

"The Impact of Quality of Audit on Earning Management"

A literature Review

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Abstract

The relationship between the (AQ) and (EM) has been the subject of numerous studies during the past decade. Where the global financial markets witnessed several financial scandals of the major international companies, such as "Enron" in 2001 and "World.com" in 2002. The is due to several reasons, the most notably the manipulation of the financial statement of these corporations, which led to questioning of many interested parties regarding the ability of the auditors to detect such manipulations. Therefore, there is an urgent need to provide high (AQ) services capable to detecting such errors. The purpose of this paper is attempting to wading into previous studies that focused on the (AQ) on (EM) by reviewing 10 relevant scientific articles in both developed and emerged economics. This paper will also discuss some of the proxies that is used to measure the (AQ) and (EM) as well as presented the main findings and suggested the future research related.

Key Words: The Quality of Auditing, Earning Management, A Literature Review.

1.0. Introduction

The relationship between the (AQ) and (EM) has been subject in many studies in both past and nowadays for both developing and developed countries. During the past period, many major companies in the world have been faced huge financial scandals as result of manipulation in their financial statements. For one or more reasons, some managers misrepresented the financial statement, which mislead the users of these "financial statements", taking advantage of the flexibility that is provided by some accounting methods (Yasser & Soliman, 2008).



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The repercussions of practices of manipulation of real activities are not only affected by the profit figure set for him in the current period, but also reflect the results of such practices as misuse of the company's resources and waste of opportunities and benefits that may be available to the company, which may affect the value of the company and its performance in the long term, so the real management of profits It means that managers deviate from the plan and optimize performance in order to influence profits, and then this practice imposes a real cost on the company (Cupertino et al, 2016).

Therefore, many companies try to hire auditors who have high quality. Because, on average, the companies that hire low quality auditors has a greater chance to report their earnings incorrectly. However, this plan may not always be successes because the investors discounting the reported earnings of such companies that have low (AQ) to protect themselves (Sahay & Peikes, 2012). The paper's procedures are as follows: it's given the definition of the (AQ) as well as the (EM), followed by presented the list of the previous studies. It will also have a discussion of the main findings. Finally, it will provide guidelines to prepare for the upcoming papers.

2.0. Method

The research methodology is based on collecting part of the definitions of each of the (AQ) and (EM) through reviewing and reviewing scientific articles that were published in international periodicals or official sites of professional bodies on the Internet, and then analyzing the content of these variables and knowing the findings of previous studies related to the topic search.

3.0. Theoretical Framework

3.1. The Quality of Auditing

There are many international organizations have been interested in establishing standards to improve the (AQ). In 2006, the first attempting to establish (AQ) framework by Financial Reporting Council (FRC) was in the United Kingdom. The main purpose of the framework was to assist the interested parties in the (AQ), such as companies, audit committee, stakeholders, as well as regulators. The FRC agrees that there is no specific definition of the concept the (AQ) because its indicators may change over the time (FRC, 2008).

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However, the (AQ) has been defined by (Yasser and Soliman, 2018) as “the audit that is performed by a highly specialized, independent auditor who issues a proper opinion based on the appropriate evidence”. The (AQ) also defines as “the audit that improves the reliability of financial statement information and allows investors to make a more precise estimate of the firm’s value” (Behn, Choi, & Kang, 2007, P2). While DeAngelo 1981 defines the (AQ) as “market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach”. In order to find the breach, the auditor will be relied on many factors, such as the sample size that is used by the auditor, technological ability of the auditor, in addition to the procedures that is used by the auditor. Moreover, the process the applied by the auditor to report the breach that was discovered will measure the independence of the auditor. (DeAngelo, 1981).

The DeAngelo definition is considered one of the most a widely accepted definitions in many books and researches that have focused on the (AQ). It has identified two of the key functions that should perform by each auditor which is finding the errors and reporting them. The auditors that have high quality are expecting to be more likely to detect the errors and report them as well as irregularities in comparison with low quality auditor. Also, the high-quality auditors will be less likely to perform questionable accounting methods. The value of the company is expected to reduce, and reputation of the company will be affected if there is misreporting of the (EM) is revealed (Becker, et al, 1998).

