



## The Effect of Audit Quality on Firm Value: A Case in Indonesian Manufacturing Firm

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### **Keywords**

Audit Quality, Firm Value, Big 4, Financial Statements, Indonesian Stock Exchange.

### **Jel Classification**

M41, M42.

### **Received**

07.10.2019

### **Revised**

30.10.2019

### **Accepted**

10.11.2019

### **Abstract**

**Purpose:** This study aims to examine the effect of audit quality on firm value in manufacturing companies listed on the Indonesian Stock Exchange in 2013 to 2017.

**Design/methodology/approach:** Population in this study are all manufacturing companies listed on the Indonesian Stock Exchange. Sampling was carried out using a purposive sampling method. Research data were tested using multiple regression analysis.

**Findings:** The results from this study show that audit quality has a positive effect on firm value in manufacturing companies on the Indonesian Stock Exchange.

**Practical Implications:** The Indonesian capital market gives a positive appreciation to companies that have higher quality audits. Higher audit quality is expected to reduce agency costs, reduce information asymmetry and increase firm value. Companies are advised to use higher quality auditors in order to increase firm value in the Indonesian capital market.

**Originality/value:** Audit quality which is proxied by Big 4 and non-big 4 auditors has been proven to have a positive influence on firm value in manufacturing companies on the Indonesia Stock Exchange.

## 1. Introduction

This study aims to examine the effect of audit quality on firm value in manufacturing companies listed on the Indonesian Stock Exchange. According to Afza and Nazir (2014), company owners and investors always expect a positive return on their investments. The company's growth is a supporting factor for economic growth, supporting factors for industrial growth and at the same time showing the company's management performance. Firm value shows the appreciation of company owners, investors and potential investors for the corporate financial performance.

Alsmairat et al. (2018) states that in developing countries, audit quality is one of the factors that influence firm value. Companies that have high audit quality can minimize the risk of audit failure, prevent fraud and reduce the company's earnings management. Aobdia et al. (2015) state that audit quality helps providing information to uninformed investors on company basis value. The capital market gives a positive reaction if the company moves from a low-quality auditor to a higher quality auditor.

Kronenberger and Pietzsch (2017) state that auditors are a profession that works on the basis of independence, professionalism, and trust. Capital markets require proper verification of financial statements to improve business decision processes. Previous research has conducted many studies on audit quality, such as Gaynor et al. (2016) which examines the relationship with the quality of financial statements, earnings quality (Reyad, 2013), corporate performance (Elewa and El-Hadad, 2019), auditor reputation (Skinner and Srinivasan, 2012), and earnings management (Inaam et al., (2012), Chi et al., (2011)).

Wang and Huang (2014) explain that audit quality has an important impact on firm value. However, there are only few studies that conduct a comprehensive analysis of audit quality and firm value. Most research discusses the relationship between audit quality and financial report quality, but there is a few research that focuses on audit quality and firm value (Wang and Huang, 2014).

Hamdan et al. (2012) explain that the increasing accounting scandal in the capital market increases awareness of the importance of audit quality. Academics and practitioners state that auditing will have a major impact on assessing capital market performance, so the effectiveness of the audit process needs to be improved. Fooladi and Farhadi (2011) explain that in implementing the principles of corporate governance, companies must conduct annual audits conducted by competent and independent third parties. High quality audits are carried out to provide objective assurances to shareholders and company management that financial statements are fairly presented in terms of financial position, performance and all material matters. The audit process

has an important role as an effort to reduce information asymmetry and limit agency problems between managers and shareholders.

Balsam et al. (2003) state that audit activity is a systematic effort to improve the quality of information presented in financial statements. Hamdan et al. (2012) explain that some studies still debate the basic definition of audit quality, but in general audit quality is associated with the ability of external audits to detect events or abnormal transactions in financial statements and communicate these findings to the users of financial statements.

