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The Relationship among Audit Quality, Earnings Management, and Financial Performance of Malaysian Public Listed Companies

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ABSTRACT

This study aims to investigate the relationship among audit quality, earnings management, and financial performance among public listed companies in Malaysia. Sample companies were randomly selected from the Industrial Products and Consumer Products industry listed on the Main Board of Bursa Malaysia during the time period of 2008 to 2013. The findings indicate that audit quality does not actually constrain earnings management practices in Industrial Products and Consumer Products companies. This may be due to the difference between the audit environment in Malaysia and that in other developed countries. On the other hand, high audit quality can contribute to better company financial performance, since large-scale audit firms are always perceived to have higher audit quality that can increase the confidence of investors. However, when earnings management is added as a mediating variable, it mediates the relationship between audit quality and financial performance. In other words, the audit quality that is delivered by either Big Four audit firms or non-Big Four audit firms does not actually improve financial performance when

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earnings manipulation activities are conducted by the management divisions of these firms.

Key words: earnings management, audit quality, financial performance, mediation

INTRODUCTION

'Going public' is among the goals of many private companies that desire to achieve in order to obtain more capital/funding from the public investors. This is primarily because investors prefer to possess liquid securities, since the illiquid stock in private companies is difficult to be valued. As such, companies are motivated to go public in order to raise capital and liquidity of their stock. Apart from that, flexibility of accounting methods, income smoothing and accruals accounting are employed by these companies. The nature of accruals accounting has given opportunities of discretion to management in determining the actual earnings of a company. The most common approach is to manage the timing of some expenditure or recognition of revenues and expenses. Amanet *et al.* (2006) mentioned that the main role of accruals accounting is considered to have created some types of earnings management which are difficult to differentiate from appropriate accrual accounting choices. Young (1999) also stated that managements prefer accruals accounting due to its low cost and difficulty to be observed. Consequently, earnings management becomes a critical issue that must be handled carefully.

PROBLEM STATEMENT

In accordance with the KPMG Malaysia Fraud, Bribery and Corruption Survey (2013), as shown in Figure 1, 48% of the survey respondents admitted that they have encountered fraud in their companies within the period from January, 2010 to December, 2012. Although there is a slight decline of 1% from the 2009 survey, it still demonstrates that fraud is deemed as a significant problem in their companies. One of the factors that leads to the occurrence of fraud or material misstatement is the manipulation of earnings in the company's financial reports. Capital market, contracting and regulatory motivations are some incentives of managers to manage earnings. One of the most important problems that affects managers' behaviors to manage earnings is to access earnings forecasts and meet the market expectations, since announcing reported earnings that are less than expected will result in a decline in stock value, and thus compromise managers' positions (Moradi, Salehi and Najari, 2012). Thus, managers may choose to increase the amount of reported earnings, and consequently, the financial performance of the company

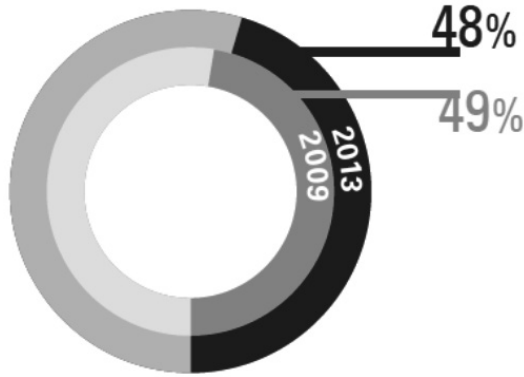


Figure 1 KPMG Malaysia fraud, bribery and corruption survey 2013

might reflect the wrong impression on investors in a sense that the financial performance of the company is improved.

