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THE IMPACT OF AUDITOR'S OPINION ON EARNINGS MANAGEMENT: EVIDENCE FROM ROMANIA

Empirical
study

Keywords

Audit
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JEL Classification

G10, M41, M42

Abstract

The aim of this research is to analyze the relation between modified audit opinion and discretionary accruals in the case of Romanian listed entities. In order to investigate the influence of auditor's opinion on earnings management, a multiple regression was designed. The final sample, after eliminating the financial institutions due to homogeneity considerations, consists of 60 companies listed on the Bucharest Stock Exchange in 2012. The most significant findings of this research are that the probability to manage earnings to the decrease is related to the issuance of a qualified audit report and the presence of a Big 4 audit firm. Thus, both audit opinion and auditor size are negatively related to discretionary accruals in the case of the Romanian listed companies.

Introduction

The external auditor plays a vital role in the corporate governance mosaic through its influence on promoting the quality of financial reporting. From this optic, the audit opinion acts as a guardian of the management's behaviour, especially when there is an increased tendency of earnings manipulation.

The aim of this research is to analyze the relation between modified audit opinion and discretionary accruals in the case of listed Romanian entities. Since corporate governance serves as a vital mechanism for assuring the quality of financial reporting, this study reaches its aim by capturing the influence of external auditor on managerial behaviour in which concerns earnings manipulation at the level of Romanian listed entities. Moreover, emerging economies are constantly confronted with a lower level of financial reporting quality and weaker corporate governance mechanisms, fact that leads to an increased need for further improvements.

Earnings management has been defined as the alteration of firms' reported economic performance by insiders to either mislead some stakeholders or to influence contractual outcomes (Healey and Wahlen, 1999). Starting from the definition supported by Healy and Wahlen, Roychowdhury (2006) states that the manipulation of accounts as a result of normal operational practices arises from management's motivation to influence investors to believe that the organization's financial targets have been met in the normal course of business.

Due to the information asymmetry which exists between the company's insiders and outsiders, individuals within an organization can rely on their control in financial reporting and their access to financial information within the company to overstate the income or to mask obtaining unfavourable results. From this optic, management may use different methods such as creating reserves for

future periods by reducing income in a year with good performance, thus reducing income volatility (Leuz et al., 2003).

The Agency Theory, which creates two diverse interest groups - owners and managers- is considered the most prevailing source of conflicts of interest. Due to the fact that management is invested with almost full powers within the organization, management may be inclined to take advantage of the trust and lack of adequate knowledge of the owners and report them unreal performance.

According to Barth and Taylor (2010), as far as earnings management is an undesirable practice from the point of view of equity holders, then it is clearly a matter of agency, generating a conflict of interest between owners - who are against the use of it - and management, manipulating income in order to increase personal wealth.

Dechow and Skinner (2000) set off income management concept analysis from the role of accruals for the reason that accruals are forms of income manipulation difficult to distinguish from appropriate practices inherent in accrual accounting.

Sill, in order for management to successfully report over-aggressive or fraudulent earnings, auditors must not succeed to discover how and where income is being manipulated. Yet, how managers can successfully deflect auditors' attention from earnings manipulations remains an important unanswered question for researchers (Peecher et al., 2007; Bell et al., 2005).

The reminder of this paper is organized as it follows: Section 2 presents the relevant literature review in the academic area which captures the influence of the auditor's opinion on earnings management, Section 3 describes the research's design, while Section 4 presents the results. Finally, Section 5 emphasizes the limitations of this research and Section 6 draws the conclusions.

Literature review

In the academic arena, there is a consensus relying on the statement that auditing is an important means of mitigating agency conflict between managers and outside shareholders. From this optic, auditing is a monitoring device for the shareholders, thus, auditors would report detected material misstatements in audited financial statements.

Due to the fact that the major observable outcome of an audit process is represented by the audit report, in the literature various proxies have been used in order to assess audit quality. Francis et al. (1999) suggest that Big 4 auditors are able to constrain opportunistic and aggressive reporting because their clients have higher total accruals, but lower discretionary accruals. This approach is focused on earnings management, on managerial behaviour which interfere with the financial reporting process. According to Lawrence et al. (2011), an extensive stream of literature focuses on the client's financial statements, in which discretionary accruals are often used as a proxy for audit quality as they reflect the auditor's constraint over management's reporting decisions.

