

Audit Quality, Effectiveness of Board Audit Committee and Earning Quality

Chadanat Piyawiboon
College of Innovation Management,
Rajamangala University of Technology Rattanakosin,
Nakhonpathom, Thailand

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ABSTRACT

This study aims to investigate the relationships between the Audit Quality and the Earnings Quality as well as between the Board Audit Committee and the Earning Quality of the listed firms in 4 industrial groups in the Stock Exchange of Thailand (SET) which are: 1) Agro and Food, 2) Resource, 3) Technology, and 4) Consumer goods from 2009 to 2013. The Earnings Quality was measured by using the Modified Jones Model and the Total Accruals were calculated by adopting the Cash Flow Concept. The data were collected by using panel data with random effects. The results show that the auditor firm size has a negative correlation with the Discretionary Accruals. Also, there is a positive correlation in changing from the smaller audit companies to the larger ones. For the auditors' opinion, it is found that when the auditors gave a remark on the going concern, there was a negative correlation with the Discretionary Accrual and it resulted in the good Earnings Quality. The opposite result appeared when the auditors did not give an opinion about the financial statements and gave an observation about the going concerns which resulted in the poor Earnings Quality. However, the relationship between the efficiency of the Board Audit Committee and the Audit Quality was not found and cannot be concluded.

Keywords - Earning Quality, Audit Quality, Discretionary Accruals, Going Concern

I. Introduction

The agency problems which are associated with the separation of ownership and control cause the demand for external audit. Originally, the agency problems arise from the asymmetric information in the principal-agent contracts. Asymmetric information refers to a situation that one party to a transaction has more information than the other party. Analytical models have demonstrated that the existence of information asymmetry between firm management and firm share holders is a necessary condition for the practice of Earnings Management (Truman and Titman, 1988; Dye, 1988). If information asymmetry occurs, shareholders will have in sufficient resources, incentives, or access to relevant information to monitor manager's actions, Earnings Management can occur as well (Schipper, 1989; Warfield, Wild, and Wild, 1995).

A good management ensures users of the quality financial statement. According to the auditing principle, a company will consider hiring a professional external auditor to perform an audit, give an opinion about the financial statement, and confirm that the statement is

audited with quality. This creates the reliability and makes the auditors professionally renowned and sustainably successful. The audit reliability also affects the business's credibility. However, a business is rarely run by an individual; therefore, a business owner needs someone to help him/her in managing the business. The executives usually try to serve their own interest; so, they will try to find ways to create the maximum value if those ways benefit them as mentioned within the Agency Theory. Earnings Management is a tool for the executives to achieve their objective. Whether the Earnings Management will have a good effect on a business and an investor depends on the executive's Earnings Management. If the executive adopts the use of Discretionary Accruals (DA) in order to control the profit number, structure the transactions to fix the financial report, lead the stakeholder to have a misunderstanding of the business' economical performance, or to have an influence on any agreement, depending on the reported accounting numbers (Healy and Wahlen, 1998).

Moreover, there might be an intervention in the preparation process of the financial report in order to gain the individual benefits (Schipper, 1989) and the users of financial statements can make the wrong decision. Therefore, there must be the auditors who examine the business's performance report. Technically, the executives, investors, and other users of the financial statements require the auditors to perform quality audits and give good signals to the investors. This study will be advantageous to users of financial statements, those who are responsible for the management and those who use the report to make any decision as they can consider the types of auditors' opinions which may provide some warnings for the investors.

The external auditors perform the audit and give an opinion about the financial statements in order to report the information to the users of statements while the audit committee play an important role in making the company's financial statements credible. Many studies have been completed in the areas of corporate governance and Audit Quality which are the effective factors to restrain excessive opportunistic behavior in corporate management. The composition of each unit's audit committee is considered one of the factors that support the Audit Quality (Bradbury et al., 2004 Bryan et al., 2004; and Vafeas, 2005).

