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Effect of Audit Quality on Earnings Management Practices

John Mwangi



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Abstract

Purpose: The aim of the study was to assess the effect of audit quality on earnings management practices.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: Research indicates that higher audit quality is associated with reduced earnings management practices. High-quality audits lead to improved financial reporting, fraud detection, and lower costs of capital. Market reactions are positive when reputable audit firms are involved. However, outcomes

may vary by industry and country, depending on regulatory and institutional factors.

Implications to Theory, Practice and Policy: Agency theory, signaling theory and information risk and auditor reputation theory may be use to anchor future studies on assessing the effect of audit quality on earnings management practices. Audit firms should invest in ongoing training and professional development programs to enhance the skills and knowledge of auditors. Regulatory authorities should continue to strengthen their oversight of the audit profession. This includes periodically reviewing and updating auditing standards, enforcing compliance with auditing regulations, and imposing penalties for audit failures.

Keywords: *Audit, Quality, Earnings, Management Practices*

INTRODUCTION

Earnings management, often measured by accruals manipulation or income smoothing, is a practice employed by firms to influence their reported financial results in order to meet or exceed market expectations, achieve desired financial goals, or project a more stable financial performance. In developed economies like the United States, this phenomenon has been a subject of concern. A study by Dechow, Ge, and Schrand (2016) found evidence of income smoothing in the USA during the late 1990s and early 2000s, with firms strategically managing accruals to reduce earnings volatility and avoid negative financial outcomes. Another example from the UK comes from a study by Shroff, Verdi, and Yu (2017), which revealed that British firms engaged in income smoothing by manipulating discretionary accruals, especially during times of economic uncertainty. This study noted that firms in the UK tended to smooth their income upwards in order to maintain consistent earnings growth and enhance their market reputation.

In developing economies like India, earnings management practices also exist. For instance, a study by Dasgupta and Jain (2018) found that Indian firms engaged in accruals manipulation to manage earnings and influence stock market reactions. The study showed that Indian firms with high accruals were more likely to meet or exceed analysts' earnings forecasts. In Japan, where earnings management is termed "tobashi," a study by Ishihara, Suzuki, and Takahashi (2020) explored the practice among Japanese firms. They found that Japanese firms used income smoothing to reduce the impact of income fluctuations on stock prices and to enhance their long-term reputation. These examples highlight that earnings management is not limited to developed economies but is also prevalent in developing economies.

In Sub-Saharan African economies, earnings management practices have been observed as well. A study by Ahrens, Kasi, and Ngoy (2018) on firms in Nigeria, a Sub-Saharan African country, showed that companies engaged in income smoothing to maintain a consistent and positive image in the eyes of investors and creditors. Similarly, a study by Lartey, Owusu-Frimpong, and Ocran (2017) focused on earnings management in Ghana, another Sub-Saharan African country. They found evidence of accruals manipulation by Ghanaian firms to improve their reported financial performance, especially during periods of economic instability. These examples demonstrate that earnings management exists across various economies, including Sub-Saharan Africa.

In developing economies like India, earnings management practices continue to be a significant concern. A recent study by Dasgupta and Gupta (2021) examined the impact of ownership structure on earnings management in Indian firms. The research highlighted that family-controlled firms in India were more prone to income smoothing through accruals manipulation compared to professionally managed firms. This finding underscores the importance of corporate governance mechanisms in mitigating earnings management practices in developing economies.

In another developing economy example, Pakistan, a study by Abid, Azmat, and Khan (2019) investigated earnings management behavior among Pakistani firms listed on the Karachi Stock Exchange. Their research revealed that firms in Pakistan engaged in income smoothing by manipulating discretionary accruals to meet or beat earnings benchmarks. The study also found that firms with higher leverage were more likely to engage in earnings management, highlighting the role of financial constraints in driving such practices in developing economies.

In Sub-Saharan African economies, where governance and regulatory environments may vary widely, earnings management practices also warrant attention. A study by Yartey and Adjasi

(2019) investigated earnings management behavior in listed firms from 19 Sub-Saharan African countries. The research found evidence of income smoothing through accruals manipulation in these economies. It emphasized that institutional factors, such as the level of enforcement of accounting standards and the quality of corporate governance, played a crucial role in influencing earnings management practices in the region.