A wide stream of researches have documented that the influence of audit on earnings management is noteworthy in the sense that high quality auditors limit earnings management practices, in contrast to lower quality external auditors (Chung et al, 2005, Othman and Zeghal, 2006). Chung et al (2005) indicate that external supervision constraints management not to use certain techniques to increase the results, fact explained by the need of the high quality external auditors to preserve their reputation and to avoid litigation.

Francis and Krishnan (1999) examined the relationship between the issuance of modified audit reports and the reported level of accruals for a sample of United States publicly listed companies. Their results indicate that auditors of firms reporting high levels of accruals are more

likely to issue modified audit reports for asset realisation reservations and for going concern issues than auditors of low accrual firms, even after controlling for client-specific and market risk variables. Moreover, the authors conclude that these findings apply only for the Big 6 (at that time) auditors, fact consistent with the incentives of the "audit giants" for acting conservatively.

The connection between the auditor's tenure at the same entity and earnings management practices was examined by Gul et al. (2009). They found out that there is a reduced association between audit tenure at the same entity and earnings quality at firms audited by specialists in the industry. Gul et al. explain this fact through the greater likelihood that auditors with expertise in clients' activity identify irregularities and disingenuous representations and perform a qualitative audit, even though the level of client-specific awareness is lower, as a result of a short-term collaboration.

Rusmin (2010) argue that the discretionary accruals of industry specialist auditor clients are lower than discretionary accruals of non- industry specialist clients. This finding suggests that auditors with industry expertise are more likely to detect misrepresentations and irregularities than auditors without industry expertise, particularly in the early years of the audit assignment. The association leans on the assumption that industry- specialist auditors have the industry expertise that results in enhanced perception of the client's business.

The study conducted by Gerayli et al. (2011) on a sample of 540 firm-year observations from the Teheran Stock Exchange for fiscal years 2004 to 2009 indicated that auditor size is negatively associated with the earnings management measured by discretionary accruals, hence indicating that companies audited by Big 4 audit firms will engage in less earnings management than firms audited by non-Big 4. Their results are consistent with

those of Chen et al (2005) which suggest that the Big-5 auditors are associated with reduced management discretion over earnings.

In the same study, Gerayli et al. (2011) found that firms audited by industry specialist auditors engage in less earnings management, finding consistent with the results of Rusmin (2010) that auditor industry specialists represent an approach to constrain earnings management. Moreover, the results from testing the association between the auditor independence and earnings management imply that the more independent an audit firm is, the more the quality of auditing will enhance, fact considered being as one of the impediment for applying earnings management in companies.

Under the aspect of auditors' independence, Luippold et al. (2013) demonstrate that "simply diverting auditors to clean accounts can deter them from finding managed earnings, resulting in a reduction of both audit and financial reporting quality". Their study also indicates that more sceptical auditors are more likely to discover managed earnings, in contrast to less sceptical auditors. Thus, given auditors' scepticism (Nelson, 2009; Hurtt et al., 2013), the discovery of errors may alarm auditors and in fact determine them to search more extensively for errors in other areas of the audit.

Another relevant research in this area is the one conducted by Butler et al. (2004). They examined whether certain modified audit opinions (scope limitations, deviations from the Generally Accepted Accounting Principles (GAAP)) are associated with discretionary accruals. Their results indicate that in the case of entities with going concern opinions there is an association between modified audit opinions and abnormal accruals, due to the fact that these entities have large negative accruals as a consequence of severe financial distress.

The results of Butler et al. (2004) are consistent with those of prior literature.

For example, Bartov et al. (2000) documented that the association between audit opinion and abnormal accruals is negative. This result inclines to be associated with severely distressed firms (with going concern opinions), rather than with firms engaging in extreme earnings management.

However, Johl et al. (2007) examined auditor reporting behaviour in the presence of aggressive earnings management in the Malaysian context. They found that Big 5 auditors emerge to issue modified audit reports more frequently than their Non-Big 5 counterparts in the presence of high levels of abnormal accruals.