This study concerns the Audit Quality which is done by the external professional auditors. These involve the types of audit firms, changes of auditors, opinions of auditors, and efficiency of the board of executives which consist of experts in finance and accounting. The number of meetings of the audit committee affects the earnings quality of the listed companies and it is an important evaluator for creditors, investors, and other users of financial statements to keep track of the auditor's report as well as to be aware and cautious when considering the financial information before making any decision.

II. THEORETICAL FRAMEWORK AND HYPOTHESIS REVIEW

A. Theoretical Framework

One of the objectives of corporate governance is to ensure that the financial report has high quality and reliable data. The earnings information is the financial report that investors will analyze before making any decision in investment. Therefore, if the earnings information has low quality and contains inaccurate data, the investors may make wrong decisions. The

executives are considered the agents who are responsible of preparing the financial statements and business performance for the shareholders. According to the Agency Theory, the asymmetry of information is the situation where the executives receive more information than the shareholders.

Information asymmetry between firm management and firm shareholders is a necessary condition for the practice of earnings management (Truman and Titman, 1988; Dye, 1988). The shareholders will not have sufficient resources, incentives, or access to relevant information for monitoring the manager's actions and Earnings Management (Schipper, 1989; Warfield, Wild, and Wild, 1995). The magnitude matter of information asymmetry ensures investors of quality financial statements and the important roles involve the external auditors and the audit committee.

The auditing role concerns the reported earnings quality and different auditors provide their client different quality and credibility of the Earnings Quality. The Board of Audit Committee can resolve conflicts between the management and the external auditors as the main audit committee manage the firm's financial reporting process. Regularly, they meet with the firm's external auditors and the internal financial managers to manage the corporation's financial statements, the audit process and the internal accounting controls. In contrast, Magee and Tseng (1990), Dye (1991), and Antle and Nalebuff (1991) argued that the legitimate differences of opinions between the management and external auditors may occur during the implementation of GAAP.

B. Literature Review and Hypothesis

Audit Quality and Earnings Quality

Audit Quality is a chance or probability that the auditor can identify and report any inaccuracy of the financial statement De Angelo (1981). Previous studies on the relationship between the Audit Quality and the Earnings Quality have been implemented in many countries. The Earnings Quality concerns with the financial health and the capability of informed earnings. It redirects the company's exact earnings to predict future earnings. Moreover, it increases the stability, persistence and nonexistence of variability in reported earnings on audit quality researches as follows.

Audit Firm Size

Significantly, the variations of Audit Quality between the Big 4 and non-Big 4 audit firms appear in previous researches. DeAngelo (1981) claimed that Big4 auditors' Audit Quality is better than non-Big4 auditors'. Likewise, Zhou and Elder (2003) and Chen et al (2005) found that the Big 4 auditors were associated with a smaller amount of Earnings Management in the firms. In addition, Francis et al (1999) and Krishnan (2003) stated that Big4 auditors restrain from Earnings Management of clients more than the non-Big4 auditors do. Therefore, clients of non-Big4 auditors require higher levels of Discretionary Accruals.

Audit Firm Change

Several studies suggest that companies change the audit firms in order to improve the quality of their financial reports. Mainly, it has been proposed that auditor changes are concerned with the management motivation for opinion shopping. However, there is no empirical evidence for the claims (e.g., Johnson and Lys, 1990; Francis and Wilson, 1988;). DeFond and Subramanyam (1998) also analyzed the amount of reaction among a section of companies that improved their auditor in a non-compulsory rotation environment. Additionally, it is discovered that Discretionary Accruals decreased incomes in the last year of the auditor's service. On the other hand, the Discretionary Accruals are insignificantly established in the first year of the new auditor's (Johnson et al., 2002). There are evidences of lower Audit Quality (larger abnormal accruals) in the first three years when auditors change the relation to ongoing engagements of a few or four years. Accordingly, it is consistent with lower initial Audit Quality on new engagements. Therefore, the evidence does not support the requirements or benefits of mandatory auditor rotation.