3.2. Earning Management

The previous studies mention several definitions of (EM). (Schipper, 1989) defined (EM) as ”purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain”.

(EM) also defined by (Healy& Wahlen, 1999), “(EM) occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers”. The definition above invoked two points regards the management ruling on its financial reporting which lead to (EM). The first point is if the purpose of the ruling the financial reporting is to

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deceive the stockholders regarding the company performance. The financial statements can be affected when the managers use their judgement to estimate some economic events, such as losses from bad debt, deferred tax, etc, because these events reflected in the financial statements. The second, if the ruling intend to impact of contractual outcome based using some on accounting method. Moreover.

(EM) also defined by (Mulford & Comiskey, 2002) as “the active manipulation of earning toward a predetermined target, which may be set be management, a forecast made by analysts or an amount that is consistent with a smoother, more sustainable earning stream”.

(Omar et al, 2014) believes that the assumption that profit management is a fraudulent activity must depend on the motives behind the methods used in managing profits and their results, as they see that, according to the different motivations of profit management, its implications and impact on the company's stock prices and its continuity, some of these implications are good. The company and some of them are bad depending on the motivations for doing profit management. Consequently, the motivations of profit management were classified in (Healy & Wahlen, 1999) study into three groups represented in capital market, contractual and organizational motives.

4.0. Literature Review

Through examining different literature, most of the previous studies indicated that (AQ) has impact on (EM). The literature selected for this review including studies covering a variety of developed and emerged countries.

A study by Becker et al (1998) focused on the relationship between (AQ) and profit management by focusing on discretionary benefits. Through the use of a sectional version of the Jones model developed in 1991, the study estimates estimated benefits through observation from the total sample 9,035 companies audited by 6 senior auditors, while the overall sample of audit firms monitored by auditors Non-senior were 1,846. The result found that the level of the estimated entitlements of companies audited by six large auditing firms was 1.5% lower than the assets of the estimated entitlement firms that audited with six insignificant auditing firms. This result also indicates that the low (AQ) is associated with more "accounting flexibility".

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Similar study conducted by Ebrahim (2001), the purpose of this study was investigated the impacts of the (AQ) on (EM) behavior taking in consideration other variables factors impacts, such as audit tenure and the importance of the client. Assuming the process of the audit plays as monitoring tool to reduce the earning manipulation that may conduct by managers. Using modified Jones model to measure the discretionary accruals between 1998 and 1999, the total sample of the study was 1938 U.S companies that were listed in New York Security Exchange, AMEX, and NASDAQ. The findings of the study indicated that the (AQ) have a negative impact on (EM). The relation between the audit tenure and discretionary accruals was also negative. Over the time, auditors will have more knowledge about financial reporting environment and operations of their client, as a result they will be more capable to prevent opportunistic accruals. The importance of the client will not have any impacts on the independence and integrity of the auditors.

In contrast to most previous studies focused on public sector companies, (Tendeloo and Vanstraelen, 2008) conducted a study on the effects of (AQ) (the four major audit firms) on profit management in private companies in six European countries. The study also examines the level of (AQ) that the Big Four auditing firm provides throughout the European Union when it audits private sector firms. This study provides evidence that private companies are less involved in managing earnings when they have a large 4 auditor compared to a non-large 4 auditor. We find that private companies based in countries with stronger investor protection are less involved in profit management. However, our results also indicate that (AQ) and strong investor protection are alternatives in restricting profit management in private companies, meaning that the quality difference between large and non-large audit firms 4 weakens in countries with stronger investor protection. The results indicate that the distinction between (AQ) is also present in private companies, indicating that the reputation concerns of the Big Four auditors are strong enough to control the high ethical risk risks in the private client segment. Moreover, the quality difference between large and large non-auditing firms 4 is weakening in countries with stronger investor protection.