Besides, managers also manage earnings in order to maximize their wealth. In these cases, reported earnings in financial reports might not accurately reflect the companies' underlying economics, which gradually leads to low earnings quality. Since the reported earnings are regarded to be relevant and useful to investors in determining future returns, the reduction in earnings quality in financial reports will reduce investors' confidence. Hence, the lack of investors' confidence in the reported earnings can impact the financial market, since investors are the largest group in providing capital support to the economic system. However, Wild (1996) mentioned that monitoring systems can restrict the managers' opportunistic behaviors. An external audit system is considered an essential monitoring system that may assist in reducing a management's ability to manage earnings. Hence, external auditors play a crucial role in monitoring companies to assure financial reports are free from material error and misstatement. In conclusion, a higher quality of audit has a greater ability to constrain earnings management, hence reduce the uncertainty in the reported earnings. Furthermore, investors are more likely to assess the true financial performance of a company as the earnings management practices are constrained by external auditors. This study investigates the relationship among audit quality, earnings management, and financial performance of public listed companies in Malaysia.

RESEARCH OBJECTIVES

1. To examine the relationship between audit quality and earnings management.

2. To determine the association between audit quality and financial performance.
3. To identify the relationship between earnings management and financial performance.
4. To examine the relationship among audit quality, earnings management and financial performance.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

The agency Theory is a common practice in research that explains the relationship between the principal (shareholders) and the agent (managers). Separation of ownership and control leads to potential conflicts of interest between both parties. This may be because the parties may have different goals, and the managers may not act on behalf of the best interests of the shareholders (Br Bukit and Iskandar, 2009; Jensen and Meckling, 1976). Gerayli, Yanesari and Ma'atoofi (2011) confirmed that this agency problem leads to the demand for external auditing.

Earnings Management

Follow the definition of Healy and Wahlen (1999), earnings management occurs during which managers manage financial reports by using judgment in order to mislead the stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that are based on the reported earnings. This indicates that managements have incentives to manipulate the earnings in the purpose of maximizing the wealth of the company and/or the manager. In this case, the financial results and position of the business might not be presented accurately. This may encourage fraud and material misstatement by the reporting companies. Since earnings management involves a higher degree of managerial judgment, this study concentrates on the negative aspect of earnings management. Jiraporn *et al.* (2008) mentioned that distortions in financial reports occur when there is a misalignment of incentives between managers and shareholders. This could drive the managers to exercise the flexibility of accruals accounting to adjust earnings opportunistically. Hence, accruals earnings management is employed in this study, and is considered the opportunistic behavior of the management.

Hypothesis Development

Previous studies have used earnings management as a mediating variable between

corporate governance and a company's financial performance. However, the mediation effect of earnings management on the relationship between audit quality and financial performance has not yet been investigated. Hence, this study examines the mediation effect of accruals earnings management between audit quality and a company's overall financial performance. Other relationships are also investigated in this study, as depicted in Figure 2. The hypotheses were developed based on previous studies in the existing body of related literature.

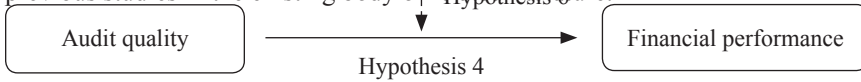


Figure 2 The relationship between audit quality, earnings management, and financial performance

Audit Quality and Earnings Management

According to DeAngelo (1981), audit quality is defined as the competency and independence of auditors in detecting and reporting material misstatement. Zehri and Shabou (2011) asserted that high quality auditors are more likely to discover questionable accounting practices by clients and report material irregularities and misstatements compared with low quality auditors. Due to this, a higher audit quality is able to better constrain earnings management, and in turn enhance the quality of financial reports. Previous research in the related literature have employed various measures as proxies of audit quality. Several studies have indicated that a higher quality of auditing mitigates accruals based earnings management (Okolie, 2014; Soliman and Ragab, 2014; Gerayli, Yanesari and Ma'atoofi, 2011; Becker *et al.*, 1998). This study used audit firm size, audit fees, and audit partner as audit quality measures.