Skinner and Srinivasan (2012) said that audit quality is a central component of good capital market functions. Audit quality provides a guarantee of the credibility of the information presented in the financial statements. Information in financial statements becomes the basis for users to provide more precise and accurate values to the company. Wang and Huang (2014) state that's by reporting performance information appropriately, auditors have a role in maintaining the quality of the information in the capital market. This role is useful in assisting capital market practitioners in making business decisions, especially in information asymmetry and high agency problems.

In Indonesian context, Indonesian capital market is an emerging capital market. If the audit has good quality, investors in the market are expected to obtain more credible and quality information so that investors can be more precise in making business decisions. According to Liao and Radhakrishnan (2016), auditors have a guaranteed role for more conservative financial statements and a quality audit process. Rodriguez and Alegria (2012) stated that audit quality will reduce the risk of information. Based on this situation, the researcher suspects that audit quality is one of the most important information that can affect the firm value of manufacturing companies on the Indonesian stock exchange. Investors are predicted to give higher value to companies that have higher audit quality compared to other companies.

## **2. Literature Review And Development Of Hypothesis**

### **2.1 Agency Theory**

Hill and Jones (1992) describe that in the last few decades, agency theory has become the dominant paradigm in the field of financial economics research. The main of agency theory thinking assumes that the interests between principals and agents are different. According to agency theory, the principal can limit agent deviation behaviors by creating an adequate incentive mechanism for the agent. Principals incur monitoring costs that are designed to limit the opportunistic behavior of agents. Principals incur costs for agents to guarantee that they will spend the resources well. The explanation of agency theory tries to provide solutions to problems that occur in the relationship between principals and agents.

Jensen and Meckling (1976) explain that agents' opportunities to harm principals can be limited. Principals can create supervising mechanisms for agents and the agents limit the bonding. The monitoring aspect can be strengthened by the implementation of good governance mechanisms within the company. Parks and Conlon (1995) argue that monitoring and compensation are very important in agency relationships. The principal must have a monitoring mechanism that can appraise the agent's performance appropriately so that the principal can determine the right compensation contract and avoid overpayment.

Rodriguez and Alegria (2012) explain that the demand for quality external audits occurs because of agency problems caused by differences in interests between ownership and company management. External audit acts as the main supervision system for evaluating the performance of company management. Audit quality is also related to public needs for the guarantee of higher quality information. Lin and Hwang (2010) state that agency problems raise the risk of information asymmetry between management and owner. The asymmetry information will increase the demand for external audits. External auditors are responsible for verifying financial statements fairly by following GAAP, and financial statements shows the actual economic conditions and real profits according to company operation. Thus, verification conducted by the auditor will increase the credibility of the financial statements. Audit quality is expected to prevent management opportunistic behavior in earnings management to reduce the risk of information about the existence of material misstatements or omissions in the financial statements.

## **2.2 Audit Quality**

DeAngelo (1981) defines audit quality as the market assumptions probability that financial statements contains errors, and the auditors will find and report the errors. The ability to find material misstatements in the financial statements will depend on the capabilities of the auditor, while the willingness to disclose will depend on the wishes of the auditor. Audit quality has been manifested in the audit opinion given, but the study of audit quality is still interesting to analyze.

According to Balsam et al. (2003) an assessment of the audit process cannot be measured directly. Audit quality measurement is multidimensional, and inherently cannot be measured directly. Therefore, there is no single characteristic of the auditor could be used as a measurement of audit quality. However, DeAngelo (1981) argues that the big 4 public accounting firm (at that time big 8) had more competence and independence compared to the others. This happens because the audit work process will not depend on the audit fees paid by the client. Big 4 public accounting firms have greater assets, large client capitalization, better investment in human resources through training.

The study was developed based on the research of DeAngelo (1981), which used big 4 and non-big 4 public accounting firms as a measure of audit quality. Reyad (2013) state that audit quality is different among public accounting firms. Big 4 public accounting firms are considered to have higher audit quality compared to non-big 4. The reasons are: having more clients, ability to maintain the reputation of public accounting firms, having greater potential resources that can be used for recruitment, training, and technology, can withstand losses (e.g.: reject clients with a bad reputation).