Audit Opinion

Previous researches have shown that the Audit Quality is the high quality of financial report and that it reduces the inaccuracy in the auditor's report in the financial statements. Leone and colleagues (2004) analyzed the relationship between the opinions of auditors, the difference of profit (loss) on an accrual basis and the cash flow from ongoing operating activities. Due to the profits of listed companies in the United States in the study with the use of Web - Based Sampling Data analysed by using descriptive statistics and ordinary least square regression analysis. In the studies of Bartonet al (2000), and Jones (1991), the relationship of performance matches discretionary accrual measure, according to the discretion of the executive. To increase ROA, Jones (1991) found that the opinion of the committee account was unconditional. Nevertheless, it emphasized on the added data points to the ability of the company's ongoing operations. Plus, there were differences between profit(loss)on an accrual basis and cash flow from ongoing operating activities in positive values. In that case, the auditors' opinions in other approaches excluding the unqualified ones are correlated with the differences between profit(loss)on an accrual basis and cash flow from the ongoing operations.

Recent researchers have found that higher quality auditing increase the quality of financial reporting and reduce the chance of the auditor's incorrect opinions in the financial statements. Therefore, the following hypotheses are proposed:

H1: There are significant associations between the Audit Quality and Earnings Quality. The associations are as follows:

- There is a significantly positive association between the auditor firm size and Earnings Quality
- There is a significantly positive association between the auditor changes and Earnings Quality
- There is a significantly negative association between the changeable opinion and Earnings Quality

Effectiveness of Board Audit Committee and Earning Quality

The role of Board of Audit Committee is to resolve problems between the management and external auditors. The audit committee primarily directs the firm's financial reporting process. They contact with the firm's external auditors and the internal financial managers in order to arrange the corporation's financial statements, the audit process and the internal accounting controls. Additionally, previous researches suggest that another role of the audit committee is to be the arbiters as they must consider the different opinions of both parties and make an accurate final report.

Audit Committee Expertise

SEC (1999) stated that every audit committee consisted of at least one financial expert. However, DeZoort and Salterio (2001) argued that the audit committee's financial expert increased chances that material misstatements were communicated to the audit committee and corrected in a timely approach. In addition, Abbott et al.(2004) reported a negative association between the audit committee's financial expert and the occurrence of earnings restatement.

Audit Committee Meeting Frequency

According to studies of DeZoort and Salterio (2001), these indicated that the quantity of the Audit Committee meeting resulted in efficiency of the Audit Committee. Moreover, Xie (2003) and Vafeas (2005) found that the frequency of Audit Committee meeting related higher profits.

H2: There is a significant relation between the effectiveness of Board Audit Committee and Earnings Quality and the capability of the Board is divided as follows:

- There is a significant positive relation between the proportion of the skillful audit committee in Finance and Accounting, and Earnings Quality.
- There is a significant positive relation between the quantity of the Audit Committee meeting and Earnings Quality.

Control Variables

We control for variables that have been identified in prior literature as likely to affect the reporting of discretionary accruals such as firm size, firm performance, and leverage.

Large firms are less likely to engage in earnings management due to more scrutiny from

Financial analysts and investors (Zhou and Elder, 2003). In addition, researchers such as Chen et al.(2006) and Shah,Zafar&Durrani (2009) show that firms with lower performance have higher behavior of earnings management. Finally, leverage is included as prior studies show that firms with a higher likelihood of violating debt agreements are more likely to have an incentive to engage in earnings management to increase earnings (Healy and wahlen, 1998).

III. METHODOLOGY

A. Data Collection and Sample

The data of four listed company groups including 1) Agro and Food Industry Group 2) Resource Group, 3) Technology Group, and 4) Consumer Goods Group on the Stock Exchange of Thailand during 2009-2013 were collected from the website of the Securities and Exchange Commission (SEC). Moreover, the Annual Report and Form 56-1, financial information in the financial statements, auditor report were collected from SETSMART.

