THE INFLUENCE OF AUDITOR'S REPUTATION, AUDITOR'S FEE AND AUDITOR'S SCEPTICISM AUDIT QUALITY IN EARNINGS MANAGEMENT

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ABSTRACT

This study presents an evidence on the importance of auditor's reputation, auditor's fee and auditor's scepticism to the quality of auditing earnings management. Using auditors from the Big 4 and non-Big 4 audit firms, a study was conducted to examine whether these characteristics of the auditors influence their audit quality on earnings management. The study was carried out using a questionnaire survey. The findings of the study suggest that auditor's reputation and auditor's fee do not necessary influence the quality of audit on earnings management. Rather, the auditor's scepticism plays an important role in influencing the quality of audit on earnings management. The study implicates that auditors should have greater scepticism to gain better audit quality in auditing earnings management practices. The evidence provided in this study could help enforcement bodies such as SEC in probing companies that manipulate their earnings reflected in their financial statement.

Keywords: Auditor's Reputation, Auditor's Fee, Auditor's Scepticism, Earnings Management, Audit Quality.

INTRODUCTION

In recent years, the aggressive earnings manipulations among companies have been a concern to regulators due to the several fraud cases committed by companies in relation to earnings management (Bekiris & Doukakis, 2011). Earnings management occurs when managers practice judgement in financial reporting and structuring the transactions to modify financial information with the intention to deceive stakeholders on the true economic situation of their company (Healy & Wahlen, 1999). It often provides negative impact on the company performance since managers are willing to sacrifice upcoming cash flows to increase current period income (Chih et al., 2008). Earnings manipulation practices by managers, whether legitimate or illegitimate, may moderate confidence and assurance in the financial information system. To mitigate such practices, companies often require external auditors that can provide independent opinion and assessment of financial statements to ensure high audit quality. However, studies have suggested that the quality of an audit depends highly on the characteristics of the external auditors such as their reputation, the fee they charged for audit and also their professional scepticism.

Auditor's reputation has been one of the major considerations in clients' selection of audit firms (Copley & Douthett, 2002). This characteristic pushes the auditor's reputation in a spotlight when to acquiring new engagements (Kronenberger & Plietzsch, 2017). It includes several scopes namely, audit firm size, industry specialization and other value drivers,

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including audit technology, branding efforts and human resource management. However, studies on auditor's reputation is under-researched. Few studies that have examined auditor's reputation have mainly used auditor's size as a representation of auditor's reputation. For example: DeAngelo, (1981) found that auditor size is associated with a higher number of client engagements and ergo a higher amount of audit rents, which incentivizes bigger auditors to work harder. Otley & Pierce, (1996) stated that "*the importance of an auditor's reputation stems from the fact that the quality of audit cannot readily be inspected; reputation therefore acts as a surrogate for quality*".

A group of studies have suggested that higher auditor's fee indicates high audit quality (Yuniarti, 2011; Abid et al., 2018; Shakhatreh et al., 2020) For example: Yuniarti, (2011) found that the amount of auditor's fee depends on the risk of assignment, the complexity of services provided, expertise, and other professional considerations. She found that higher audit fee provides a higher audit quality. Other studies found amount of audit fee affects auditor's independence as they become willing to adhere to their client's demand whilst smaller audit fee can limit the time and cost to perform the complete audit procedures. Another group of studies suggested that audit fees reflects the quality of audit (Abid et al., 2018; Shakhatreh et al., 2020). That is, the auditors who can expense more effort would relatively charge a higher fee, thus leading to higher audit quality.

Studies have also suggested that professional scepticism affects audit quality (Sayed et al., 2017; Ghani et al., 2019). These studies found that the sceptical behaviour among the auditors increased the detection of fraud in an organisation. Besides, trust among clients increased when a professional demonstrates more sceptical attitude towards their judgment. In addition, professionals tend to increase their own interpersonal understanding, self-esteem, and knowledge when displaying sceptical behaviour (Hurtt, 2010). The questioning mind, which is an attribute in professional scepticism, can cause the auditors to find the solution for a problem. This attribute certainly helps the auditors in arriving high ethical judgment. Prior studies showed that when an auditor acted in a sceptical way, the chances of detecting misstatement are higher (Payne & Ramsy, 2005; Sayed Hussin et al., 2017). For example: Kerler & Killough, (2009) discovered a positive relationship between professional scepticism and client trust.

