



AUDIT QUALITY DETERMINANTS AND THEIR
EFFECT ON EARNINGS MANAGEMENT DURING
THE GLOBAL FINANCIAL CRISIS

BY

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ABSTRACT

The early twenty first century witnessed several accounting scandals that culminated in the collapse of many renown large organizations such as Enron and the bankruptcy filing of WorldCom. These scandals cast doubts on the quality of auditing. As part of the efforts of restoring quality of auditing and earnings reporting, several standards, guidelines, and codes have been imposed by International and Malaysian regulatory bodies. However, those regulatory authorities view audit quality as subjective, multi-dimensional, vast and a complex issue (Financial Reporting Council, 2007; International Auditing and Assurance Standard board, 2011; Canadian Public Accountability Board, 2012), which makes it difficult to define and measure. In order to untangle this multi-dimensional and complex issue, this study conducted a systematic review, maps the audit quality literature and came up with an audit quality framework (AQF). AQF is a comprehensive framework with the inclusion of the International Standard on Quality Control 1 (ISQC 1). The AQF is further enhanced by inculcating qualities from an Islamic perspective. The AQF reveals that the outcome of a quality audit should be reflected in the financial reporting quality, which is proxied by diminished earnings management practices. There is strong evidence that earnings management practices during the abnormal time (financial crisis) differed in terms of magnitude and direction (Mohd-Saleh and Ahmed, 2005; Johl et al., 2007; Iatridis and Dimitras, 2013). Hence, whether earnings management practices in the context of Malaysian listed companies really differ during the recent financial crisis needs to be tested before determining whether audit quality determinants are able to alleviate it. Therefore, this study examines earnings management practices during the recent financial crisis and makes a comparison with the pre-crisis period. In addition, this study investigates the effect of different determinants of audit quality on earnings management practices. The hypotheses of this study were developed and examined based on the related literature, both agency and big bath theories. Data were collected from literature, databases, related regulations and standards (audit quality framework), annual reports (audit quality determinants), and the Bloomberg database (earnings management components). The AQF suggests that audit quality determinants can be categorized into two major dimensions of attributes (i.e. proficiency and morality). The proficiency attributes dimension is related to the ability of the auditor to detect the misstatement, whilst the morality attributes dimension is the willingness of the auditor to report the detected misstatement. The Islamic perspective shows that the two main categories of the AQF (proficiency, morality) are not new and are referred to in the Holy Qur'ān as strength and trustworthiness. Furthermore, Islam emphasizes more on the latter. As for the empirical findings of paired-sample T-tests analysis for 1,189 firm-years, it is revealed that there is a significant decrease of positive earnings management and a significant increase in

downwards earnings management during the recent global financial crisis (2009; 2008) compared to before crisis period (2006; 2005). These findings confirm that Malaysian managers apply the big bath strategy during the crisis period. However, the magnitude of earnings management of the Malaysian companies in the recent financial crisis was distinctly lower than those of prior studies (Johl et al., 2007; Iatridis and Dimitras, 2013). Considering this difference, the study tests whether audit quality determinants, as used by prior studies, similarly deterred earnings management practices in the recent crisis in Malaysia. The findings of the regression analysis for the 245 Malaysian listed companies revealed that five out of ten audit quality determinants (i.e. audit firm type, auditor industry specialist, board of directors' size, board of directors' independence, and audit committee independence) play a significant role in restricting earnings management practices. Therefore, the study shows that, by analysing the empirical findings and referring back to the AQF, audit quality determinants related to competent monitoring by expert auditors (proficiency attributes) and independent board of directors and audit committee (morality attributes) deter earnings management practices during the recent financial crisis. However, other audit quality determinants seem ineffective under these circumstances.