A research carried out by Gerayli, Yanesari and Ma'atoofi (2011) demonstrates that companies with Big Four audit firms are involved in lower earnings management than companies with non-Big Four audit firms. Consistently, Soliman and Ragab (2014), and Zgarni, Hlioui and Zehri (2012), confirmed that audit quality has a significant negative association with earnings management when earnings management is measured by using discretionary accruals. This indicates that Big Four audit firms provide better audit quality than non-Big Four audit firms in mitigating accruals based earnings management. However, Yasar (2013) argued that the audit quality of Big Four audit firms may not restrain accrual earnings management in some institutional environments.

Alali (2011) indicated that higher discretionary accruals result in higher audit fees in order to constrain the accruals based earnings management practices and

improve earnings quality. On the other hand, Gerayli, Yanesari and Ma'atofi (2011), and Okolie (2014), argued that high audit fees have impaired audit independence, which leads to poor audit quality, and tolerate greater accruals based earnings management. However, Farouk and Hassan (2014) argued that it should be remembered that audit firms normally bill their clients based on the number of working hours. In other words, high audit fees imply high audit effort, which gives a sense of responsibility to auditors to provide better quality to their clients.

Okolie (2014) defined audit tenure as the length of the relationship between an auditor and a client company. An overly long relationship of auditors with clients may constitute a threat to independence. This is because personal ties and familiarity may build up among the parties, which may potentially lead to a lower level of attentiveness and alertness by the auditor. Piot and Janin (2007) mentioned that the auditors may contribute less effort to detect the internal control weakness and potential risks, as the audit engagement may become a routine over years. In addition, Chi and Huang (2005) confirmed that, for audit partner tenure or audit firm tenure, familiarity helps in the auditing process, since it produces a higher quality of earnings, but excessive familiarity impairs audit quality.

In Malaysia, there is a provision under the Malaysian Institute of Accountants (MIA, 2011; paragraph 290.151) By-Laws which states that the lead engagement partner should be rotated after a period of not more than five years. In this case, MIA By-Laws (2011) support the hypothesis that longer audit tenure is correlated with an increase in the value of accruals based earnings management in the Malaysian context.

Audit Quality and Financial Performance

There are a few studies that demonstrate that audit quality improves the financial performance of a company. Afza and Nasir (2014) mentioned that quality of external audit improves a firm's performance due to the perception of investors. They perceive that companies that are audited by big audit firms will disclose reliable, proper, and authentic financial reports, which strengthen the overall investors' confidence towards these companies. Furthermore, Jusoh, Ahmad and Omar (2013) claimed that high audit quality might reduce agency costs where auditors provide an indicator about credibility and integrity of financial reports, which could in turn lead to lower monitoring costs and result in better performance by the corporation. Similarly, Fooladi and Shukor (2012), and Farouk and Hassan (2014), reported a significant and positive relationship among audit quality and company performance. Hence, audit quality is expected to have a positive relationship with financial performance.

Earnings Management and Financial Performance

Empirical studies implied that there is a significant negative relationship between earnings management and financial performance (Farooqi, Harris and Ngo, 2014; Ardekani, Younesi and Hashemijoo, 2012; Kang and Kim, 2011). Hassan and Ahmed (2012) claimed that accruals are the most common activities of earnings management that are performed by management to either increase or decrease reported earnings. This indicates that the practice of accruals based earnings management has negatively affected the financial performance of a company. However, Tang and Chang (2014) demonstrated that the relationship between earnings management and firm performance varies according to a company's governance quality. Kang and Kim (2011) asserted that accruals based earnings management may have a negative impact on shareholders' accurate access to the true financial performance of a company. Consequently, this may affect the long term performance of the company's response to shocks. In this case, accruals based earnings management is expected to have a negative association with the financial performance of the company. Regarding this, the measurement of true financial performance is stripped of the influence of opportunistic earnings management practices by the management, which is expected to reflect the true value of the company.