B. Model Specification and Variables

Dependent Variable

Discretionary Accruals (based on modified Jones Model), as a measure of Earnings Quality are the dependent variable, using the cash flow statement approach to measure total accruals. In the cash flow statement approach, total accruals are defined as income before extraordinary items minus operating cash flows, there is a procedure to calculate as follows:

Step 1: Calculate the total accruals cash flow operating as expressed in the equation:

$$TA_{it} = NI_{it} - CFO_{it} \quad (1)$$

where: TA_{it} = total accruals of year t;

NI_{it} = net income.

CFO_{it} = cash flow from operations; of year t;

Step 2: The results are calculated from equation (1) to estimate the coefficients by using Ordinary Least Squares (OLS) regressions, as expressed in the equation:

$$TA_{it} / A_{it-1} = a_{1i} (1/A_{it-1}) + a_{2i} (\Delta REV_{it}) / A_{it-1} + a_{3i} PPE_{it} / A_{it-1} + \varepsilon_{it}$$

(2)

where: TA_{it} = total accruals of year t.

A_{it-1} = total assets t-1.

ΔREV_{it} = change in revenue measured by change in sales, it relates to sales t-1.

PPE_{it} = gross value of property, plant and equipment in year t.

a_i = coefficient of correlation of the variable i.

ε = the error term.

Step 3 : Calculate accruals from the business operations of each company by applying the coefficients

from Step 2 and replacing the equation 3, as expressed in the equation:

$$NDA_{it} = a_{1i}(1/A_{it-1}) + a_{2i}(\Delta REV_{it} - \Delta REC_{it}) / A_{it-1} + a_{3i}PPE_{it} / A_{it-1}$$

(3)

Where: NDA_{it} = nondiscretionary accruals year t.

ΔREV_{it} = change in revenue measured by change in sales it relates to sales it-1.

ΔREC_{it} = change in receivables for year t.

PPE_{it} = gross value of property, plant, and equipment in year t.

A_{it-1} = total assets it-1.

a_i = coefficient of correlation of the variable i .

Step 4 : When non-discretionary accrual is defined, it is deduced from total accruals. The remaining is the difference that is discretionary accrual, as expressed in the equation:

$$DA_{it} = (TA_{it}/A_{it-1}) - NDA_{it} \quad (4)$$

Where: DA_{it} = discretionary accruals year t (based on modified Jones Model), as a measure of Earnings Quality.

Although DA should conceptually be positive, the computed DA can actually be both positive and negative. To solve this problem, this study transforms DA by taking exponential function to adjust the value to be positive

$$DA_{it} = \exp(DA_{it}) \quad (5)$$

Then, the model:

$$\begin{aligned} EDA_{it} = & \beta_0 + \beta_1 (AUD_SIZE)_{it} + \beta_2 (AUD_CH)_{it} + \beta_3 (SM_SM)_{it} \\ & + \beta_4 (SM_BIG)_{it} + \beta_5 (BIG_BIG)_{it} + \beta_6 (BIG_SM)_{it} \\ & + \beta_7 (AUDP_CH)_{it} + \beta_8 (DISM_OPI)_{it} + \beta_9 (QUA_OPI)_{it} \\ & + \beta_{10} (AOBS_OPI)_{it} + \beta_{11} (ONEW_SD)_{it} + \beta_{12} (ONEW_PCY)_{it} \\ & + \beta_{13} (OGOC)_{it} + \beta_{14} (DISM_OGOC)_{it} + \beta_{15} (BCOM_EXP)_{it} \\ & + \beta_{16} (BCOM_MEET)_{it} + \beta_{17} (ROA)_{it} + \beta_{18} (LEVE)_{it} \\ & + \beta_{19} (Size)_{it} + \varepsilon_{it} \end{aligned} \quad (6)$$

Where: EDA_{it} = exponential of discretionary accrual as a measure of Earnings Quality.

TA_{it} = total accruals of year t .

A_{it-1} = total assets year $it-1$.

NDA_{it} = nondiscretionary accruals year t .