Additionally, in Nigeria, a study by Obidike, Kajola, and Adebisi (2017) examined earnings management in the context of the Nigerian banking sector. The research revealed that Nigerian banks engaged in earnings management practices, primarily to meet regulatory requirements and maintain market confidence. The study indicated that the level of earnings management was influenced by regulatory changes and macroeconomic factors, demonstrating the complex interplay between external factors and earnings management in Sub-Saharan Africa.

In Brazil, a study by Oliveira, Ferreira, and Rodrigues (2017) examined earnings management behavior in Brazilian publicly-traded companies. The research found that Brazilian firms engaged in income smoothing and accruals manipulation, particularly during periods of economic uncertainty. The study attributed these practices to factors such as managerial incentives and market pressure. It also highlighted the importance of accounting standards and regulatory enforcement in mitigating earnings management.

In the Middle East, the United Arab Emirates (UAE) has been a focal point for economic growth. A study by Alkhatib, Abuzayed, and Sartawi (2020) explored earnings management behavior in UAE firms. The research revealed that UAE firms practiced income smoothing, with accruals manipulation being a common strategy to achieve this. The study emphasized the role of corporate governance mechanisms and the adoption of International Financial Reporting Standards (IFRS) in influencing earnings management practices in the UAE.

In South Africa, a study by Ntim et al. (2020) investigated earnings management behavior in listed firms. The research found evidence of income smoothing and accruals manipulation in South African companies. The study emphasized the influence of corporate governance mechanisms and ownership structure in shaping earnings management practices in the country. Furthermore, the study noted that firms with higher levels of foreign ownership were less likely to engage in earnings management, highlighting the role of international investors in promoting financial reporting quality.

In Malaysia, another emerging economy, research by Chua, Cheong, and Gould (2020) examined earnings management in the context of Islamic banks. The study revealed that Islamic banks in Malaysia engaged in income smoothing and accruals manipulation. It suggested that the need for regulatory compliance with Islamic principles and the desire to maintain a stable financial image drove these practices.

Audit quality, measured by auditor reputation and audit firm size, plays a crucial role in mitigating earnings management practices such as accruals manipulation and income smoothing. Firstly, auditor reputation is a significant determinant of audit quality. A study by Chen, Li, and Wu (2019) examined the relationship between auditor reputation and earnings management in the United States. They found that firms audited by reputable audit firms were less likely to engage in earnings management through accruals manipulation. Auditor reputation acts as a signal of the audit firm's commitment to maintaining integrity and high-quality financial reporting, discouraging managers from manipulating earnings.

Secondly, audit firm size is another vital factor influencing audit quality. Larger audit firms tend to possess more resources and expertise, which enhances their ability to conduct thorough and effective audits. A recent study by Lin and Wang (2021) investigated the impact of audit firm size on earnings management in China. Their findings indicated that larger audit firms were associated with lower levels of earnings management, including income smoothing. The resources and reputation of larger audit firms act as a deterrent to management's inclination to engage in earnings management practices, as the risk of detection and reputational damage is more significant when working with prominent audit firms.

Problem Statement

The Effect of Audit Quality on Earnings Management Practices has garnered significant attention in contemporary accounting research due to its critical implications for financial reporting integrity. Audit quality, often measured by auditor reputation and audit firm size, is considered a key factor in ensuring the reliability and transparency of financial statements. Recent studies have examined the relationship between audit quality and earnings management practices, including accruals manipulation and income smoothing, to shed light on the extent to which high audit quality acts as a deterrent against such practices.

Chen, Li, and Wu (2019) investigated the impact of auditor reputation on earnings management in the United States, but questions remain regarding the generalizability of their findings to other international contexts. Additionally, while Lin and Wang (2021) explored the influence of audit firm size on earnings management in China, it is essential to examine whether similar effects are observed in different regulatory environments and economies. Furthermore, the evolving landscape of accounting standards and regulations, such as the adoption of International Financial Reporting Standards (IFRS) in various countries, raises questions about how audit quality may interact with these changes and influence earnings management practices. Therefore, this study aims to address these gaps by conducting a comprehensive analysis of the effect of audit quality on earnings management practices in diverse global settings, considering recent developments in accounting and auditing standards.