Accruals Earnings Management as a mediator between Audit Quality and Financial Performance

As previously mentioned, several studies investigated in terms of earnings management whether accruals based activities are negatively associated to financial performance of a company (Farooqi, Harris and Ngo, 2014; Ardekani, Younesi and Hashemijoo, 2012; Kang and Kim, 2011; Cohen and Zarowin, 2010). In this case, if external auditors constrain earnings management practices by managers effectively, the audit quality may have a positive influence on financial performance of the company. Several studies reported a positive relationship between audit quality and financial performance (Farouk and Hassan, 2014; Afza and Nasir, 2014; Jusoh, Ahmad and Omar, 2013; Fooladi and Shukor, 2012). These findings provide a motivation to investigate whether earnings management enhances the causal link between audit quality and financial performance. In the study of Kang and Kim (2011), earnings management functions as a mediator between corporate governance and company performance. The results suggested that earnings management strengthens the causal link between corporate governance and firm performance. Therefore, in this study, earnings management functions as a mediator, and it is expected that it amplifies the relationship between audit quality

and financial performance.

METHODOLOGY

Sample

This study focuses on the listed Industrial Products and Consumer Products companies in the Main Board of Bursa Malaysia during the period of 2008 to 2013. A total of 100 sample companies were selected randomly from these two industries. The purpose of selecting these two industries was in order to minimize the effect of industry difference. In this context, companies in the financial services industry are not included due to the varying capital and profits of financial companies, which adopt a different methodology for estimating discretionary accruals. Secondary data were collected from annual reports from Bursa Malaysia and Datastream.

Determinants of Variables

The variables considered are presented in Table 1.

Table 1 Variables and proxies

Variables	Proxies	Labels	Operationalisation
Audit quality (AQ – Independent variables)	Audit firm size	AudSIZE	A dummy variable; 1 is given to the company that is audited by a Big Four audit firm; 0 otherwise.
	Audit fees	AudFEE	Natural log of audit fees paid to an audit firm in a year.
	Audit partner tenure	TENURE	Length of relationship between audit partner and client company.
Earnings management (EM – Mediating variables)	Discretionary accruals	DA	Modified Jones Model (1991)
	Absolute discretionary accruals	DA	Absolute value of DA.
Financial performance (FP – Dependent variables)	Return on assets	ROA	Earnings before Interest and Tax divided by previous year Total Assets
	True return on assets	TROA	ROA minus DA
Control variable	Company size	SIZE	Natural log of company's total average assets

Modified Jones Model (1991)

Following Etemadi and Moghadam (2014), and Hassan and Ahmed (2012), this study employed the Modified Jones Model (1991), which was modified by Dechow, Sloan and Sweeney (1995), and is a more powerful model in detecting earnings management. The cash flow statement approach was employed in this paper to determine total accruals. Consistent with the study of Br Bukit and Iskandar (2009), all the variables are scaled by previous year total assets to reduce the heteroskedasticity of the regression.

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_0 \left(\frac{1}{A_{i,t-1}} \right) + \alpha_1 \left[\frac{\Delta REV_{i,t} - \Delta AR_{i,t}}{A_{i,t}} \right] + \alpha_2 \left(\frac{PPE_{i,t}}{A_{i,t-1}} \right) + \varepsilon_{i,t}$$

where:

- TA_t = total accruals of year t;
- $IBEL_t$ = income before extraordinary items of year t;
- OCF_t = net cash flows in operating activities of year t;
- $\alpha_0, \alpha_1, \alpha_2$ = estimated coefficients of Modified Jones Model (1991);
- $TA_{i,t}$ = total accruals for sample company i in year t;
- $A_{i,t-1}$ = total assets for sample company i in year t-1;
- $\Delta REV_{i,t}$ = change in net revenues for sample company i in year t;
- $\Delta AR_{i,t}$ = change in account receivables for sample company i in year t;
- $PPE_{i,t}$ = grossvalue of property, plant and equipment for sample company i in year t;
- $\varepsilon_{i,t}$ = discretionary accruals (error term) for sample company i in year t; and
- $NDA_{i,t}$ = non-discretionary accruals for sample company i in year t.

The Multiple Regression Model

This study employed a multiple regression model to test the relationship among the variables. In testing the multiple regression model, the hypotheses of the study were developed for Industrial Products and Consumer Products sectors as follows:

H1 : There is a significantly negative association between audit firm size and accruals based earnings management.