Another study conducted by (Jordan et al 2010), the goals of the study was to investigate the impact of the (AQ) on (EM). Unlike other studies who is examined the effect of the (AQ) on (EM) in general, this

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study focused on one specific type of (EM) which is “earnings manipulation to achieve cognitive reference points in earning per share (EPS)”. Through using the size of the audit (big 4 versus non-big4) as a proxy for quality of the audit, the study argue weather the (AQ) prevents the (EM) to impact the users reference point in earning per share in the United States. The study found that companies who were audit by a big 4 audit and large CPA firms did not manipulate their (EM) to achieve a user reference points in EPS on the contrary with companies that were audit by a non-big 4 audit, the findings indicated that managers of the firms rig their earnings in order to change their earning per share to users references points. To sum up, the study showed that large audit firms have a significant impact in terms of constrains their clients from manipulate their earnings as well as EPS compared with audit firm that are relatively small in the United States.

Chen et al (2011) conducted a study on the effects of (AQ) on (EM) and costing capital for two groups of companies in China. The first group was state-owned companies (SOEs) and second non-state-owned corporations (NSOEs), and the differences between them were related to factors such as the nature of ownership and bankruptcy risk in addition to the agency's relationship. The study used discretionary benefits as an alternative to gain management by applying the absolute and signed to the Jones model of the corresponding performance adjustment, while applying the size of the audit firm as an alternative to (AQ). The study found that non-state companies have a greater reduction in the cost of capital than private companies when they use both NSOEs and SOEs as high-quality auditors. It also found that high-quality auditors play a governance role in China, this role is limited to a subset of companies, even under the same legal jurisdiction, and the effects of (AQ) (in the form of lower profit management and cost of equity capital) differ between firms with structures Different ownership.

Another study also conducted by Yaşar (2013), the study aimed to examine the affect the (AQ) on the (EM). The study uses the audit firm size as measurement for the (AQ) in addition to using the discretionary accruals as proxy for the (EM). Through using a cross-section version of modified Jones model over the period of 5 years extending from 2003 to 2007, 290 samples of the Turkish manufacturing companies that listed in Istanbul Stock Exchange (ISE) were observed. However, there was

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proximity 55% (160) of these companies were audit by non-big 4 audit firms, while the other 45% (130 companies) were audit by a big 4 auditors. The result of the study found that the size of the audit firm which use as measurement of (AQ) has not any effect on (EM). Basically, in Turkey, there is no different of (AQ) between the big 4 firms and non-big 4 firms in terms of prevent the (EM) during the period of the sample. Unlike the developed countries, such as United States who have a high motivation audit environment, Turkey has non-stimulating audit environment. Due to the absence of the efficiency and mechanism control of the audit in Turkey, auditors may not have the incentives to provide audit with high quality that constrains their clients from practicing the (EM).

Based on sample of 337 non-financial listed over 4 years between 2006 and 2009, Habbash & Alghamdi (2016), examined the relation between the (AQ) and (EM) in less developing economics: the case of Saudi Arabia. The size of the audit firm, auditor industry specialization, the opinion of the auditor, auditor change in addition to timing of auditor report were the five proxies used to measure the (AQ). while using the absolute value of the discretionary accruals as a proxy for (EM). The study hypothesis that the first four proxies listed above have a negative impact on the (EM), while they argue the timeliness of auditor report have a positive impact on (EM). The study used a performance-matched accrual measure by Kothari et al (2005) model as well as OLS regression analysis to measure the relation between the (AQ) and (EM). The results of this study showed that the size of the audit firm, specialist auditors, auditor change, and the timeliness of the audit report did not constrain the (EM). On the other hand, the only proxy that had impact on the (EM) was the auditor opinion. The study also rejected the agency theory that (EM) can be reduce by effective (AQ).

Ahmad et al (2016) in their study investigated the effect of (AQ) on (EM). The study used the audit firm size as well as industry specialist auditors as proxies for (AQ), while, used the discretionary accruals as measurement for (EM). Over 4 years of observations between 2010 and 2013, the total sample of the study was 420 manufacturing listed companies in Indonesian Stock Exchange. The study used a pooled cross-sectional variation modified Jones model to measure the discretionary accruals. The findings of the study showed that manufacturing companies

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in Indonesian who were audit by a non-big 4 audit firm will have a high level of (EM) than those who were audit by a big 4 audit firm. Moreover, Indonesian manufacturing companies were less involved in (EM) when they audit by industry specialists' auditors.