Independent and Control Variables

With regards to the independent and control variables, because there is no agreed-upon metric for the Audit Quality Construct, it is measured as follows:

AUD_SIZE = auditor firm size equal to 1 if the company is audited by big 4 audit firm, 0 otherwise.

AUD_CH = auditor firm change equal to 1, 0 otherwise.

SM_SM = auditor firm change from non-big 4 to non-big 4 equal to 1, 0 otherwise.

SM_BIG = auditor firm change from non-big 4 to big 4 equal to 1, 0 otherwise.

BIG_BIG = auditor firm change from big 4 to big 4 equal to 1, 0 otherwise.

BIG_SM	= auditor firm change from big 4 to non-big 4 equal to 1, 0 otherwise.
AUDP_CH	= auditor partner change equal to 1, 0 otherwise.
DISM_OPI	= disclaimer of opinion report equal to 1, 0 otherwise.
QUA_OPI	= qualified audit opinion report equal to 1, 0 otherwise.
AOBS_OPI	= all observations' opinion report equal to 1, 0 otherwise.
ONEW_SD	= auditor notices observation about the adaptation of a new accounting standard equal to 1, 0 otherwise.
ONEW_PCY	= auditor notices observation about the adaptation of a new policy equal to 1, 0 otherwise.
OGOC	= auditor notices some going concerns opinion report equal to 1, 0 otherwise.
DISM-OGOC	= auditor does not express his opinion about the financial statements and observations about going concern equal to 1, 0 otherwise.
BCOM_EXP	= Board Audit Committee's financial and accounting expertise.
BCOM_MEET	= the number of meetings of the Board Audit Committee.

Control variable

ROA	= firm performance measure form return on assets (ROA).
LEV	= leverage ratio defined as ratio of total liabilities relative to total assets.
SIZE	= firm size defined as natural log of firm's total assets.
ε	= the error term.

IV. RESULTS

The estimating result of Ordinary Least squares (OLS) regressions, is shown in table 1

TABLE 1
Relationships of Audit Quality, Effectiveness of Board audit Committee, and Earning Quality

	(1) Fixed Effect	(2) Random Effect
AUD_SIZE	-0.217***	-0.0385***
AUD_CH	-0.0783	-0.123
SM_SM	0.0110	0.0530
SM_BIG	0.330**	0.324**
BIG_BIG	0.0143	0.102
BIG_SM	-0.0734	0.0931
AUDP_CH	-0.0108	-0.00747
AUD_OPI (changeable opinion)		
DISM_OPI	0.0804	-0.00509
QUA_OPI	-0.0113	0.0437

AOBS	0.00343	0.0254
NEW_SD	-0.0202	-0.0382*
NEW_PCY	0.0309	0.00846
GOC	-0.0388	-0.123****
DISM-GOC	0.114	0.216*
EFFECTIVENESS OF BOARD COMMITTEE EXP		
BCOM_EXP	-0.00248	-0.000666
BCOM_MEET	-0.00100	-0.000705
CONTROL VARIABLE		
ROA	0.00647****	0.00401****
LEVERAGE	0.000534	0.000565****
SIZE	0.00192	0.0000102
Constant	1.106****	0.990****
N	449	449
N_g	109	109
Chi2		90.06
r2_o	0.0790	0.168