H2 : There is a significantly negative association between audit fees and accruals based earnings management.

- H3 : There is a significantly positive association between audit partner tenure and accruals based earnings management.*
- H4 : There is a significantly positive association between audit quality and financial performance.*
- H5 : There is a significantly negative association between accruals based earnings management and financial performance.*
- H6 : Accruals based earnings management mediates the relationship between the audit quality and financial performance.*
- H7 : The level of accruals based earnings management of smaller-sized companies is greater than larger-sized companies.*

There is a relationship between the variables if the coefficient is positive or negative and statistically significant at the confidence level of 95%. The following regression models are employed to investigate the relationship between the variables of audit quality, earnings management and financial performance.

Sobel Test

This study used the Sobel test to examine the indirect effect of earnings management on the relationship between audit quality and financial performance. It requires the standard error that was derived from the multiple regression analysis. Partial mediation and full mediation effects are determined based on the results.

$$\text{Model 1 : } EM_{i,t} = \beta_0 + \beta_1 AQ_{i,t} + \beta_2 SIZE_{i,t} + \varepsilon_{i,t}$$

$$\text{Model 2 : } FP_{i,t} = \beta_0 + \beta_1 AQ_{i,t} + \beta_2 SIZE_{i,t} + \varepsilon_{i,t}$$

$$\text{Model 3 : } FP_{i,t} = \beta_0 + \beta_1 EM_{i,t} + \beta_2 SIZE_{i,t} + \varepsilon_{i,t}$$

$$\text{Model 3 : } FP_{i,t} = \beta_0 + \beta_1 AQ_{i,t} + \beta_2 EM_{i,t} + \beta_3 SIZE_{i,t} + \varepsilon_{i,t}$$

DISCUSSION

Table 2 Summary of multiple regressions analysis

Model	Unstandardised coefficients		Standardised coefficients	t-value	Sig.	
	B	Std. error	Beta			
Model 1: AQ & EM						
DA	(Constant)	-7.6E-6	0.033		0.000	1.000
	AudSIZE	0.000	0.003	0.005	0.117	0.907
	AudFEE	-0.003	0.006	-0.023	-0.470	0.639
	TENURE	0.001	0.001	0.030	0.733	0.464
	SIZE	0.002	0.004	0.018	0.367	0.714
R ² = 0.001						
Adjusted R ² = -0.005						
F value = 0.198						
F Significance = 0.939						
.....						
DA	(Constant)	0.083	0.022		3.820	0.000***
	AudSIZE	-0.001	0.002	-0.028	-0.681	0.496
	AudFEE	-0.004	0.004	-0.043	-0.863	0.389
	TENURE	0.001	0.001	0.034	0.848	0.397
	SIZE	-0.005	0.003	-0.084	-1.723	0.085*
R ² = 0.016						
Adjusted R ² = 0.009						
F value = 2.413						
F Significance = 0.048						
.....						
Model 2: AQ & FP						
ROA	(Constant)	-0.605	0.075		-8.089	0.000***
	AudSIZE	0.017	0.006	0.100	2.628	0.009**
	AudFEE	-0.025	0.015	-0.078	-1.713	0.087*
	TENURE	0.000	0.002	0.006	0.173	0.862
	SIZE	0.096	0.010	0.428	9.559	0.000***
R ² = 0.170						
Adjusted R ² = 0.164						
F value = 30.438						
F Significance = 0.000						
.....						

Table 2 (Cont.)