The quality of auditors, reputation of audit firms and industry expertise of external auditor are not the only factors that have an influence on earnings management. For example, Caramanis and Lennox (2008) investigated the influence of the effort to conduct an audit, measured in numbers of audit hours, on the possible use of earnings management techniques. The research results indicated that there is a greater likelihood that management is using techniques to increase earnings (manipulate earnings) when the number of audit hours is lower.

Research design

This section states the research's hypotheses, presents the sample selection criterion and introduces the empirical model.

The research hypotheses are constructed in accordance with the aim of this research, namely to analyze the relation between modified audit opinion and earnings management in the case of Romanian listed entities. The study relies on the expectation that there will be a significant negative association between auditor size and the occurrence of earnings management. Thus, the following research hypotheses were developed:

Hypothesis 1: There is a significant negative association between auditor size

and the occurrence of earnings management.

Hypothesis 2: There is a significant negative association between audit opinion and earnings management.

Hypothesis 3: There is a significant negative association between audit opinion of Big 4 audit firm and earnings management.

Sample Selection

The aim of this research is to investigate the relation between modified audit opinion and abnormal accruals (discretionary accruals) in the case of Romanian listed entities.

The sample consists of companies listed on the Bucharest Stock Exchange which publish their individual financial statements in accordance to the International Financial Reporting Standards (IFRS). Thus, a few restrictions are required for this study, as it follows:

- Companies present their financial statements for the year 2012 according to the International Financial Reporting Standards – IFRS 1;
- Companies operating in the financial sector are eliminated from the study due to homogeneity considerations - these financial institutions have specific regulations considering their activity.

After implementing the above-mentioned restrictions, the final sample consists of 60 companies listed on the Bucharest Stock Exchange, compiling both Tiers I and II. In order to conduct this study, the variables included in the below presented model were collected from the individual financial statements of the 60 analyzed companies for the year 2012. After analyzing the financial statements from the annual reports, the financial elements were set up in the database and analyzed with the Analyse-it statistical instrument.

Empirical Model

The empirical model is represented by the multiple regression which aims to determine the factors that influence the discretionary accruals. The logistic model is presented above:

$$DISCACC_{i,t} = \alpha_0 + \alpha_1 AO_{i,t} + \alpha_2 AS_{i,t} + \alpha_3 SZ_{i,t} + \alpha_4 LEV_{i,t} + \varepsilon_{i,t}$$

Where:

- DISCACC: discretionary accruals;
- AO: audit opinion (dummy variable), equals 1 if audit opinion is qualified, 0 otherwise;
- AS: auditor size (dummy variable), equals 1 if external auditor is Big 4, 0 otherwise;
- SZ: firm size, natural logarithm of total assets;
- LEV: financial leverage, measured as total liabilities divided to total assets,
- ε : error term;
- i : The company and t : the year.

Dependent variable. The dependent variable of the regression model is represented by the discretionary accruals, namely the part of total accruals which is more susceptible to manipulation by managers. In prior studies, discretionary accruals are frequently used as a proxy for earnings management (for example, Jones, 1991).

Discretionary accruals represent the difference between total accruals and non-discretionary accruals; total accruals are determined as difference between operating income and cash flows from operations. In the Jones` modified model, non-discretionary accruals are the predicted (or expected) portion of total accruals. Moreover, in the same model, the total accruals are regressed on changes in revenue, gross property, plant and equipment, and return on assets (Kothari et al., 2005).

Following Kothari et al. (2005), the next model is being used in order to determine the total accruals:

$$ACCR_{i,t} = \beta_1 + \beta_2 \Delta REV_{i,t} + \beta_3 GPPE_{i,t} + \beta_4 ROA_{i,t} + \varepsilon_{i,t}, \text{ all the variables are divided by } TA_{i,t-1},$$

Where:

- ACCR : total accruals for sample firm i for year t;
- TA: total assets for sample firm i for year t-1;
- REV: changes in net revenues for sample firm i for year t;
- GPPE: gross property, plant and equipment for sample firm i for year t;
- ROA : return on assets for sample firm i for year t, determined by dividing the company's annual earnings (net income) by its total assets;
- $\varepsilon_{i,t}$: unexpected portion of total accruals for sample firm i for year t.
- The discretionary accruals are represented by the residuals $\varepsilon_{i,t}$ from this equation.

