' financial activities, each

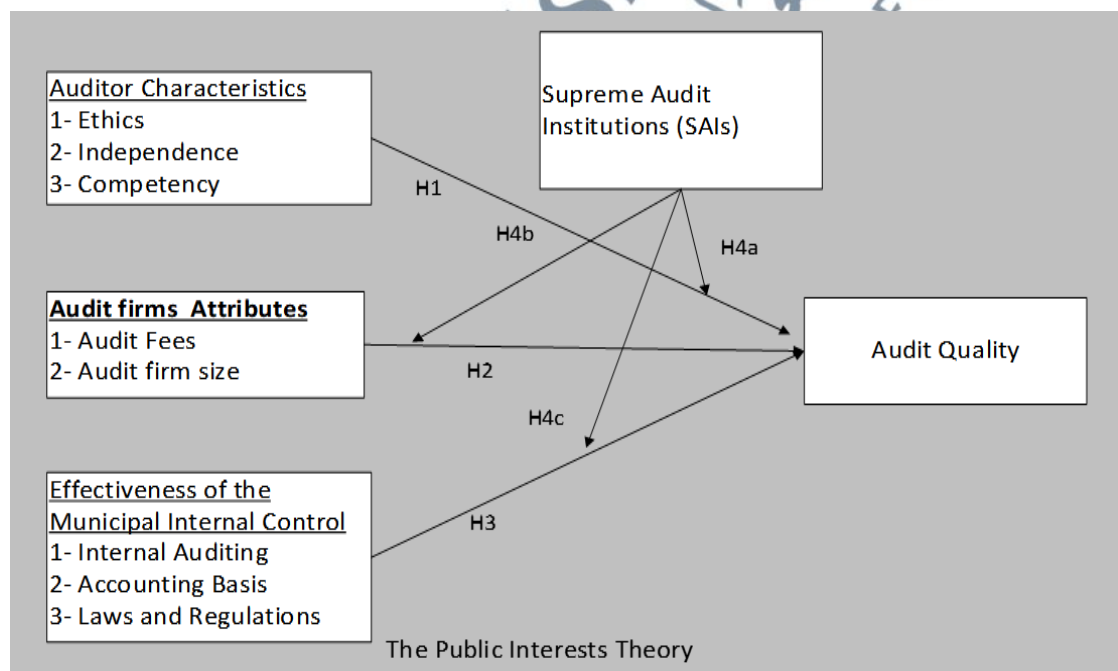
municipality is required to form an audit committee from the members of the local council. Additionally, the MOLG has published policies and guidelines that outline how to switch from cash basis to accrual basis accounting and urges local governments to do so because it is a more accurate manner of accounting. Along with the FACB, the MOLG also established the GDCG to keep track of how well the LGUs, particularly municipalities, adhere to relevant laws and regulations.

The above procedures taken by the MOLG are consisting with the elements and objectives of COSO Integrated framework and the public interest theory. For example, MOLG issues and updates the laws, regulations, guidelines, and accounting policies and procedures to support the municipalities and other LGUs to achieve the objectives of COSO and its elements as controls of the environments, control activities, risk assessment, information and communication, and monitoring. Also, the establishing GDCG in MOLG and encouraging the establishment of internal auditing units in the municipalities support the monitoring element of COSO.

From the above discussion, the interventions of the superior authority, in this case the MOLG, in the municipalities to achieve public interest are consistent with the public interest theory. The moderating impact of SAIs can be explained by the public interest theory, as well as the correlations between the independent variables and the dependent variable. Also, there are other supporting theories that can explain specific issues in this study, such as the stakeholder theory and agency theory (see Sections 2.3.2 and 2.3.3).

According to the audit quality literature, three categories are used in this study to classify audit quality attributes: (1) auditor characteristics (ethics, independence, and competence); (2) audit firm attributes (audit fees and audit firm size); and (3) effectiveness of municipal internal control (internal audit, accounting basis, and laws

and regulations). This classification provides an effective framework to facilitate the understanding and measurement of audit quality in Palestinian municipalities from the perspectives of their accountants and internal auditors who play a significant role in creating the financial accounts and who frequently communicate with external auditors. The study includes only two or three factors under each construct to facilitate the research, as it is unfeasible and complex to include all possible determinants of audit quality. Additionally, the determinants of audit quality tend to overlap, and as such only the most representative factors are included. This study also explores whether the SAIs, as unique entities within the context of the municipalities, moderate the relationship between audit quality and its three main determinants. The conceptual framework is summarized in Figure 2.3.