Model	Unstandardised coefficients		Standardised coefficients	t-value	Sig.	
	B	Std. error	Beta			
TROA	(Constant)	-0.604	0.079		-7.626	0.000***
	AudSIZE	0.017	0.007	0.094	2.441	0.015**
	AudFEE	-0.022	0.015	-0.066	-1.434	0.152
	TENURE	0.000	0.002	-0.006	-0.158	0.875
	SIZE	0.094	0.011	0.401	8.872	0.000***
R ² = 0.152						
Adjusted R ² = 0.146						
F value = 26.645						
F Significance = 0.000						
Model 3: EM & FP						
ROA	(Constant)	-0.662	0.069		-9.557	0.000***
	DA	0.187	0.094	0.074	1.990	0.047**
	SIZE	0.089	0.008	0.397	10.603	0.000***
R ² = 0.163						
Adjusted R ² = 0.161						
F value = 58.312						
F Significance = 0.000						
ROA	(Constant)	-0.660	0.070		-9.394	0.000***
	DA	0.037	0.141	-0.010	-0.265	0.791
	SIZE	0.089	0.008	0.396	10.485	0.000***
R ² = 0.156						
Adjusted R ² = 0.155						
F value = 56.003						
F Significance = 0.000						
TROA	(Constant)	-0.662	0.070		-9.503	0.000***
	DA	-0.770	0.095	-0.293	-8.147	0.000***
	SIZE	0.089	0.008	0.378	10.519	0.000***
R ² = 0.228						
Adjusted R ² = 0.225						
F value = 88.040						
F Significance = 0.000						

The Relationship among Audit Quality, Earnings Management, and Financial Performance

Table 2 (Cont.)

Model	Unstandardised coefficients		Standardised coefficients	t-value	Sig.	
	B	Std. error	Beta			
TROA	(Constant)	- 0.660	0.074		-8.878	0.000***
	DA	0.018	0.149	0.005	0.119	0.905
	SIZE	0.089	0.009	0.377	9.888	0.000***

R² = 0.142

Adjusted R² = 0.139

F value = 49.370

F Significance = 0.000

Model 4: AQ, EM & FP

ROA	(Constant)	-0.605	0.075		-8.108	0.000***
	AudSIZE	0.017	0.006	0.100	2.625	0.009**
	AudFEE	-0.024	0.015	-0.076	-1.679	0.094*
	TENURE	0.000	0.002	0.004	0.115	0.909
	DA	0.183	0.093	0.073	1.957	0.051*
	SIZE	0.096	0.010	0.427	9.551	0.000***

R² = 0.175

Adjusted R² = 0.168

F value = 25.232

F Significance = 0.000

ROA	(Constant)	-0.602	0.076		-7.946	0.000***
	AudSIZE	0.017	0.006	0.100	2.628	0.009**
	AudFEE	-0.025	0.015	-0.078	-1.719	0.086*
	TENURE	0.000	0.002	0.007	0.182	0.856
	DA	-0.036	0.141	-0.010	-0.254	0.800
	SIZE	0.096	0.010	0.428	9.559	0.000***

R² = 0.170

Adjusted R² = 0.163

F value = 24.325

F Significance = 0.000

Table 2 (Cont.)

Model		Unstandardised coefficients		Standardised coefficients	t-value	Sig.
		B	Std. error	Beta		
TROA	(Constant)	-0.604	0.075		-8.041	0.000***
	AudSIZE	0.017	0.006	0.096	2.613	0.009**
	AudFEE	-0.024	0.015	-0.073	-1.670	0.095*
	TENURE	0.000	0.002	0.003	0.081	0.936
	DA	-0.774	0.094	-0.294	-8.218	0.000***
	SIZE	0.096	0.010	0.407	9.477	0.000***
R ² = 0.239						
Adjusted R ² = 0.232						
F value = 37.209						
F Significance = 0.000						
TROA	(Constant)	-0.606	0.080		-7.551	0.000***
	AudSIZE	0.017	0.007	0.094	2.442	0.015**
	AudFEE	-0.022	0.015	-0.066	-1.426	0.154
	TENURE	0.000	0.002	0.006	0.162	0.871
	DA	0.022	0.149	0.006	0.150	0.881
	SIZE	0.094	0.011	0.402	8.853	0.000***
R ² = 0.152						
Adjusted R ² = 0.145						
F value = 21.826						
F Significance = 0.000						

Note: *Significant at 0.10 level; ** significant at 0.05 level; *** significant at 0.01 level.