Theoretical Framework

Agency Theory

Agency theory, originated by Jensen and Meckling (1976), focuses on the relationship between principals (shareholders) and agents (management) within a corporation. It examines how conflicts of interest between these parties may lead to agency problems, including opportunistic behavior by managers. In the context of "The Effect of Audit Quality on Earnings Management Practices," agency theory is highly relevant as it helps explain the role of audit quality in mitigating agency conflicts related to earnings management. Auditors act as external monitors, aligning the interests of shareholders and managers by providing credible assurance on financial statements. High audit quality can reduce information asymmetry and discourage managers from engaging in earnings management practices that benefit them at the expense of shareholders (DeFond & Zhang, 2019).

Signaling Theory

Signaling theory, developed by Spence (1973), posits that individuals or entities use signals to convey private information to external parties. These signals are credible indicators of the sender's true characteristics or intentions. In the context of audit quality and earnings management,

signaling theory suggests that audit quality can serve as a signal of a firm's commitment to transparency and reliable financial reporting. High-quality audits signal the firm's intention to provide accurate information to stakeholders, reducing the need for earnings management. Stakeholders can use audit quality as a credible signal to assess the reliability of financial statements (Li & Tang, 2020).

Information Risk and Auditor Reputation Theory

Information risk theory, with contributions from Watts and Zimmerman (1986), posits that investors demand higher returns to compensate for the risk associated with uncertain or less credible financial information. Auditor reputation theory extends this concept by emphasizing the role of auditor reputation in reducing information risk. In the context of "The Effect of Audit Quality on Earnings Management Practices," these theories suggest that audit quality, as reflected in the reputation of the auditing firm, can influence the perceived credibility of financial statements. A reputable auditor is more likely to provide reliable assurance, reducing information risk for investors and discouraging managers from engaging in earnings management practices (Cheng & Wang, 2021).

Empirical Review

In an extensive study conducted by DeFond and Zhang (2014), the primary purpose was to thoroughly investigate the intricate relationship between audit quality and earnings management practices among publicly traded firms in the United States. To achieve this, the researchers employed a comprehensive panel data analysis methodology that encompassed multiple financial periods and an array of control variables. Their meticulous analysis revealed that higher audit quality, as measured by auditor reputation and industry expertise, was significantly and inversely related to the extent of earnings management. The study provided robust evidence supporting the argument that audit quality is a critical determinant of financial reporting integrity. As a result, it strongly recommended that regulators, firms, and stakeholders alike focus on enhancing audit quality as an effective means to curb earnings management practices and bolster investor confidence. This research remains highly relevant in today's dynamic financial landscape, where the quality of financial reporting continues to be a paramount concern (DeFond & Zhang, 2014).

Krishnan (2015) conducted a comprehensive and in-depth research endeavor aimed at exploring the multifaceted impact of audit committee characteristics on earnings management in Indian firms. The study encompassed a vast dataset of Indian corporations, and its purpose was to provide a nuanced understanding of how specific audit committee attributes influence the extent of earnings management. To achieve this objective, the researcher employed a sophisticated quantitative approach, meticulously analyzing financial data and corporate governance structures. The findings of this meticulous investigation revealed that a strong and independent audit committee played a pivotal role in mitigating earnings management practices within Indian companies. This discovery underscores the significance of corporate governance mechanisms in maintaining financial transparency and integrity. Therefore, the study recommended that Indian firms should prioritize the independence and competence of their audit committees, a recommendation that holds true even today as corporate governance remains a critical focus area for regulators and businesses (Krishnan, 2015).

Chen, Huang, and Li (2016) conducted an extensive empirical study to scrutinize the intricate relationship between audit quality and earnings management practices within the context of

Chinese publicly traded companies. The study's overarching purpose was to provide a comprehensive understanding of how the reputation and expertise of audit firms impact earnings management behaviors in a dynamic and rapidly evolving market like China. Employing a rigorous cross-sectional analysis methodology, the researchers meticulously examined a large dataset of financial statements, auditor attributes, and corporate characteristics. The study's findings were profound, highlighting a significant negative association between higher audit quality, as assessed by the reputation of the audit firm, and the prevalence of earnings management. These findings have substantial implications for Chinese companies, regulators, and investors, suggesting that engaging reputable audit firms can be instrumental in enhancing financial reporting integrity. As such, the study recommended that Chinese regulators and businesses alike should consider the benefits of involving reputable audit firms to safeguard the quality of financial reporting and maintain investor confidence (Chen et al., 2016).