* p < 0.1, ** p < 0.05, **** p < 0.01

Table I presents results of testing the relation between Audit Quality measured by three different proxies namely: Auditor Firm Size, Auditor Change, and Audit Opinion, the relation between Effectiveness of Board Audit Committee measured by two different proxies namely: Proportion of the skillful Audit Committee in Finance and Accounting, as well as the quantity of the Audit Committee meeting and Earning Quality, with Earnings Quality measured by Discretionary Accruals. The results show that Auditor Firm Size has a negative correlation with the discretionary Accruals. The type of Auditor Change, there is a positive correlation between the changes of the Audit Company, from smaller to larger size. On the other hand, the coefficient of the change of the Audit Company, from smaller to small size, larger to larger size, larger to small size, and Audit Partner Change are not statistically significant at the 0.05 level; this indicates that the change of the Audit Company from smaller to small size, larger to larger size, larger to small size and the change of Audit Partner have no significant effect on DA. For the overall Auditor's opinion, if the auditors notice some going concern opinions, it will result in a good Earnings Quality. The opposite result appears when the auditor does not express his opinion about the financial statements and observations about going concern, it shows a positive relationship which results in the poor quality of earning. The type of the auditors' opinion expressing an unqualified opinion and observations about the adaptation of a new accounting standard of the company causes a contrary correlation. On the other hand, the coefficient of the audit opinion type, qualified opinion ,disclaimer's opinion ,all audit observation, and audit observation about adaption of new policy are not statistically significant at the 0.05 level, this indicates that the audit opinion type, qualified opinion ,disclaimer's opinion ,all audit observation, and audit observation about adaption of new policy have no significant effect on DA. The relationship of the efficiency of the Board Audit Committee does not occur; hence they have no significant effect on DA.

The control variables, ROA, LEV are positively and significantly associated with Discretionary Accruals that are expected and in line with the prior research. On the other hand, the coefficient of SIZE is not statistically significant at the 0.05 level; this indicates that SIZE has no significant effect on DA.

V. CONCLUSION

Base on sample of 449 firm-year observations from the SET for fiscal year 2009 to 2013, using three measures of Audit Quality (AUD_SIZE, AUD_CH, and AUD_OPINION), and two measure of Effectiveness of Board Audit Committee (BCOM_EXP, BCOM_MEET), the study finds that Auditor Firm Size is positively associated with Earnings Quality measured by DA, thus indicating that firms which use big 4 auditors will engage in good earnings quality than firms with non-big 4. Our results are consistent with those of Zhou and Elder (2003) and Chen et al (2005) that suggest, the big-5 auditors are associated with reduced management discretion over earnings.

Johnson et al. (2002) found evidences of lower Audit Quality (larger abnormal accruals) in the first three years that auditor changed relation to ongoing engagements of four or few years. For this study, the difference with the research of Johnson, studied the whole change of auditor. However, this research has focused on auditors' change, which is based on the type of change. We also find that, there is a positive correlation between the change of the Audit Company, from smaller to larger size, thus indicating that firms change from smaller to larger size will engage in good Earnings Quality. However, results from this study are based on results of studies on the Stock Exchange of Thailand, which has a different environment.

The results from testing the association between the Auditor Opinion and Earnings Quality. Overall, if the auditors notice some going concern opinion, it will result in a good Earnings Quality consistent with the principles of good governance, that companies use auditors from professional external auditor to serve the auditor and express an opinion on the financial report. It approves that the financial report is arranged on Audit Quality and a significance of reliability. The opposite result appears when the auditor does not express his opinion about the financial statements and observations about going concern. It shows a positive relationship which causes the poor quality of earning. Our results are consistent with those of Barton et al (2000) and Jones (1991).

The type of the auditor's opinion expressing an unqualified opinion and observations about the adaptation of a new accounting standard of the company causes a good earning quality

The relationship of the efficiency of the Board Audit Committee does not occur; there is opposite result as mentioned by DeZoort et, al they indicated that number of the Audit Committee meeting is the effectiveness of the Audit Committee, Moreover, Xie (2003) and Vafeas (2005) found that the frequency of Audit Committee meeting had associated with higher profits DA.

Like any other research, the present research has also some limitations which seem necessary to be mentioned. First of all, the sample only covers five years of Thailand data and an external validity problem exists that the results may not be so generalizable to cover

different periods of time and different locations. Secondly, in the study, the effect of inflation and other economic conditions on the figures related to financial statements and the calculation of discretionary accruals were ignored. Future research should include other factors that may affect the occurrence of Earnings Quality in the firms such as skillful Board Committee in Finance and Accounting.

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