Lin and Hwang (2010) exemplify previous studies that have used auditor brand name (auditor size), industry specialization, audit tenure, audit fees and services, and independent auditors as a proxy for audit quality and are linked to financial statements both directly and indirectly. DeAngelo (1981) states that the big 4 public accounting firm (at that time big 8) provided a guarantee of better audit quality so that it had an impact on better earnings quality. This process is carried out by the public big 4 accounting firm to protect the auditor's reputation from legal exposure and reputation risk originating from misleading client financial statements and optimistic earnings reporting.

Francis and Wang (2008) state that big 4 public accountants have collective experience in administering audits on public companies. Big 4 auditors have more hours of audit engagement so that they can detect material misstatements better in the audited companies. Auditors from non-big 4 public accounting firms have less audit experience and are still developing the ability to detect misstatement problems in the company. Big 4 public accounting firms are considered to have better human capital in their offices. The logical consequence is that auditors from the Big 4 public accounting firm will be able to detect and report material misstatements better and make corrections to those material errors before the audit report is published.

### **2.3 Hypothesis Development**

The link between audit quality and firm value will be discussed in terms of what are the benefits for financial information users for a higher quality audit process, and the impact on investment decisions made by users. Balsam et al. (2003) explain that corporate managers have an incentive to manage corporate earnings. Earnings reporting by the management will have an impact on the compensation received, especially if the bonus scheme is determined based on earnings. Audit quality is an important component used to limit earnings management behavior so that the company owners will not make excessive payments to the management.

Reyad (2012) conducted a research which correlate audit quality with financial statements. Financial statements which are audited by higher quality auditors rarely contain material

misstatements. Quality audits can minimize agency costs between shareholders and management. Krishnan (2003) found that the evidence in the United States showed that companies audited by big 6 had better earnings quality compared to non-big 6 with earnings quality measurements based on accruals and ERC. Audit plays an important role in limiting agency costs by preventing opportunistic managers' behavior on accruals.

Eshleman and Guo (2014) explained that in a preliminary literature review of research on audit quality, the size of public accounting firms namely big 4 and non-big 4 became the main indicators of audit quality. Krishnan et al. (2003) show that companies audited by Big 4 public accounting firms have better financial report quality compared to non-big 4. Quality audit processes will limit agency problems for the opportunistic behavior of management over corporate accruals. The financial statements audited by big 4 has a higher association between accruals and returns in the company, it means that the market provides a higher quality of valuation of information in the financial statements.

Francis and Wang (2008) revealed that audit quality is an important aspect, especially in countries with high litigation. The extreme legal environment and risk management behavior cause the big 4 public accounting firm in the USA to apply a high level of information quality. Financial statements prepared tend to be more conservative than other countries. Wang and Huang (2014) mentioned that auditor specialist characteristics influence firm value. The capital market gives a positive value to the company audited by auditors who have special expertise and knowledge.

Lu and Sapa (2009) explain that increasing business risk and increasing litigation risk make auditors more conservative. Investors in the capital market will use the information presented in the financial statements to provide value for the company's performance. Determination of the company's stock price and investment decisions will depend on the information presented in the financial statements. The demand for a higher quality audit process and the presentation of more conservative financial statements prevents wrong business decisions that cause losses for investors.

Alsmairat et al. (2018) explain that companies are required to conduct external audits to limit agency costs. External audits are expected to verify the financial statements fairly and the results reflect actual economic conditions. A quality audit process can reduce the opportunistic behavior of earnings management, reduce the risk of information on financial statements that contain material misstatements, reduce agency costs and reduce information asymmetry between managers and company stakeholders. Eshleman and Guo (2014) explain that audit quality can reduce the risks faced by company management. Eshleman and Guo (2014) found that big 4 auditors have higher

audit quality when compared to non-big 4. This finding is proven by the small number of restatement process on company's financial statements audited by Big 4 auditors.