Palmrose and Scholz (2017) embarked on an extensive research journey to investigate the impact of auditor tenure, a crucial aspect of audit quality, on earnings management practices within European firms. The primary purpose of this study was to provide a comprehensive understanding of how the duration of the auditor-client relationship influences the propensity for earnings manipulation. The researchers employed a meticulous longitudinal analysis methodology, spanning multiple years and examining a broad array of European companies. Their findings shed light on the intricate dynamics between auditor tenure and earnings management, revealing a somewhat surprising result: longer auditor tenure was associated with higher levels of earnings management. This discovery has profound implications for European regulators and firms, suggesting that there might be benefits in considering limitations on auditor tenure to maintain audit quality and reduce the prevalence of earnings management. Thus, the study provided valuable insights that remain pertinent in today's discussions about auditor independence and audit quality (Palmrose & Scholz, 2017).

Guo and Tang (2018) undertook an extensive and rigorous research endeavor to comprehensively examine the effects of regulatory changes on audit quality and earnings management practices in the context of the banking sector. The study's overarching purpose was to provide a holistic understanding of how regulatory reforms can impact audit quality and, consequently, the prevalence of earnings management within financial institutions. To achieve this objective, the researchers employed a sophisticated difference-in-differences methodology, meticulously analyzing the financial performance and reporting practices of banks before and after the implementation of regulatory changes. Their meticulous analysis revealed a compelling insight: stricter regulatory requirements were indeed effective in enhancing audit quality and reducing earnings management practices within the banking sector. These findings have far-reaching implications, suggesting that regulatory authorities should continue to strengthen their oversight to maintain high audit quality, especially within critical sectors like banking, where financial transparency is paramount. Thus, this study's recommendations hold significant relevance in the ongoing discussions surrounding regulatory reforms and financial stability (Guo & Tang, 2018).

Li and Wang (2019) conducted an extensive and in-depth research study to investigate the intricate relationship between auditor industry specialization and earnings management practices within Chinese listed firms. The primary purpose of this research was to provide a comprehensive understanding of how auditors with specialized industry knowledge impact the propensity for earnings manipulation in the Chinese market. To achieve this objective, the researchers employed

a rigorous regression analysis methodology, meticulously examining financial data and auditor characteristics. The study's findings were robust and illuminating, indicating that auditor industry specialization had a significant negative effect on earnings management. This insight underscores the importance of engaging specialized auditors in enhancing audit quality and financial reporting integrity. Thus, the study recommended that Chinese firms should carefully consider the advantages of engaging specialized auditors to bolster their financial transparency and credibility, a recommendation that remains pertinent in the evolving landscape of Chinese business (Li & Wang, 2019).

Zhang and Yang (2020) embarked on a comprehensive and qualitative research journey to delve into the intricate role of corporate governance mechanisms in curbing earnings management practices within Chinese state-owned enterprises (SOEs). The study's overarching purpose was to provide an in-depth and nuanced understanding of how governance structures influence the prevalence of earnings manipulation within SOEs, which are a unique and significant segment of the Chinese economy. To achieve this objective, the researchers employed a multifaceted approach, including interviews and detailed case studies, to gain rich insights into the intricacies of governance practices within SOEs. The study's findings were insightful, emphasizing the critical role of effective governance structures in reducing earnings management practices within SOEs. These findings have profound implications for policymakers and stakeholders, suggesting that efforts to strengthen corporate governance should be a top priority in the pursuit of financial transparency and accountability within these entities. As such, this research remains highly relevant in the ongoing discussions surrounding corporate governance reforms in China (Zhang & Yang, 2020).

METHODOLOGY

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

RESULTS

Conceptual Research Gap: The studies discussed primarily focus on the relationship between audit quality and earnings management practices, emphasizing the importance of audit quality as a deterrent to earnings management (DeFond & Zhang, 2014; Krishnan, 2015; Chen et al., 2016; Palmrose & Scholz, 2017; Guo & Tang, 2018; Li & Wang, 2019; Zhang & Yang, 2020). However, there is a conceptual research gap in terms of exploring the underlying mechanisms through which audit quality influences earnings management. Future research could delve deeper into the specific processes, practices, and auditing techniques that contribute to the effectiveness of audit quality in reducing earnings management.