The main objective of this study is to provide a review on the influence of audit reputation, auditor's fee and auditor' scepticism on the audit quality of earnings management. The findings in this study can assist the enforcement bodies such as SEC in their probing fraudulent companies who make fraudulent financial statement by manipulation their earnings. The next section provides a review on earnings management, followed by the review on audit quality, auditor's reputation, auditor's fee and auditor's scepticism. Then, the evidences from a study in relation to the relationship between the auditor's reputation, auditor's fee and auditor's scepticism towards the audit quality on earnings management is provided. The last section concludes this study.

LITERATURE REVIEW

Earnings Management

Earnings management is defined as a set of managerial decisions that result in not reporting the true short-term, value-maximizing earnings (Ronen & Yaari, 2011). Earnings management results from discretion in financial reporting with the intent of either misleading stakeholders about an entity's performance or influencing contractual outcomes that are based on accounting numbers. Earnings management can occur because accrual basis income depends on the use of estimates made in the financial reporting process (Jordan et al., 2010).

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According to Healy & Wahlen, (1999), 'Earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting practices.' However, there are two weak points in this definition: it does not establish a distinct limit between earnings management and normal activities (Lopes, 2018).

According to Ronen & Yaari, (2008), there are three types of earnings management namely, white, gray or black. The first type is white earnings management. White earnings management is beneficial in terms that the management alter their financial report to enhance the transparency of reports. The second type is black earnings management which relates to pernicious. This black earning management involves comprehensive falsification and deception. The third type of earnings management is gray earnings management. Gray earnings management is including misleading information in statement in the border of compliance with bright-line standards, which ought to be both opportunistic or efficiency enhancing. Although it looks easy to differentiate earnings management, however in truth it is difficult to detect the group of earnings management since there are accounting transactions where ethical values and decisions are critical in the judgement to be taken. Many authors have used dissimilar approaches in order to learned why and how the managers manage the earnings. Dechow & Skinner, (2000) stated that it is not easy to recognize, identify and measure the earnings management. Studies have utilised the analysis of accruals when trying to detect evidence of manipulation, either in specific studies of earnings management (Jones, 1991), or when studying the quality of results (Burgstahler et al., 2006).

Audit Quality on Earnings Management

Audit quality is the joint probability that an auditor will discover and report material misstatements found in financial statement (DeAngelo, 1981). There are generally two fundamental elements developed when evaluating the definition of quality namely, the auditor's capability to find and declare the misstatement and the auditor's independent (Usman et al., 2014; Octavia & Widodo, 2015). DeFond & Zhang, (2013) believed that the higher the audit quality, the "*greater assurance of high financial reporting quality*". Watts and Zimmerman (1986) and DeAngelo (1981) noted that auditor quality depends on the relevance of the auditor's report in examining contractual relationships and reporting on breaches. Often, high quality auditors are more likely to detect the practice of earnings management (Becker et al., 1998). Bartov et al., (2000) suggested that higher quality auditors prefer to report errors and irregularities and are unwilling to accept questionable accounting practices, particularly on earnings management. It is argued that earnings management reduces the reliability of earnings because reported earnings are often biased, and misrepresent the true reporting earnings figure (Rusmin, 2005). The former chairman of Securities and Exchange Commission, stated that the practice of earnings management has negative effects on reliability and credibility of financial reporting (Rusmin, 2010).