ملخص البحث

شهد القرن الواحد والعشرين العديد من الفضائح المحاسبية، مثل انهيار شركة انرون (Enron) و أفلاس شركة ووالدكوم (WorldCom). كما شهد القرن الواحد والعشرين أيضاً إغياراً لكثير من أسعار الأسهم في الأسواق العالمية. هذه الفضائح تثير الشكوك حول فعالية مراجعة الحسابات في تعزيز الثقة في تقارير الأرباح. وقد فُرضت العديد من المعايير و المبادئ التوجيهية من قبل هيئات المحاسبة و المراجعة المهنية الدولية و الماليزية لتحسين جودة التدقيق المحاسبي و عملية الإفصاح عن الأرباح أيضاً. مع ذلك إلا أن هذه الهيئات المهنية لازالت تعتبر موضوع جودة مراجعة الحسابات ذو أبعاد متعددة متشعبة و معقدة، و هذا بدوره يزيد من صعوبة تحديد و قياس جودة مراجعة الحسابات. و في سبيل حل هذا التعقيد و التعدد في جودة مراجعة الحسابات قامت هذه الدراسة بإجراء مراجعة للدراسات السابقة ذات العلاقة بمراجعة الحسابات بصورة منظمة و متعدد الأبعاد و تلخيصها في إطار نظري لجودة المراجعة (AQF). و لجعل هذا الإطار النظري لجودة مراجعة الحسابات أكثر شمولية فقد تم إدراج معيار جودة الرقابة الدولي 1 (ISQC 1). أيضاً تم تعزيز الإطار النظري لجودة مراجعة الحسابات بالأخذ بعين الاعتبار مفهوم الجودة من المنظور الإسلامي. هذا الإطار النظري لجودة مراجعة الحسابات يظهر أن حصيلة جودة مراجعة الحسابات هي جودة القوائم المالية، و التي تُقاس بتقليص حجم ممارسة التلاعب بالأرباح. بعض هذه الفضائح المالية و الاقتصادية مرتبطة بسوء تطبيق المبادئ المحاسبية المقبولة عموماً (GAAP) من قبل المدراء الذين انحرفوا بقوة في عملية إدارة الأرباح. و هناك أدلة قوية على أن ممارسات إدارة الأرباح خلال الفترات غير الطبيعية (الأزمات المالية) تختلف من حيث الحجم و الاتجاه. علاوة على ذلك، تزايدت الشكوك من قبل الأطراف ذات العلاقة من مستثمرين و أكاديميين و هيئات قانونية و وسائل الإعلام و جمهور حول فاعلية مراجعة الحسابات في محاربة الممارسات الانتهازية من قبل مدراء الشركات في التلاعب بالأرقام المحاسبية من خلال عملية إدارة الأرباح. و بالتالي، فإن الممارسات الانتهازية في التلاعب بالأرباح بين الشركات المدرجة في سوق البورصة الماليزية خلال الأزمة المالية الأخيرة تحتاج لوضعها قيد الاختبار للتأكد من وجود اختلاف في الحجم و الاتجاه من عدمه، و ذلك قبل تحديد ما إذا كانت محددات جودة مراجعة الحسابات قادرة على محاربة و تخفيف مثل هذه الممارسات. و لذلك فإن هذه الدراسة تتحقق من حجم و اتجاه ممارسات إدارة الأرباح خلال الأزمة المالية الأخيرة و