Independent variables. AO (audit opinion) is the independent variable of interest (the categorical independent variable), being defined as a dummy variable which equals 1 if audit opinion is qualified and 0 otherwise;

The non-categorical independent variables are represented by auditor size, firm size and financial leverage:

- AS (auditor size) is defined as a dummy variable which equals 1 if external auditor is Big 4 audit firm and 0 otherwise;
- SZ (firm size) is an independent variable associated to firms' characteristics and is defined as natural logarithm of total assets;
- LEV (financial leverage) is an independent variable associated to firms' characteristics and it is

calculated as total liabilities divided to total assets.

Results

This section presents the output of both univariate and multivariate tests which were conducted. The univariate analysis presents the descriptive statistics for the dependent and independent variables engaged in this study, the correlation between variables, as well as the results of the Mann-Whitney test. The multivariate tests bring into light the multiple regression's output.

Univariate analysis

Descriptive statistics. The descriptive statistics for the dependent variable of this study, namely discretionary accruals, and the non-categorical independent variables is presented in Table 1.

[INSERT TABLE 1]

The results presented in Table 1 indicate that on average the discretionary accruals are negative, implying that the average of the detected earnings management is to the decrease. Moreover, as it can be noticed in Table 1, a third of companies (31.66%) are audited by a Big 4 audit firm.

[INSERT TABLE 2]

The results presented in Table 2 indicate that out of the 60 companies, only 21 entities present a qualified audit opinion. This fact signify that only 35% of the companies have a qualified audit opinion, while the majority, namely 65%, have a favourable audit output for the year 2012. Due to the fact that the number of entities which have a qualified audit opinion is reduced, this opinion will not be analyzed through its types.

[INSERT TABLE 3]

As it can be noticed in Table 3, Big 4 clients have on average higher total accruals compared to the companies audited by a non-Big 4 audit firm. Moreover, the discretionary accruals are on average lower in the case of Big 4

clients. As stated by Francis et al. (1999), Big 4 auditors are able to constrain opportunistic and aggressive reporting because their clients have higher total accruals, but lower discretionary accruals.

[INSERT TABLE 4]

Table 4 presents the descriptive statistics for companies with qualified audit opinion. On average, companies with qualified audit opinion present negative discretionary accruals (-0.0262), meaning that the average of the detected earnings management is to the decrease. Out of the 21 companies with qualified audit opinion, 8 companies were audited by a Big 4 auditor (approximately 38%).

[INSERT TABLE 5]

Table 5 presents the descriptive statistics for companies with unqualified audit opinion. The results indicate that on average the discretionary accruals are positive (0.0141), leading to the affirmation that the average of the earnings management detected for the companies with unqualified audit opinion (clean opinion) is to the increase. Out of the 39 companies with clean audit opinion, 11 companies were audited by a Big 4 audit firm (approximately 28%).

The next step is represented by the analysis of correlation between variables. In order to determine the level of correlation, the Pearson's Correlation Matrix was integrated, as it can be seen in Figure 1.

[INSERT FIGURE 1]

The largest association (0.5691) is between auditor size and firm size, fact consistent with findings in prior literature which state that there is a strong correlation between auditor size and the company's size. Except for this large correlation, the coefficients of correlation are small, not exceeding the value of 0.1799 (correlation between audit opinion and financial leverage).

The coefficient of association between audit opinion and discretionary accruals is -0.1393, signalling a negative association between these two variables.

Thus, discretionary accruals are negatively related to the qualified audit opinion, supporting Hypothesis 2. When analyzing the coefficient for audit size, the results indicate a negative coefficient (-0.0526) which suggests that discretionary accruals are negatively related to the Big 4 audit firms, fact which supports Hypothesis 1. Therefore, a negative Big 4 coefficient would suggest that Big 4 auditors do not allow their clients to manage earnings (Johl et al., 2007).

Mann-Whitney test results. The results of the Mann-Whitney Test for the variable audit opinion (see Table 6) indicate that there is a statistically significant difference in the discretionary accruals between companies with qualified audit opinion and those with unqualified opinion. Thus, firms with qualified audit report will be more susceptible to manage the discretionary accruals to the decrease than those with unqualified audit opinion, fact which supports Hypothesis 2.