Source: Author

Figure 2.3: Conceptual Framework

2.8 Review of Empirical studies on Audit Quality

Prior studies have investigated the determinants of audit quality in the private sector. A few studies have been carried out on PSOs, including municipalities. Table 2.2 summarizes past empirical research on the association between audit quality and its determinants.



Table 2.2: Summary of Some Prior Studies on the Determinants of Audit Quality

Study	Independent variables	Evidence	Significance	Audit quality or its proxies	Notes
Ismail et al. (2019) Malaysia	Auditor independence	+	Sig.	Audit quality	Survey data collected from 114 auditors involved of public entities in Malaysia. The data is analyzed using correlation test and regression test.
	Auditor competence	+	Sig.	Audit quality	
	Work overload	-	Not Sig.	Audit quality	
Kusumawati and Syamsuddin (2018) Indonesia	Auditor quality			Audit quality	Indirect effect
	Professional skepticism	+	Sig.	Audit quality	Direct effect
	Auditor quality	+	Sig.	Professional skepticism	Direct effect
	1. Ethics				
	2. Commitment				
	3. Independence				
	4. Competence	+	Sig.	Auditor characteristics	
5. Experience					
	1. Auditor's doubt towards audit evidence	+	Sig.	Professional skepticism	Survey of auditors in the Audit Board of the Republic of Indonesia in South Sulawesi Partial least squares for analysis
	2. Immediate confirmation				
	1. Field work instructions				
	2. Responsiveness to the need of clients	+	Sig.	Audit quality	
	3. Leader involvement in the audit				
	4. Auditor work				

Table 2.2, continued

Study	Independent variables	Evidence	Significance	Audit quality or its proxies	Notes
Butcher, Harrison, and Ross (2013) Australia / NSW	<ol style="list-style-type: none"> 1. Relationship <ul style="list-style-type: none"> • Council experience • Industry expertise 2. Competence <ul style="list-style-type: none"> • Reputation • Assurance • Capability 3. Independence 4. Audit Service qualities/ Responsiveness 	+	Sig.	Audit service quality Auditor retention	The survey for the sample of 235 finance professionals, and 35 internal auditors of NSW municipalities
Boon et al. (2008) Australia / NSW	<ol style="list-style-type: none"> 1. Council experience 2. Industry expertise 3. Technical competence 4. Field work conduct 5. Executive involvement 6. Skepticism 7. Independence 8. Freshness of perspective 9. Due care 10. Quality commitment 11. Individual responsibility 12. Ethical standards 13. Responsiveness 14. Audit Committee 	+, except skepticism	Sig.	Audit service quality satisfaction	The survey for the sample of 235 finance professionals, and 35 internal auditors of NSW municipalities

Source: Author

Ismail et al. (2019) studied the relationship among audit quality and auditor independence, auditor competence, and work overload. They emphasized that auditor independence positively relates to audit quality. Auditor competence has the strongest relationship with audit quality, while work overload negatively affects audit quality. Data were collected through a survey of 114 public sector auditors in Malaysia, and they were analyzed using correlation test and regression test. Similar to this study, the authors focus on the public sector context. The factors were measured from the perspective of SAI auditors without using any audit quality proxy. Their study was underpinned by the theory of inspired confidence, which argues that audit quality increases with more independent and competent auditors.

Kusumawati and Syamsuddin (2018) examined the relationship between auditor characteristics (auditor ethics, independence, commitment, competence, and experience), professional skepticism (auditor's doubts towards audit evidence and immediate confirmation), and audit quality (good response to the need of clients, guidelines for field work, the involvement of leader, and auditor work). According to the study, there is a direct relationship between auditor characteristics and professional skepticism, a direct relationship between professional skepticism and audit quality, and an indirect relationship between auditor characteristics and audit quality via professional skepticism. The study investigated the relationship between audit quality and professional skepticism. The province of South Sulawesi's auditors for the Republic of Indonesia's Audit Board were surveyed by the authors. The partial least squares method was used to examine the data. The authors focus on public sector audit and examined the effects of auditor characteristics on audit quality through the mediation of professional skepticism. However, they did not include audit firm

attributes and environmental factors. Moreover, they did not examine the quality of external auditors.

Within the context of mandatory tendering for local governments in the Australian state of New South Wales, Butcher et al., (2013) investigated the relationship between auditor retention and perceived audit service quality. The authors distributed a questionnaire containing 48 audit service quality attributes drawn from the literature to finance professionals and internal auditors in local government units. The study was based on the marketing model in Ismail et al., (2006) and hypothesized a positive correlation between the perceived quality of audit services and auditor retention due to the satisfaction of the local government councils with the audit quality. The study used the taxonomies of Carcello et al. (1992) and Schroeder et al. (1986) in its sensitivity analysis. The study offers proof that higher-order relationship variables (by the expertise dimension) and service qualities (via the responsiveness to client needs dimension) are linked to auditor retention. This study focuses on the public sector in a developed country. It examined audit quality through the proxy of audit retention, which indicates the satisfaction of clients with the audit.

