

THE RELATIONSHIP BETWEEN AUDITOR QUALITY AND DISCRETIONARY ACCRUALS: CASE OF AUSTRALIAN LISTED COMPANIES

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Abstract

This study empirically examines the relation between two dimensions of auditor quality, auditor independence and auditor specialization, and the level of discretionary accruals, a proxy for earnings management. This study focuses on earnings management in response to mounting pressure amongst investors, policy makers and corporate governance reformists for mechanism to curb excessive opportunistic behaviour amongst corporate management. Auditor independence and auditor specialization are the epicentre of this analysis as these two factors are considered to be key determinants of earnings management. As earnings management, auditor independence and auditor specialization are unobservable, I use absolute discretionary accruals, the ratio of non-audit to total fees and auditor industry market share as respective proxies.

Using 2004 data hand collected from 325 Australian publicly listed firms I find no significant association between the non-audit/total fee ratio and the magnitude of earnings management. Thus, this result suggests the provision of non-audit services by the incumbent auditor does not compromise independence and, therefore, the auditor's ability to constrain earnings management. This study also fail to find a firm engaging an audit firm with industry specialization skills has significantly lower levels of absolute discretionary accruals than a firm using the services of a non-specialist. The main findings of this study are robust to various sensitivity checks. Findings have implications for various stakeholders. For instance, there is currently appears to be a preoccupation amongst corporate governance reformists and policy makers internationally to curb the provision of non-audit services by the incumbent auditor to aid in such matters as the reduction in earnings management. These findings suggest this preoccupation may be misplaced and that constraining the ability of firms purchase non-audit services from the incumbent auditor could provide only limited benefits whilst increasing costs. In addition, policy makers and reformists need to consider more clearly the costs and benefits of any moves to limit industry concentrations within the audit market.

Keywords: *auditor independence, earnings management, auditor specialization, proxy for auditor independence, proxy for control variables*

INTRODUCTION

This study investigates the association between earnings management and two major auditor qualities: independence and expertise. It utilizes a sample of 325 publicly listed companies on the Australian Stock Exchange (ASX). The cross-sectional modified Jones (1991) model is used to measure discretionary accruals (the proxy for earnings management).

Consistent with previous research, this study uses the ratio of non-audit fees to total fees as a proxy for auditor independence (e.g., Scheiner 1984; Firth 1997; Gore, Pope, and Singh 2001; Frankel, Johnson, and Nelson 2002; Larcker and Richardson 2004) and auditor industry market share to proxy auditor expertise in an industry sector (e.g., Pearson and Trompeter 1994; Craswell, Francis, and Tay-