[INSERT TABLE 6]

When analyzing the Z-Statistics, the results indicate that there is not a significant statistical difference between the means of the two categories (calculated Z is less than critical Z) results which emphasize that, on average, companies with qualified audit opinion do not present higher discretionary accruals.

[INSERT TABLE 7]

Table 7 presents the results of the Mann-Whitney Test for the variables audit opinion and auditor size. When analyzing the U-statistics, the results indicate that there is a statistically significant difference in the discretionary accruals between companies with qualified audit opinion having a Big 4 audit firm and those with qualified opinion corresponding to a non-Big 4 auditor. Thus, firms with qualified audit report having a Big 4 audit firm will be more susceptible to manage the discretionary accruals to the decrease than those audited by non-Big 4 external auditors, fact which supports Hypothesis 3.

Moreover, when analyzing the Z-Statistics, the results indicate that there is not a significant statistical difference between the means of the two categories (calculated Z is less than critical Z) results which emphasize that, on average, companies with qualified audit opinion having a Big 4 audit firm do not present higher discretionary accruals.

Multivariate analysis

This section presents the multiple regression output, as it can be seen in Figure 2.

[INSERT FIGURE 2]

When analyzing the coefficients corresponding to the regression's variables, the results indicate that the coefficient corresponding to the audit opinion variable is negative, however, it is not statistically significant, partially supporting Hypothesis 2. The results are consistent with those of Butler et al. (2004), who found that firms which received going concern opinions had negative accounting accruals.

Thus, firms with qualified audit reports tend to have lower discretionary accruals, the phenomenon of income decreasing accruals signalling a conservative application of the International Financial Reporting Standards (IFRS) by managers.

The coefficient for auditor size is negative; still, it is not statistically significant. This negative coefficient indicate that discretionary accruals are negatively related to auditor size – Big 4 and non-Big 4- indicating that clients of Big 4 audit firms have lower discretionary accruals, consistent with Hypothesis 1.

As for the control variables, the coefficient of firm size is positive and not significantly different from zero, reflecting that larger firms tend to have higher accruals. Financial leverage has a positive coefficient, not significantly different from zero, indicating that discretionary accruals are positively related to financial leverage.

Limitations of this research

This study presents a series of drawbacks. First of all, the sample population is rather small, only 60 companies having been investigated. However, the sample is homogeneous (the restrictive criterion established in the sample selection process took into consideration the heterogeneity aspect, so that the sample would not be affected by heterogeneous characteristics). Second of all, the number of companies which present a modified audit report is rather small, only 21 firms (35%) having a qualified audit opinion. Under this aspect, the results might not be very representative. Moreover, due to the reduced number of qualified audit reports, a distinction between the categories of modified audit opinion has not been conducted.

Conclusions and further research

Since the external auditor influences the perceived quality of financial reporting, the audit opinion acts as a guardian of the management's behaviour, especially when there is an increased tendency of earnings manipulation.

This research aimed to analyze the relation between modified audit opinion and earnings management in the case of Romanian listed entities. In order to investigate the influence of auditor's opinion on earnings management, a multiple regression was designed. The dependent variable of the regression which measures the earnings management phenomenon is represented by discretionary accruals, being defined as the part of total accruals that is more likely to manipulation by managers. The independent variables, namely audit opinion, audit firm size, firm size and financial leverage, constitute the explanatory variables of the regression which aims to properly capture the impact of auditor's opinion on reducing earnings management in order to improve the quality of financial reporting process.

The most significant findings of this research are that the probability to manage earnings to the decrease is related to the issuance of a qualified audit report and the presence of a Big 4 auditor. Consistent with the findings of Gerayli et al. (2011) and Chen et al. (2005), the results of this study indicate that auditor size is negatively associated with the earnings management measured by discretionary accruals, thus indicating that companies audited by Big 4 audit firms will engage in less earnings management than firms audited by non-Big 4. In other words, Big 4 auditors are associated with reduced management discretion over earnings.