Boon et al. (2008) examined the most important audit quality attributes as perceived by local councils in New South Wales, Australia. The data were collected using a questionnaire sent to 235 finance professionals and internal auditors in the local councils. The results showed that audit firm experience with a local council, industry (public sector) expertise, auditor competence in technical aspects, ethical values and principles, due care, and independence are the most significant attributes of audit service quality. The least important attributes are skepticism, audit firm size, freshness of perspective, and non-audit services. The study focuses on local councils in developed country. However, it only determined audit service quality attributes as

perceived by the internal financial experts and auditors of those councils. They did not consider other factors that may affect audit quality, such as SAIs.

In addition to the above studies, Ghebremichael (2018) collected 54 audit quality attributes divided into three categories of technical (competence) audit quality, functional audit quality, and auditor independence. Technical audit quality includes whistle blowing (public agent), detection and reporting of fraud and illegal acts, and integrity in financial reporting process. Functional audit quality includes reliable audit process, company and industry knowledge, easy-to-deal-with, reliable, providing quality insights, and accessibility. The author considered auditor independence as a unique technical audit quality attribute in the sense that it is a single variable loaded into a factor by itself. Moreover, Lai and Pham (2020) found five key factors affecting audit quality, namely tangibles, reliability, responsiveness, assurance, and non-audit service. But Duff (2004) provided a model for audit quality that had two key dimensions: technical quality and service quality. Technical quality had five lower-order factors: reputation, competency, independence, expertise, and experience (responsiveness, empathy, client service, and non-audit services).

There are many studies on audit quality, but most of them either focus on the private sector and developed countries and address one or more determinants of audit quality. Only a few of them have proposed an integrated framework to understand the causes of audit quality (Chadegani, 2011; DeFond & Zhang, 2014; Francis, 2011; Knechel et al., 2013). This study discusses audit quality and its attributes in Palestinian municipalities. Palestine is a developing country under the Israeli occupation and administration of the PNA. Results from the private sector cannot be easily generalized to the public sector since managers and auditors are subject to different institutional and incentive frameworks (Greenwood & Zhan, 2019).

However, both sectors still share some common concepts, theories, and practice, hence it is possible to build on the wealth of literature on audit quality in the private sector.

While prior studies investigated one or more variables of audit quality or introduce different frameworks of audit quality in the private or public sector, this study provides a comprehensive integrated framework of audit quality in municipalities as the most important type of PSOs. This study examines three main categories of audit quality determinants. Each category includes selected elements that totally or partially represent the other elements in the category. Auditor characteristics include auditor ethics, independence, and competence. Audit firm attributes include audit fees and audit firm size. The effectiveness of municipal internal controls includes internal audit, accounting basis, and laws and regulations. This study adds to its framework the moderation effect of SAIs as a unique audit institutions of PSOs between audit quality and its determinants.

Prior studies used proxies for audit quality because it is not directly observable. Most studies measure audit quality as the tendency of the auditor to issue a going concern audit opinion, a modified audit opinion, and discretionary accruals, but these proxies are not entirely applicable to the public sector. Most PSOs are established by political decisions and operate according to applicable laws and regulations without considering the efficiency of their activities and generating profits, even if the governments encourage PSOs to operate their activities economically. When these organizations suffer from losses or face high risks, they do not become bankrupt or enter liquidation, unlike private organizations. This means that the going concern opinion is not a suitable measure of audit quality in municipalities. Abnormal accruals and discretionary accruals are also unsuitable proxies because municipalities use cash

basis accounting, and most accruals such as debts are governed by laws and government regulations. This study relies on the satisfaction of accountants and internal auditors towards the performance of the external auditors to measure audit quality. The attributes were collected from instruments in the literature. They were then modified and reclassified to fit into the conceptual framework of this study. The current study contributes to the literature by examining new external audit quality variables, namely SAIs and some elements of the effectiveness of municipal internal controls.

2.9 Summary

This chapter has presented the background of PSOs and discussed the underpinning theories of the study. It has also discussed audit quality and its importance, definitions, measures, and determinants, as well as auditor characteristics and audit firm attributes. Additionally, it has discussed the effectiveness of municipal internal controls and supreme audit institutions (SAIs). The research hypotheses have been formulated after reviewing the relevant audit quality literature. Similarly, the conceptual framework has been designed. The chapter ends with a review of empirical studies on audit quality.