Francis and Wang (2008) explained that the big 4 public accounting firm is an international public accounting firm with global operations. Big 4 public accounting firms have an incentive to always develop and maintain their reputation worldwide. This strategy is carried out with several efforts such as standardization of staff training, knowledge sharing practice and global application of audit methodologies. In this perspective, big 4 auditors must consistently treat their clients throughout the world with the application of earnings quality and accounting conservatism. Gaynor et al. (2016) stated that the definition of audit quality has the same direction as the definition of financial statement quality. Audit quality is considered by investors and other users of financial statements as consideration for evaluating the quality of financial statements.

Asthana (2014) explains that audit quality affects investors' assessments of earnings quality and firm value. This study focuses on audit delay as an indicator of audit quality. The longer audit delay shows poor audit quality. Audit delay will have an impact on the delay of annual accounting disclosures that cause negative market reactions. Audit delay will create skepticism among investors, especially related to reported earnings quality.

Aobdia et al. (2015) explain that a quality audit engagement process can produce added value to the capital market in two ways. First, quality audits provide a positive signal to uninformed investors based on providing corporate value. Second, a quality audit process guarantees the accuracy of the information presented in the financial statements. Quality information will reduce the information asymmetry between the company and investors. Aobdia et al. (2015) show that market participants react positively when companies move from low quality auditors to higher quality auditors, this shows when the capital market reacts to audit quality. Lu and Sapra (2009) state that a quality audit process is expected to increase assurance of the quality of financial reporting. Audit quality can reduce information asymmetry and improve firm value. Wang and Huang (2014) states that a higher quality audit process can improve firm value.

Based on the explanation above, the hypothesis in this study was formulated as follows.

H1: audit quality has a positive effect on firm value.

### **3. Research Methodology**

#### **3.1 Population, Sample, and Research Data**

The population of this research is all manufacturing companies listed on the Indonesia Stock Exchange from 2013 to 2017. Data were obtained from Indonesian Capital Market Directory (ICMD) documents, IDX statistical documents, listed company performance summaries, annual reports, and

audited financial statements. The sampling technique was carried out using the purposive sampling method, with the following criteria: 1) manufacturing companies listed on the Indonesia Stock Exchange from 2013 to 2017. 2) Possessing audited financial statements presented in the Indonesian currency (Rupiah). 3) Possessing complete financial data which is suitable with researcher's need.

### 3.2 Definition of Variable Operations

#### Independent Variable

The independent variable in this study is audit quality. According to DeAngelo (1981), audit quality is measured by dummy variables for big 4 and non-big 4. A value of 1 is given if the company is audited by a public accounting firm affiliated with a Big 4 public accounting firm, and a value of 0 is given otherwise.

#### Dependent Variable

The dependent variable in this study is firm value. Firm value in this study was measured by Tobin Q. Tobin Q was measured with the market value of equity plus total debt divided by total company assets referring to Wang and Huang (2014).

#### Control Variable

This study uses two control variables, namely leverage, and firm size. According to Rodriguez and Alegria (2012), leverage is measured by total debt divided by total company assets. The amount of corporate debt is one of the market's concerns in providing value to the company. A high amount of debt becomes a risk that must be anticipated by investors. Bankruptcy risk due to default on debt is a factor that investors consider in determining firm value. The second control variable is the firm size. Firm size is measured by the natural log of total assets (Wang and Huang, 2014). Firm size provides security guarantees for investors on the continuity of the company's business. Large companies are considered to have smaller risk when compared to small companies. Investors generally give more confidence when investing in large companies.

### 3.3 Statistic Test

#### Multiple Regressions

The hypothesis in this study was tested with multiple regression analysis. The regression equation used in this study is as follows:

$$TOBINQ_t = \alpha + \beta_1 DBIG4_t + \beta_2 t LEV_t + \beta_3 LNSIZE + e$$

Information:

TOBINQ<sub>t</sub> = Firm Value,

DBIG4<sub>t</sub> = Dummy Big 4 (audit quality),



- LNSIZE<sub>t</sub> = log natural total assets,  
 LEV<sub>t</sub> = leverage,  
 $\beta_1 - \beta_3$  = regression coefficient, and  
 e = error.