Another significant finding of this research is that firms of which audit opinions are qualified manage the discretionary accruals more negative and more significant than those with unqualified audit opinions. The coefficient corresponding to the audit opinion variable is negative, implying that discretionary accruals are negatively related to the qualified audit opinion.

Francis et al. (1999) suggest that Big 4 auditors are able to constrain opportunistic and aggressive reporting because their clients have higher total accruals, but lower discretionary accruals. According to their statement, the results of this research indicate that in the case of Romanian listed companies, the clients of a Big 4 audit firm have higher total accruals, however lower discretionary accruals.

As for further research, this study can be improved by analyzing the qualified audit opinion through the types of audit report issued. Moreover, this research can be enlarged through capturing other mechanisms that improve the quality of financial reporting, such as audit committees and the composition of the Board of Directors.

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Table 1

Descriptive Statistics for the Dependent and Non-categorical Independent Variables

	<i>DISCACC</i>	<i>AS</i>	<i>SZ</i>	<i>LEV</i>
Number of Observations	60	60	60	60
Mean	6.01371E-18	0.3166	19.0308	0.2951
Median	-0.0072		18.8508	0.2099
Standard Deviation	0.1391	0.4691	1.509	0.2765
Range	1.106		7.8574	1.4418
Minimum	-0.2425		16.5072	0.0078
Maximum	0.8635		24.3646	1.4496

Table 2

Descriptive Statistics for the Categorical Independent Variable

Audit Opinion	<i>Frequency</i>	<i>Percent</i>
Qualified	21	0.35
Unqualified	39	0.65
TOTAL	60	100

Table 3

Companies` Accruals related to the Audit Firm

Companies` Audit Firm	<i>N</i>	<i>Total Accruals – Mean</i>	<i>Discretionary Accruals- Mean</i>
Big 4	19	2107094700	-43469158.95
Non-Big 4	41	-77181.9	20144244.39
TOTAL	60		

Table 4

Descriptive Statistics for Companies with Qualified Audit Opinion

	<i>Mean</i>	<i>Median</i>	<i>MIN</i>	<i>MAX</i>	<i>Range</i>
DISCACC	-0.0262	-0.0455	-0.1607	0.1573	0.3181
AS	0.3157				
SZ	18.7778	18.4947	16.8176	22.3216	5.504
LEV	0.3623	0.274	0.0221	1.4496	1.4274

Table 5

Descriptive Statistics for Companies with Unqualified Audit Opinion

	<i>Mean</i>	<i>Median</i>	<i>MIN</i>	<i>MAX</i>	<i>Range</i>
DISCACC	0.0141	-0.00003	-0.2425	0.8635	1.106
AS	0.3166				

SZ	19.1671	19.043	16.5072	24.3646	7.8574
LEV	0.2589	0.2045	0.0078	0.9823	0.9744

Table 6
Mann-Whitney Test Results- Audit Opinion

	<i>N1</i>	<i>N2</i>	<i>U-Statistics</i>	<i>Z-Statistics</i>
DISCACC/AO	21	39	551	-1.31

Table 7
Mann-Whitney Test Results- Audit Opinion and Auditor Size

	<i>N1</i>	<i>N2</i>	<i>U-Statistics</i>	<i>Z-Statistics</i>
Qualified Audit Opinion				
Big 4 / Non-Big 4	8	13	86	-0.17
Unqualified Audit Opinion				
Big 4 / Non-Big 4	11	28	221	0.03

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Figure 1
Variables` Correlation Matrix

	<i>DISCACC</i>	<i>AO</i>	<i>AS</i>	<i>SZ</i>	<i>LEV</i>
<i>DISCACC</i>	1				
<i>AO</i>	-0.1393	1			
<i>AS</i>	-0.0526	0.1014	1		
<i>SZ</i>	0.0005	-0.1241	0.5691	1	
<i>LEV</i>	0.0098	0.1799	-0.0102	-0.0416	1

Figure 2
Regression Output

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	-0.0033	0.2875	-0.0116	0.9908
<i>AO</i>	-0.0405	0.0404	-1.0029	0.3203
<i>AS</i>	-0.0129	0.0492	-0.2614	0.7948
<i>SZ</i>	0.0009	0.0153	0.0562	0.9554
<i>LEV</i>	0.0176	0.0682	0.2583	0.7972