According to the multiple regressions analysis, Model 1 examines the relationship audit quality and earnings management. As previously mentioned, absolute discretionary accruals are used to test the association between audit quality and earnings management, hence, this section focuses on absolute discretionary accruals. Based on Table 2, the results demonstrate that there is no statistically significant linear dependence of the mean of earnings management towards the proxies of audit quality, which are audit firm size, audit fees, and audit partner tenure, although there is a relationship between them. This indicates that audit quality does not really affect the earnings management practices of Malaysian public listed companies in the industry of Industrial Products and Consumer Products. This may be because the audit environment in Malaysia is different than that of other developed countries such as the US and the UK.

Prior to 2010, there was no effective audit and oversight mechanism for auditors in Malaysia. The Audit Oversight Board (AOB) that was established in Malaysia on 1 April 2010, which is an oversight mechanism for auditors, may be relatively new. Thus, the efforts and effects to motivate auditors to provide high quality audits by AOB may not be obvious and evident during the first few years. In such institutional environments, auditors may not be constrained to the practices of earnings management of their client companies, since there is no difference in audit quality between Big Four audit firms and non-Big Four audit firms, as well as audit fees. The effort of the AOB in promoting higher audit quality may be effective in the following years, and thus, the earnings management may become better constrained. For audit partner tenure, the result is not significant. This may be due to the audit partner tenure becoming shorter, which is on average two years after the implementation of the mandatory audit partner rotation of five years. Audit partners tend to be rotated more frequently when there is a mandatory audit partner rotation, and thus, this results in no significant relationship with earnings management practices.

In Model 2, the relationship between audit quality and financial performance was examined. The results revealed that audit firm size is statistically significant (p -value = 0.009) and positively correlated with ROA, with a t -value of 2.628. Moreover, audit firm size is also statistically significant (p -value = 0.015) and positively correlated with TROA, with a t -value of 2.441. This indicates that Big Four audit firms have a higher audit quality, which results in better financial performance by the companies compared to non-Big Four audit firms. This may be because companies usually audited by Big Four audit firms are perceived to have a higher audit quality that can improve the financial performance of the companies. In addition, a high quality of external auditing may increase investors' confidence on the audited financial reports. In this case, less monitoring costs may be incurred, as Big Four auditors tend to provide a higher audit quality, which increases integrity and credibility of the financial reports. Therefore, this can result in better financial performance by the companies.

On the other hand, no statistically significant linear dependence of the mean of ROA and TROA on audit fees was found, although there is a negative relationship between audit fees and financial performance. This suggests that a higher audit quality in terms of higher audit fees do not definitely affect the company's financial performance. For audit partner tenure, there was also no statistically significant linear dependence of the mean of ROA and TROA on it. In this case, mandatory audit partner rotation in Malaysia does not have a significant effect on the company's financial performance. One of the possible explanations for audit fees is that, in some

cases, high audit fees charged by audit firms will result in higher costs incurred, and thus, will lead to lower income generated by the business. Moreover, audit partner tenure does not affect the financial performance of the companies, which is probably because investors do not view the length of the auditor-client relationship as a threat which may affect the company's performance.

Model 3 tested the relationship between earnings management and financial performance. No statistically significant linear dependence of the mean of financial performance on absolute discretionary accruals was detected. However, there is a statistically significant linear dependence of the mean of ROA on signed discretionary accruals (p -value = 0.047), and both of them are positively correlated, with a t -value of 1.990. This indicates that accrual based earnings management practices in Malaysia do have a significant impact on financial performance, whereby when a company tends to exercise income-increasing accruals, the financial performance tends to be better, and vice versa. For instance, when the manager's goal is to maximize the company's value, he or she tends to exercise income-increasing accruals to advance the recognition of sales revenue by credit sales in order to increase the overall revenue. Consequently, this can improve the financial performance of the company. On the other hand, a manager may also exercise income-decreasing accruals (e.g., increase the provision for the purpose of increasing expenses) so that it will result in lower financial performance. This may occur when in the case the company intends to show poor performance so that other companies will not acquire it or take it over.