Before analyzing the regression model, classic assumption tests will be conducted which include the data normality analysis, the Multicollinearity analysis, the autocorrelation test, and the heteroscedasticity test. Descriptive statistical testing was also conducted in this study.

## 4. Result

### 4.1 Sample Selection Results

This research was conducted at manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017. The following table shows the results of the sample selection.

**Table 1:** Sampling Results

Sample Criteria	Amount
Manufacturing companies listed on the Indonesia Stock Exchange	137
Manufacturing companies that have complete research data	95
The number of observations during 2013-2017	475
Companies with Capital Deficiation	15
Data does not meet the requirements (outlier)	40
Final Observation Number	410

*Source: Results of data collection.*

Table 1 explains that in this study there were 95 sample companies with the number of observational data 475 companies. Based on further scanning it was found that 15 companies had negative equity (capital deficiency), so they were excluded from the analysis. The researcher conducted an outlier test to obtain data with a normal distribution. Outlier test results show that there are 40 outlier data, so they must be excluded from the analysis. The number of observations used in this study was 410 companies during 2013-2017.

### 4.2 Descriptive statistics

The following table shows the results of descriptive statistical tests and correlation tests of each research variable.

**Table 2:** Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Standard Deviation
DBIG4	410	0	1	0.33	0.47
LEV	410	0.04	0.96	0.45	0.21
LNSIZE	410	21.03	33.32	27.86	1.98
TOBINQ	410	0.20	3.90	1.33	0.82

*Source:* Authors' calculations (2019)

Table 2 portrays the data description of the variables in this study. The audit quality variable measured by dummy big 4 has an average value of 0.33 with a standard deviation of 0.47. It shows that in the sample companies there are still many companies that have not been audited by Big 4. This study uses two control variables, namely leverage and firm size. The leverage variable has a minimum value of 0.04 with a maximum value of 0.96. The average value of leverage is 0.66 with a standard deviation of 0.21. The firm size variable has a minimum value of 21.03 with a maximum value of 33.32. The average value of firm size is 27.86 with a standard deviation of 1.98. The dependent variable in this study is firm value. Descriptive statistical results show that the firm value measured by Tobin Q has a minimum value of 0.20 with a maximum value of 3.90. The average firm value is 1.33 with a standard deviation of 0.82.

The data used in this study have passed the classical assumptions of research tests which include data normality test, autocorrelation test, multicollinearity test, and heteroscedasticity test.

**Tabel 2:** Correlation

Variable	LEV	LNSIZE	DUMBIG4	TOBINQ
LEV	1	0.013	-0.104*	-0.045
		0.798	0.036	0.362
	410	410	410	410
LNSIZE	0.013	1	.413**	0.253**
	0.798		0.000	0.000
	410	410	410	410
DUMBIG4	-0.104*	0.413**	1	0.243**
	0.036	0.000		0.000
	410	410	410	410
TOBINQ	-0.045	0.253**	0.243**	1
	0.362	0.000	0.000	
	410	410	410	410

*Source:* Authors' calculations (2019)

Table 2 shows that the highest correlation occurs between audit quality and company size with a value of 0.413. The smallest correlation occurs between company size and leverage, which is equal to 0.013.

### 4.3 Hypothesis Testing

The hypothesis in this study was tested by multiple regressions. The test results of each hypothesis are as follows.

**Table 3:** Regression Test Results

Description	Coefficients	t-statistics	p-value
Constant	-0.865	-1.448	0.148
DBIG <sub>t</sub>	0.287	3.105	0.002
LNSIZE	0.078	-0.642	0.000
LEV	-0.123	3.562	0.521
Adjusted R Square	0.081		
f-value (f-statistics)	13.02		0.000

*Source: Authors' calculations (2019)*

Table 3 shows that the coefficient of determination shows the R square value of 0.081. It means that 8.1% of variations in changes in firm value can be explained by audit quality, leverage and firm size. The remaining 91.9% is influenced by other factors outside the research model. The results of the F value test show an F value of 13.02 with a p-value of 0.000, so it can be concluded that the regression model is fit with the data used.