مقارنة ذلك بما قبل هذه الأزمة. ثم إنها تتناول التحقق من مدى فاعلية بعض محددات جودة مراجعة الحسابات في منع و تحجيم عمليات التلاعب و إدارة الأرباح خلال الأزمة المالية. و من ثم فقد تم وضع فرضيات الدراسة و اختبارها على أساس الدراسات السابقة ذات العلاقة. و قد تم جمع البيانات من الدراسات السابقة و قواعد البيانات و المعايير و القوانين ذات الصلة (إطار جودة المراجعة)، و التقارير السنوية للشركات (محددات جودة مراجعة الحسابات)، و قاعدة بيانات Bloomberg (عناصر إدارة الأرباح). أما الإطار النظري لجودة مراجعة الحسابات المقترح في هذه الدراسة فقد قام بتصنيف محددات جودة المراجعة إلى بُعد الكفاءة و بعد الأخلاق حيث يمثل الكفاءة القدرة على اكتشاف الأخطاء و التجاوزات، في حين يمثل البعد الأخلاقي الاستعداد للإبلاغ عن الأخطاء و التجاوزات المكتشفة. بالإضافة إلى ذلك، تم إدخال القيم الإسلامية إلى النقاش المتعلق بالإطار النظري لجودة مراجعة الحسابات. حيث أن الإطار النظري لبعدي جودة مراجعة الحسابات (الكفاءة و الأخلاق) ليسا جديدين فهما مذكورين في القرآن الكريم تحت مصطلحي القوة و الأمانة. كما أن التعاليم الإسلامية ركزت على دور القيم و الأخلاق للمراجع في تعزيز جودة مراجعات الحسابات. فيما يخص النتائج الإحصائية، فقد قامت هذه الدراسة بإجراء تحليل paired-sample T-test — 1,189 شركة خلال أربع سنوات 2005–2009، حيث أظهرت النتائج وجود انخفاض كبير في إدارة الأرباح بالاتجاه الإيجابي خلال فترة الأزمة المالية (2008; 2009) مقارنة مع ما فترة ما قبل الأزمة (2005; 2006). و في الوقت نفسه أشارت النتائج إلى زيادة ممارسة إدارة الأرباح بالاتجاه السالب بصورة كبيرة خلال فترة الأزمة المالية من قبل الشركات الماليزية. على الرغم من أن حجم ممارسة إدارة الأرباح يعد صغيراً مقارنةً بالدراسات السابقة، و بالنظر إلى هذا فإن الدراسة الحالية قامت بالتحقق من دور محددات جودة مراجعة الحسابات في الحد من ممارسة إدارة الأرباح خلال الأزمة العالمية بين الشركات الماليزية. حيث تم إجراء تحليل الانحدار لـ 245 شركة مدرجة في سوق الأوراق المالية الماليزية لعشرة محددات جودة مراجعة الحسابات و دورها في الحد من ممارسات إدارة الأرباح. و قد أظهرت نتائج التحليل أن خمسة محددات فقط (حجم شركة التدقيق، تخصص شركة التدقيق حسب القطاع، حجم مجلس إدارة الشركة، استقلالية مجلس الإدارة، و استقلالية لجنة المراجعة) لها دور فعال في الحد من التلاعب بالأرباح من قبل الشركات. لذلك تُظهر الدراسة من خلال تحليل النتائج الإحصائية و بالرجوع إلى الإطار النظري لجودة مراجعة الحسابات AQF، أن محددات جودة مراجعة الحسابات المتصلة بكفاءة و خبرة المراجعين (بُعد الكفاءة) و استقلالية

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APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Abdullah Mohammed Ahmed Ayedh

Signature

Date

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.....

Date

My father's spirit, beloved mother, my family, all my teachers in the Mosque, the schools and Universities, especially Imam Hassan Al-Banna, Dr. Fatima, and the Ummah

أهدي هذا البحث إلى أبي و أمي الحبيبة و إلى روح الشهيد الامام حسن البناء و إلى جميع أفراد عائلتي و أستاذتي في مختلف المراحل الدراسية بالخصوص د. فاطمة عبدالحميد و زوجتي الحبيبة و إلى الأمة الإسلامية بشكل عام