Lopes (2018) is also conducted an empirical study regarding the (AQ) and (EM). Through study the behavior discretionary accruals of non-listed companies in Portuguese, her study generally focused on the relation between the (AQ) and the manipulation of the results. By using Modified Jones model over 3 years of observations between 2011 and 2013, the total sample of the study was 4723 of non-listed companies in Portuguese. 83% of the total sample was audit by a non-big 4 audit firms, while, only 17% of the remaining sample was audited by a big 4 audit firms. The result found that there is a relation between the (AQ) and the manipulation of the result. The result proposed that companies that were audit by a non-big 4 firms have a high degree of manipulation in their results in compared to company's audit by a big 4 firms. The study also indicated that as the higher profitability of companies, the tendency to practice the (EM) become more.

Yasser and Soliman (2018) The study uses the audit firm size, auditor's industry experts and audit tenure as proxies of the (AQ). While relied on using OLS regression analysis to examine the (AQ) proxies and (EM), the study used modified Jones model to estimate the discretionary accruals for revealed the (EM). The total sample of the study was 70 companies that were listed in Egyptian Stock Exchange (EGX) over a period of 5 years between 2012 and 2016. The findings of this study showed that the size of the audit firm as well as the industry specialist auditors has not any significant impact on the (EM). The only proxy that showed a significant impact on the discretionary accruals was the audit tenure. The study also showed that the (EM) could be impacted by the size of the firm and financial leverage.

5.0. Conclusions & Discussion

This paper reviewed the effect of the (AQ) and (EM) in both developed and emerging countries in order to consider the state of our knowledge, points the limitation and suggest directions for future research. Most of the prior studies that was conducted in developed economic, such as United States and China, showed that big 4 or 8 audit firms constrains (EM) due to the fact these countries have a strong

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litigation environment that motivate auditors to provide high (AQ). The findings weren't the same in less developed economics, such as Turkey, Egypt, Saudi Arabia, etc, where size of audit firms did not prevent companies from manipulation of their earning.

Most of the previous studies use audit size as proxy for (AQ) in addition to using discretionary accruals as proxy for (EM). Whether using these proxies are perfect way to measuring the (AQ) and (EM) or not is still questionable question? Moreover, most prior studies focus only on one implication of having high (AQ) which is constrains (EM). The future research will focus on other implications of having high (AQ) such as cost of capital. The role of corporate governance mechanisms in limiting (EM) practices.

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"أثر جودة التدقيق على إدارة الأرباح" مراجعة أدبيات

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المستخلص

أن العلاقة بين جودة التدقيق وإدارة الأرباح تم تناولها في العديد من الدراسات في السنوات السابقة. حيث شهدت الأسواق المالية العالمية العديد من الانهيارات المالية لكبرى الشركات العالمية مثل شركة "Enron" عام 2001 وشركة "World.com" في عام 2002. ويرجع ذلك إلى العديد من الأسباب التي كان أهمها التلاعب في القوائم المالية لتلك الشركات الأمر الذي أدى إلى تشكيك العديد من المهتمين في قدرة المدققين على اكتشاف مثل هكذا أخطاء، لذا ظهرت الحاجة إلى تقديم خدمات تدقيق ذات جودة عالية قادرة على اكتشاف تلك الأخطاء. أن الغرض من هذه الدراسة هو محاولة الخوض في الدراسات السابقة حول أثر جودة التدقيق على إدارة الأرباح باعتماد عشرة مقالات علمية ذات الصلة بالموضوع في كل من الاقتصاديات المتقدمة والناشئة. يناقش البحث أيضاً بعض المؤشرات التي تشير إلى جودة التدقيق وإدارة الأرباح ويعرض البحث النتائج الرئيسية المتعلقة بهذا الموضوع بالإضافة إلى تقديم التوصيات للبحوث المستقبلية ذات الصلة بالموضوع.

الكلمات المفتاحية: جودة التدقيق ، إدارة الأرباح ، مراجعة الأدبيات.