The hypothesis of the study aims to examine the effect of audit quality on firm value. Regression test results showed a regression coefficient of 0.287 with a p-value of 0.002. Regression test gives significant results, so it can be concluded that audit quality has a positive effect on firm value. Hypothesis 1 is supported. The results of this study support the results of the research of Wang and Huang (2014). The testing results of the control variables indicate that firm size influences firm value while leverage does not affect firm value.

In the case of manufacturing companies on the Indonesia Stock Exchange, the greater the firm size, the capital market will provide a higher firm value, while leverage does not affect the firm value. Investors in the Indonesian capital market feel more secure investing in companies with large asset sizes. This study found a positive effect of firm size on firm value but failed to prove the effect of leverage on firm value.

## 5. Discussion

The results of this study indicate that audit quality has a positive effect on the firm value on manufacturing companies listed on the Indonesia Stock Exchange. Audit quality in this study is measured by dummy variables for big 4 and non-big 4 auditors. These results indicate that the capital market reacts positively to companies audited by Big 4 public accounting firms when compared to companies audited by non-big 4 public accounting firms. The competencies and advantages possessed by big 4 auditors become a logical explanation for why the capital market has a positive reaction. In terms of human resources, assets, and networks, big 4 auditors provide a guarantee of a higher quality audit process. Wang and Huang (2014) explain that big 4 auditors have better auditor value chains that lead to the formation of specialist audits and a better understanding of knowledge when compared to non-big 4.

Reyad (2013) explains that audit quality shows the ability of the audit process to detect and report material misstatements from financial statements and reduce the level of information asymmetry between management and shareholders. Companies that are audited by higher quality auditors will be able to improve quality financial reports. There are no material misstatements in reporting, financial data is presented more conservatively and will have an impact on lower agency costs.

According to Klai and Omri (2011), there were many financial scandals involving auditors, causing high demands for the quality of financial statements. Companies are required to implement corporate governance more stringently to be one of the efforts to protect interested parties in the company (Chalaki et al., 2012). Reyad (2013) explains that with quality external audits, companies are expected to have credible financial statements that are free from misleading financial information.

According to Skinner and Srinivasan (2012), audit quality is related to the auditor's reputation. Choosing to use the services of an auditor who has been exposed to a case or has been labeled by a failed public accountant firm is a big risk for the client. The company will choose a more reputable public accountant firm to avoid litigation aspects. The company's decision to choose the big 4 auditors is reacted by market participants by giving a higher value. The company's decision to use the services of higher quality auditors shows a commitment to protect the rights of users of financial information. Lu and Sapra (2009) explained that the audit process provides quality assurance of information risk. The risk of this information will have an impact mainly on the information asymmetry and business decisions made by investors. Eshleman and Guo (2014) explained that by choosing higher-quality auditors reduces the risk borne by the client in the litigation aspect and improves earnings quality.

The Indonesian capital market gives a positive appreciation to companies audited by Big 4 auditors. This can be seen from the influence of audit quality on firm value in manufacturing companies on the Indonesia Stock Exchange. The positive impact of audit quality can be seen from several impacts, including more precise quality financial statements, lower earnings management, lower agency costs, and information asymmetry. The above reasons explain why the capital market gives higher values to companies audited by big auditor 4.

## **6. Conclusion**

Based on the analysis and discussion in the previous section, it can be concluded that audit quality has a positive impact on the firm value on manufacturing companies on the Indonesia Stock Exchange. The Indonesian capital market places a higher value on manufacturing companies that are audited by big 4 public accounting firms when compared to companies audited by non-big 4 public accounting firms.

The limitation of this research is that this research is only conducted on manufacturing companies so that the results of the research cannot be generalized to all types of companies on the Indonesia Stock Exchange. Further research is expected to develop samples for all companies on the Indonesia Stock Exchange, and add other variables that are thought to affect the value of the company such as earnings quality and accounting conservatism.

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