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LIST OF ABBREVIATIONS

A	Total assets at the beginning of the year
AAA	American Accounting Association committee
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AC	Audit Committee
AC.Ex	Audit committee financial expertise
AC.In	Audit committee independence
AC.Mt	Audit committee annual meetings
ACI	Audit Committee Institute Malaysia
AF	Audit Fees
AH	Audit Hours
ANOVA	Analysis of Variance
AO	Audit Opinion
AOB	Audit Oversight Board
AQ	Audit Quality
AQF	Audit Quality Framework
AQuR	Audit Quality Rating System
AR	Annual Report
AS	Audit Specialist
ASB	Accounting Standards Board
AT	Audit Tenure
ATA	Absolute Total Accruals
AZ	Audit Size
BD	Board of Directors
BD.In	Board of directors independence
BD.Mt	Board of directors annual meetings
BD.Z	Board of directors size
BM	Bursa Malaysia
CEO	Chief Executive Officer
CFO	Cash Flow from Operation
CG	Corporate Governance
Co Act	Company Act
CPA	Certified Public Accountant
CSRC	China Securities and Regulatory Commission
CV	Control Variable
DA	Discretionary Accruals

DA1	Discretionary accruals computed by modified Jones model by Dechow et al. (1995)
DA2	Discretionary accruals computed by modified Jones model by Kothari et al. (2005)
DF	Degree of Freedom
DUA	Duality between CEO and chairman positions
DV	Dependent Variable
D-W	Durbin-Watson test
EDA	Estimated Discretionary Accruals
EM	Earnings Management
ERC	Earnings Response Coefficient
FIFO	First In, First Out
FRQ	Financial Reporting Quality
FSRC	Financial Statements Review Committee
GAAP	Generally Accepted Accounting Principle
GDP	Growth Domestic Product
GLC	Government Linked Company
IA	Internal Auditing
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
IFAC	International Federation of Accountants
IMF	International Monetary Fund
Insp. R	Inspection Report
IOS	Investment-Opportunity-Set
IPC	Inter Process Communication sector
IPO	Initial Public Offering
ISA	International Standard on Auditing
ISD	Independent School District
ISQC 1	International Standard Quality Control 1
IV	Independent Variable
KLSE	Kuala Lumpur Stock Exchange
Lev	Leverage
LIFO	Last In, First Out
MAREF	Malaysian Accountancy Research and Education Foundation
MCCG	Malaysian Codes of Corporate Governance
MIA	Malaysian Institute of Accountants
MSA	Malaysian Standards on Auditing
N	Number of companies
NACRA	National Annual Corporate Reports Awards 2002
NAS	Non-Audit Services
NDA	Non-Discretionary Accruals

NI	Net Income before extraordinary items
OIC	Organization of the Islamic Cooperation
OLS	Ordinary Least Square
OS	Ownership structure
SFAS	Statement of Financial Accounting Standards
SOE	State-Owned Enterprises
SSA	Strategic-Systems Auditing
TA	Total Accruals
UiTM	University Technology Mara
UK	United Kingdom
US	United States of America
VIF	Variable Inflation Factor
Y	Yes

CHAPTER ONE

INTRODUCTION

1.0. INTRODUCTION

A quality audit is an essential element in monitoring financial reporting quality. Due to its importance, audit quality (AQ) has been keenly studied. However, since AQ is a complex issue, it cannot be studied from a single perspective. Therefore, this thesis uses two main parts to study AQ; i.e. from the perspective of its determinants, which is summarized into a comprehensive framework, and from the perspective of the outcome of a quality audit, which is its effect on earnings management (EM). It is hoped that an integration of two relatively different sides to AQ would help in a better appreciation of AQ, particularly since the empirical data used in this thesis focused on a specific period in Malaysia, which is during the recent financial crisis. Further elaboration on the thesis is provided below as this chapter offers an overview of the thesis. The chapter is organized into four sections. The first section discusses the background of this study and draws out the research problem. The second section highlights the research questions and research objectives. The following section discusses the significance of the study. The chapter concludes by outlining the structure of the thesis.

1.1. BACKGROUND OF THE STUDY

Audit quality is an important issue based on the fact that it directly and significantly enhances the credibility and reliability of the financial information which influences the share price of the auditors' client companies (Chaney and Philipich, 2002;