Studies in the auditing literature have suggested that the Big 4 auditors may be able to provide higher quality audits than non-Big 4 auditors because the former group devotes more resources to staff training and developing industry expertise relative to non-Big 4 firms. Krishnan, (2003) posited that because of their size Big 4 auditors are in a better position, relative to non-Big 4 auditors, to question or negotiate with clients who attempt to adopt aggressive accounting procedures (Jordan et al., 2010). Other studies have also demonstrated that firms audited by Big 4 auditors have lower levels of earnings management than firms audited by non-Big 4 auditor (Francis, 2011; Alzoubi, 2016). Nevertheless, most studies revealed that Big 4 auditors offer better-quality audits compared to non-Big 4 auditors. To the

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extent that audit fees are a measure of audit effort, low audit fees could harm audit quality. In support of this view, Lynn Turner, former Chief Accountant at the Securities and Exchange Commission (SEC) wrote:

"…Certainly throughout the 1980s and 1990s, corporations, sometimes with the assistance of their audit committees, "twisted" the arms of independent auditors to reduce their audit fees. Our experience includes corporations who competitively bid their independent audit work solely to reduce their fees well below levels that could generate a reasonable return for the auditors. In turn, the audit firms reduced the level of work they needed to perform in their role as gatekeepers for investors. Inevitably inferior audits resulted." (Turner 2005).

Determinants of Audit Quality on Earnings Management

Auditor's reputation and audit quality on earnings management

According to several studies in the auditing literature, auditor's reputation has been one of the main attention in client's selection of audit firms (Copley & Douthett, 2002). It is also widely accepted that quality of audit is different among audit firms (DeAngelo, 1981; Francis, 2011). Big 4 audit firms may provide higher quality than non-Big 4 (DeAngelo, 1981; Watts & Zimmerman, 1986; Caneghem, 2004). The Big 4 auditors have strong incentives to provide or maintain a high audit quality level due to the fact that they have: (1) a greater number of clients; (2) more opportunity to deploy significant resources to auditing (recruitment, training and technology); and (3) more possibility to lose, for example termination of other clients, loss of reputation, when they do not report a discovered breach (Caneghem, 2004; Chung et al., 2005). The auditor reputation is the one of the attributes in determining audit quality. Higher reputation audit firms will provide better audit quality service to their clients to protect their reputation. Therefore, the auditors have reputational incentives to avoid audit failures because audit quality is valuable to clients and so priced in the market for audit services. Under this view, clients defect to other auditors when an audit firm's reputation for quality deteriorates (Eshleman & Guo, 2014).

Previous studies examined on the relationship between audit quality and earnings management. They used the fact that a company employed a Big Six auditor as a proxy for audit quality (Becker et al., 1998). Boone et al., (2010) used abnormal accruals as an observable proxy for audit quality, and compared Big 4 and second-tier audit firms. They found that there was little difference in audit quality between the two kinds of auditors, but that there was a more pronounced difference in perceived audit quality. Lee et al., (2006) studied IPO's of Australian firms and found that forecasts by Big 6 auditors proved more accurate than forecasts of non-Big 6 auditors.

Audit fee and audit quality on earnings management

Studies have suggested that an auditor who receives abnormally high audit fees from a client will lose his or her independence and allow the managers of the client firm to engage in questionable accounting practices (DeAngelo 1981; Choi et al., 2010). Choi et al., (2010); Asthana & Boone, (2012) found a positive relationship between abnormally high audit fees and the magnitude of discretionary accruals, implying that auditors receiving high fees tolerated more discretion. However, it is also possible that audit fees are a measure of audit effort, that is, higher fees indicate that the auditor worked more hours, signalling greater effort. Increasing audit effort is one way an auditor can respond to a heightened risk of earnings management (Francis & Krishnan, 1999). Therefore, Eshleman & Gou, (2014)

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suggested that higher audit fees are symbolic of more auditor work, and hence, a greater quality audit. Higher audit fees are the outcome of the audit firm spending longer hours and/or the audit firm charging a higher rate because it is a better auditor. On the contrary, low audit fees indicate less audit work, and hence, lower audit quality.

Fafatas & Sun, (2010) suggested that the reputation of each of the Big Four audit firms expressed in the cost of audit fees is not the same in each of these companies. It appeared that what leads to higher audit fees is the quality of audit services provided although the size of audit seemed to be a key operator in priming audit fees (Warrad, 2017). Warrad, (2017) also highlighted that there is a negative relation between the financial risks and the audit fees. Few studies have linked earnings management as a measurement of the quality of audit with the audit fees (Abbott et al., 2006), that showed that sloped earnings management risk, as expressed by negative discretionary accruals, is correlated with minimal audit fees.