Contextual Research Gap: While the studies by DeFond and Zhang (2014), Krishnan (2015), Chen et al. (2016), Palmrose and Scholz (2017), Guo and Tang (2018), Li and Wang (2019), and Zhang and Yang (2020) provide valuable insights into audit quality and earnings management in the United States, India, China, Europe, and Chinese state-owned enterprises, respectively, there remains a contextual research gap regarding the applicability of these findings to other global

contexts. Future research should explore how the relationship between audit quality and earnings management varies in different regulatory, cultural, and economic environments.

Geographical Research Gap: The existing studies primarily focus on the United States, India, China, and Europe, leaving a geographical research gap in terms of examining the relationship between audit quality and earnings management in other regions, such as Africa, South America, or Southeast Asia. Investigating these regions would provide a more comprehensive understanding of the global applicability of audit quality as a deterrent to earnings management and shed light on regional variations in this relationship.

CONCLUSION AND RECOMMENDATION

Conclusion

The extensive body of research examining the effect of audit quality on earnings management practices has yielded valuable insights and critical implications for the field of financial reporting, auditing, and corporate governance. The studies discussed in this context have collectively highlighted the pivotal role of audit quality in shaping the integrity and transparency of financial reporting. They underscore the importance of robust audit processes, auditor expertise, and regulatory oversight in deterring earnings management behaviors among publicly traded firms.

The empirical evidence consistently supports the argument that higher audit quality, characterized by auditor reputation, industry expertise, and regulatory reforms, is associated with reduced levels of earnings management. These findings have substantial implications for regulators, firms, investors, and auditors alike. They emphasize the need for continuous efforts to enhance audit quality, strengthen corporate governance structures, and implement regulatory reforms to ensure the accuracy and reliability of financial statements.

However, it is crucial to acknowledge the existence of research gaps, particularly in terms of understanding the underlying mechanisms through which audit quality exerts its influence, the contextual variations in this relationship across different regions, and the geographical coverage of studies. These gaps provide fertile ground for future research endeavors that can deepen our understanding of this critical relationship and its nuances in diverse settings.

In essence, the effect of audit quality on earnings management practices remains a significant concern in contemporary finance. As financial markets evolve, and regulatory environments change, the ongoing exploration of this relationship is essential for maintaining the trust of investors, safeguarding financial stability, and ensuring the accuracy of financial reporting. Consequently, this body of research serves as a foundation for informed decision-making by stakeholders and provides a solid platform for future scholarship in the pursuit of financial transparency and accountability.

Recommendation

The following are the recommendations based on theory, practice and policy:

Theory

Future research should delve deeper into the underlying mechanisms through which audit quality impacts earnings management. This exploration could involve investigating the specific auditing procedures, techniques, and methodologies that are most effective in mitigating earnings manipulation. This contribution would enhance the theoretical foundation of our understanding of

audit quality and earnings management, providing more precise guidance for practitioners and policymakers. Theoretical frameworks should be developed to understand how the relationship between audit quality and earnings management varies across different contexts, such as regulatory regimes, cultural settings, and economic conditions. This would contribute to a more comprehensive theory that accounts for the nuances of this relationship, recognizing that a one-size-fits-all approach may not be applicable in diverse environments.

Practice

Audit firms should invest in ongoing training and professional development programs to enhance the skills and knowledge of auditors. This includes staying updated on industry-specific issues, emerging risks, and advanced audit methodologies. A well-trained and informed audit workforce can contribute significantly to maintaining high audit quality and detecting earnings management practices effectively. Auditors should adopt proactive risk assessment techniques to identify potential areas of earnings management early in the audit process. By focusing on key risk factors and utilizing data analytics and technology, auditors can better target their audit efforts and increase the likelihood of detecting and preventing earnings manipulation.

Policy

Audit firms should invest in ongoing training and professional development programs to enhance the skills and knowledge of auditors. Regulatory authorities should continue to strengthen their oversight of the audit profession. This includes periodically reviewing and updating auditing standards, enforcing compliance with auditing regulations, and imposing penalties for audit failures. An effective regulatory environment is essential for maintaining and enhancing audit quality. Policymakers should consider regulations that promote the independence and competence of audit committees within organizations. Ensuring that audit committees consist of members with relevant expertise and no conflicts of interest can enhance their effectiveness in overseeing the audit process and reducing the likelihood of earnings management. Policymakers at the international level should work towards harmonizing auditing standards and practices across different jurisdictions. This would contribute to consistency in audit quality and make it more challenging for firms to engage in earnings management across borders.

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