On the other hand, the results reveal that signed discretionary accruals are statistically significant (p -value = 0.000) and negatively correlated with TROA, with a t -value of -8.147. This demonstrates that, when the management of the company tends to increase earnings, the true value of financial performance is actually lower than the face value shown in financial reports, and vice versa. True financial performance (TROA) is stripped of the influence of opportunistic earnings management practices by management, which is expected to reflect the true value of the company. Therefore, when financial performance reflects the true value of the company, it shows that when true financial performance is lower, the management tends to increase the income by exercising the discretion over the accruals, thus increasing the reported performance, and vice versa. This may be because companies tend to report an average financial performance so that they will not be questioned by the investors or other stakeholders about the overvalued or undervalued financial performance.

In Model 4, the relationship among audit quality, earnings management, and the financial performance is investigated. The overall results and significant level of this model are composed of the combination of Models 1, 2, and 3. Besides,

the results generated from the Sobel test showed insignificant results for the mediation effect of earnings management on the relationship between audit quality and financial performance. This reveals that there is a full mediation effect of accruals based earnings management on the relationship between audit quality and financial performance, when audit quality is measured by audit firm size. Thus, H6 is supported, which indicates that accruals based earnings management mediates the relationship between audit quality and financial performance.

Similar to Model 2, the results have shown a positive significant association between audit quality and financial performance. However, when accruals based earnings management is added as a mediating variable, no significant relationship is found between audit quality and financial performance. In other words, audit quality no longer affects the company's financial performance after accruals based earnings management has been controlled. This may be because the auditors are unable to detect the earnings management practices. Thus, this results in the audit quality delivered by Big Four audit firms having no effect on financial performance, as there is no difference in audit quality between Big Four and non-Big Four audit firms. In addition, investors are perceived that Big Four auditors deliver higher audit quality, and provide proper and reliable financial reports. Hence, the management tends to employ big audit firms in order to exercise the earnings manipulation activities. In this case, audit quality no longer improves the financial performance. Hence, it is suggested that accruals based earnings management mediates between audit quality and financial performance. In terms of audit fees and audit partner tenure, the mediating effect is not applicable because the relationship between them and financial performance is not significant, even though earnings management is not added as a mediating variable.

In terms of the control variable, the results of this study demonstrated that there is a negative, but an insignificant, relationship between the control variable of company size and the mediating variable (earnings management), which is measured by using absolute discretionary accruals. This means that the management will exercise their discretion over accruals, regardless of whether the size of the company is small or large. This may be because the earnings management is affected by factors other than company size, such as the company's ownership, leverage, and market to book value. On the other hand, the findings have demonstrated that there is a significant positive relationship between company size and financial performance. This reveals that the financial performance of larger-sized companies is better than that of smaller-sized companies. This may be because a larger-sized company has more resources and capital to operate their business in order to maximize its overall value.

CONCLUSION

This paper investigated the relationship between audit quality, earnings management, and financial performance in the Industrial Products and Consumer Products sector for Malaysian public listed companies. Various proxies were used in the study to measure the audit quality. The results revealed that audit quality does not truly constrain the earnings management practices in Industrial Products and Consumer Products companies. This may be because Malaysia has an audit environment that is different than that of other developed countries such as the US and the UK. Therefore, the theory of audit quality in mitigating earnings management is not always valid in developing countries.

Besides, the findings also indicated that companies in Malaysia exercise income-increasing and income-decreasing accruals in order to achieve their objectives. It also shows that the companies are more likely to report an average financial performance so that they will not be questioned by the investors or other stakeholders about their overvalued or undervalued financial performance. Consequently, the investors might not access the company's true financial performance. On the other hand, high audit quality can contribute to better company financial performance. This is because big audit firms are always perceived to have higher audit quality, and thus, increase the investors' confidence in financial reports. However, when earnings management is added as a mediating variable, it mediates the relationship between audit quality and financial performance. In this case, the audit quality that is delivered by either Big Four audit firms or non-Big Four audit firms does not truly improve the financial performance when earnings manipulation activities are conducted by the management.

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