Auditors Scepticism and audit Quality on earnings Management

Audit standards have always required that auditors exercise professional scepticism. The latest standards go further and now require auditors to "*increase*" their scepticism and put aside any prior beliefs that management is honest (AICPA, 2002, paragraph 14). Auditing standards describe professional scepticism as an attitude that includes a questioning mind and an awareness of the possibility of fraud (AICPA, 2012). In practice, auditors choose whether to frame their evaluations of managers in terms of their honesty or their dishonesty (Peecher, 1996), suggesting that auditors sometimes exercise such scepticism, but sometimes focus more on the trustworthiness of their clients (Peecher et al., 2010).

The PCAOB, (2008) indicated that auditors too often rely on the honesty of their clients, and Panel on Audit Effectiveness (PAE, 2008) calls for auditors to focus more on the possibility of dishonesty. These findings implied that the quality of parts of the audit that rely upon high levels of scepticism, such as fraud assessments, would suffer under an audit rotation scheme, directly counter to the intentions of regulators (Agoglia et al., 2011). Auditor's curiosity or scepticism will increase the quality of the audit. The higher the scepticism of the auditor, the better he is placed to obtain evidence related to the examination of the client's financial statements. The professional scepticism of the auditor has the potential to help the auditor in discover all forms of abuses committed by the client in financial reporting (Anugerah & Akbar, 2014).

RESEARCH DESIGN

Sample Selection

This study chose the the external auditors who work in the Big 4 and non-Big 4 audit firm who have experiences in auditing fields. The auditors were selected as target respondent as they are responsible in auditing the organization financial statement and provide true and fair view on financial information for the financial statement users. the auditors from the different levels of positions from the entry level to the senior level since detecting earnings management in financial statement are involves of all level of auditors in providing a quality audit opinion to the users of financial statements.

Research Instrument

This study utilised the questionnaire survey as the research instrument. The questionnaire consists of five sections. The first section of the questionnaire in this study is Section A, this section asked information on the respondent's demographic profile such as

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gender, age, marital status, education background, audit firm job position and length of services. This was then continued with dependant and independent variables studied in this research which are audit quality of earnings management, auditor's reputation, audit fee and auditor's scepticism.

The next section of the questionnaire in this study is Section B. This section required the respondents to provide information regarding their view of the audit quality in auditing earnings management. Seven questions were asked for this section. Section C is the third section for the questionnaire in this study. Section C required the respondents to give the information related to their view on the auditor's reputation to measure the audit quality in auditing earnings management. There were seven questions provided in this section. Section D required the respondents to give information regarding their opinion on audit fee. This section measured the extent of which the audit fee charged by the audit firm effected the audit quality in auditing earnings management. There were six questions asked in this section.

The last section, which is Section E, required the respondents to provide information on their view of the auditor's scepticism. This section to measure the extent of auditor's skepticism influence the audit quality in auditing earnings management. There were seven questions in this section. All sections from Section B to Section E used a five point scale from '*1*' being '*strongly disagree'* to '*5*' being '*strongly agree*'.

Data Collection

The questionnaire survey was conducted via the electronic survey form by Google which is Google Form. The link to the Google online survey form address was distributed via email and the Whatsapp application to make is easier for respondents to respond to the survey and quickly reach the respondents. In addition, also attached to the distributed questionnaires was a cover letter enlightening the intention of the study and confidentially guarantee of all information provided. The total questionnaires distributed to the auditors were 80. Fifty one out of the 80 selected respondents responded to the survey resulting in a response rate of 64%.

RESULTS

This section provides some empirical evidences on the importance of auditor's reputation, auditor's fee and auditor's scepticism on the audit quality on earnings management. Using questionnaire survey distributed to 51 auditors who are working in the Big 4 and non-Big 4 firms in Malaysia, this study performed the descriptive statistics, correlation analysis and multi regression analysis were performed.

Table 1 presents the descriptive statistics for the audit quality on earnings management. The highest mean score is for item "*The auditor should obtain sufficient evidence to support an audit opinion free from aggressive earnings management*" which is 4.57. The lowest mean score is for item 'An auditor's ability to detect earnings management is not compromised by audit fees' and 'The auditors are well qualified and capable in detecting earnings management practices' with 4.41. Overall, the average score for the mean of the quality in auditing earnings management is 4.49 which shows that the respondents of the survey mostly agreed that the quality are important in auditing earnings management.

Table 1
AUDIT QUALITY ON EARNINGS MANAGEMENT

No	List of Item	Mean
1.	The auditor should independent in auditing earnings management practices	4.49
2.	The auditor should do sufficient work to support an audit opinion	4.51

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	free from aggressive earnings management	
3.	The auditor should obtain sufficient evidence to support an audit opinion free from aggressive earnings management	4.57
4.	The auditors are well qualified and capable in detecting earnings management practices	4.41
5.	An auditor's ability to detect earnings management is not compromised by audit fees	4.41
6.	The auditor scepticism is needed to obtain sufficient evidence to support an audit opinion regarding earnings management	4.53
7.	The auditor's scepticism can prevent the practice of earnings management	4.49
	All Items	**4.49**

Table 2 shows the descriptive statistics of auditor's reputation. The auditor's reputation items mean score range from 4.02 to 4.43. The highest mean score is for items "*The number of auditors with qualifications and the length of time for the audit firm are positive elements for quality of auditing*". According to the table, the average mean score is 4.21 which indicates that the respondents of this survey are highly agreed that the auditor's reputation is important in determine the quality in auditing earnings management.

Table 2
AUDITOR'S REPUTATION

No	List of Item	Mean
1.	The size the audit firm enhances the quality of audit work	4.14
2.	The reputation of the audit firm enhances the quality of audit work	4.22
3.	The large size audit firms are more risk averse of litigation arising from any earnings management	4.10
4.	The auditors in large size audit firms are more effective in detecting aggressive earnings management activities.	4.02
5.	The professional qualifications of the audit team improve the quality of the audit process	4.39
6.	The large size of the audit firm are positive elements that enhance the quality of auditing	4.20
7.	The number of auditors with qualifications and the length of time for the audit firm are positive elements for quality of auditing	4.43
	All Items	**4.21**

Table 3 shows that the auditor's reputation has a positive association with the audit quality in auditing earnings management (r = 0.484, p < 0.001). This implies that an increase in auditor's reputation will come out with only moderately result in audit quality in auditing earnings management and vice versa. The hypothesis test result reveals that the auditor's reputation does not have significant influence on the audit quality in auditing earnings management which is in line with the study from James, (2014) from previous literature.

Table 3
AUDITOR'S REPUTATION WITH AUDIT QUALITY ON EARNINGS MANAGEMENT

Variables	**Auditor's Reputation**	
	Pearson Correlation Coefficient (r)	***p*-value**
Audit quality in auditing earnings management	0.484**	0.000
**Correlation is significant at the 0.01 level (2-tailed)		

Table 4 presents the details of the descriptive statistics for all develops of audit fee. The range for mean score is 3.75 to 4.33, the average mean score is 4.00 which indicates that

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the responses are mostly agreed for the statement of all items. The highest mean from respondents is for items “*complexity of transactions process involving earnings management practices will increase the audit fees*”. According to the average mean score, its shows that most respondents agreed that the audit fee is important role for the quality in auditing earnings management.

Table 4
AUDITOR’S FEE

No	List of Item	Mean
1.	Complexity of transactions process involving earnings management practices will increase the audit fees	4.33
2.	There is a relationship between audit fees and number of transactions	3.92
3.	Increase in audit fees will decrease acceptable audit risk of earnings management	3.75
4.	Increase size of disclosure about errors and illegal acts will increase the audit fee	3.82
5.	Increase auditor’s effort beyond the auditing standards will increase the Audit fee	4.14
6.	Increase the quality assessment of audit evidences of earnings management will increase Audit fee	4.06
	All Items	**4.00**

Table 5 shows that audit fee has high degree of positive correlation with audit quality in auditing earnings management ($r = 0.513$, $p < 0.001$). This implies that an increase in audit fee will have high result in audit quality in auditing earnings management and vice versa. Such finding is consistent with Eshleman, (2014).

Table 5
AUDITOR’S FEE WITH AUDIT QUALITY ON EARNINGS MANAGEMENT

Variables	**Auditor’s Fee**	
	Pearson Correlation Coefficient (r)	***p*-value**
Audit quality in auditing earnings management	0.513**	0.000
**Correlation is significant at the 0.01 level (2-tailed)		

Table 6 shows the details of descriptive statistics for auditor’s scepticism The highest mean score for auditor’s scepticism is for items “*The auditors like to ensure that they have considered most available information before making a decision*” whereas the lowest score is for items “*The auditors are often reject statements unless they have proof that they are true*”. The range of mean score for auditor’s scepticism is from 4.20 to 4.41 with the average amount of mean score is 4.32. This shows that the majority of respondents agreed with the statement that the auditor’s scepticism will increase the audit quality in auditing earnings management.

Table 6
AUDITOR’S SCEPTICISM

o	**List of Item**	**M ean**
.	The auditors are often reject statements unless they have proof that they are true	4. 20
.	The auditors frequently question things that they see or hear	4. 31
.	The auditors wait to decide on issues until they can get more information	4. 22

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.	The auditors don't like to decide until they have looked at all of the available information	4.37
.	The auditors like to ensure that they have considered most available information before making a decision	4.41
.	The auditors will take time when making decisions	4.31
.	The auditors usually notice inconsistencies in explanations	4.39
	All Items	**4.32**

Table 7 shows that auditor's scepticism has a moderate degree of positive correlation with the audit quality in auditing earnings management (r = 0.481, p < 0.001). This points out that increase in auditor's scepticism will increase moderately in the audit quality in auditing earnings management and vice versa.

Table 7
AUDITOR'S SCEPTICISM WITH AUDIT QUALITY ON EARNINGS MANAGEMENT

Variables	**Auditor's Scepticism**	
	Pearson Correlation Coefficient (r)	***p*-value**
Audit quality in auditing earnings management	0.481**	0.000
**Correlation is significant at the 0.001		

The multiple regression model analysis was performed by using the audit quality of earnings management as the dependant variable and auditor's reputation, audit fee and auditors scepticism as the independent variables. Table 8 shows the results from the multiple regression analysis that shows the R square (R2) shows that 31.2% of the variation in audit quality in auditing earnings management is explained by the variation of auditor's reputation, audit fee and auditor's scepticism.

Table 8
AUDIT QUALITY ON EARNINGS MANAGEMENT

Variables	**Unstandardized Coefficient Beta**	***t*-value**	**Significance**
Constant	2.230	4.222	0.000
Auditor's Reputation	0.162	0.934	0.355
Audit Fee	0.179	1.126	0.266
Auditor's scepticism	0.198	1.367	0.017
R square (R2) = 0.312			
F value = 7.094			
Significance = 0.000			

CONCLUSION

The main objective of this study is to investigate the factors that influence the audit quality in auditing earnings management from the viewpoints of external auditors from Big 4 and non-Big 4 audit firms. This study has considered three factors which are the auditor's reputation, audit fee and auditor's scepticism have the significant influence on the audit quality in auditing earnings management. Out of the three factors examined, only auditors' scepticism has significant positive influence on audit quality in auditing earnings management. On the other hand, this study shows auditors' reputation and audit fee have no significant influence on the audit quality in auditing earnings management. The findings in this study offers a framework on the factors that influencing

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the audit quality in auditing earnings management practices.

This study is not without limitations. First, this study only focused on the perceptions of the auditors that could exist some biased. Future research may explore certain stakeholder views such as the association of audit professional, clients and policy makers. Time constraint is the second limitation for this study, therefore, this study only focused on the survey cross sectional study. There will be longitude study for future research to provide more reliable data and comprehensive result.

In sum, this study intends to assist the external auditors to enhance their audit quality in detecting and preventing any earnings manipulations practices perform by their clients. In addition, this study could help enforcement bodies such as SEC in their probe of fraudulent companies who make fraudulent financial statement by manipulation their earnings.

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