

## STATE-OWNED COMPANY DECISION ON CHOOSING AUDITOR: EVIDENCE FROM EARNING QUALITY ANALYSIS

Imam Prakoso

University of Indonesia

E-Mail: [imam.prakoso41@ui.ac.id](mailto:imam.prakoso41@ui.ac.id), [imamprakoso90@ymail.com](mailto:imamprakoso90@ymail.com)

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### ABSTRACT

*The importance of using big accounting firm may depend on governance level in each company. If they have good corporate governance and have high concern on improving governance, the company may prefer to use big accounting firm (Lina & Liub 2009; and Houqe, Zijl, Dunstan, & Karim 2015). State-owned enterprise (“BUMN”) may have higher agency problem as their objective is people welfare but still profit-oriented. So, they have higher ability to defer the earning than other company. We include research sample of all BUMN which listed on Indonesia stock exchange (IDX) except those which participate in banking and financial industry (JASICA 8). By using discretionary accrual as proxy of lower earning quality and accounting firm size as proxy of audit quality, we found negative relationship between those variable. In other words, if the company want to improve their earning quality they should consider on using big accounting firm. In additional analysis, we found that big accounting firm able to reduce management intention to defer earning and tax expense. I encourage government of Indonesia (“the Government”) to advise BUMN to consider on using big accounting firm to improve earning quality and reduce fraudulent act through financial reporting by management.*

### 1. INTRODUCTION

Indonesian and the Government delegate the management of country's resource to BUMN. Most of BUMN operate in industry which related to people welfare such as natural resources, infrastructure, telecommunication, etc. Although they are profit-oriented, the Government may use their right as shareholder to controls the operation align

with the regulation. As result, based on ministry of BUMN regulation (PER-04/MBU/2014) the Government creates incentive for management of BUMN to meet the goals. The incentives are decided based on previous year achievement. Furthermore, the Government add additional incentive for BUMN which able to compete in foreign market and operate based on global standard. So, BUMN may defer the earnings or penetrate foreign market by using lower price so the management may have higher benefit with lower tax expense due to lower sales. Chen, Chen, Lobo, & Wang (2011) argue that BUMN may not have higher motivation to achieve high profit than non-BUMN by managing their profit. However, BUMN still have serious agency problem because they only focus on profit and management does not have opportunity to gain big portion of company's share (Tang, Chow, & Lau 1999).

Some countries (e.g. Indonesia) regulate the listed companies to rotate the accounting firm each six year and partner each three year. However, the other countries which decide not to rotate the accounting firm (e.g. Australia, USA, and others) still regulate the partner rotation. Bandyopadhyay, Chen, & Yu (2014) argue that the benefit on rotating the accounting firm is less than the cost of the rotation. Their finding may not applicable for some countries due to the difference on quality.

According to *Transparency International*, corruption, openness, and governance score in Indonesia is low. Government audit or internal reporting division is not sufficient to ensure the financial report has properly reported based

on accounting standard on BUMN, there may be conflict of interest because the auditor is supervised by the Government. Public investor will be suffered from this condition because management of BUMN may falsify the financial information. This will reduce stakeholder trust on BUMN then the cost of capital will be higher (Persakis & Iatridis 2015). To anticipate this condition, BUMN need to engaged more independent, professional, and competent accounting firm.

This research does not discuss about the cost and benefit from accounting firm rotation and partner rotation but to provide empirical evidence on the relationship between audit quality and aggressivity of financial reporting. This research contributes to the literature on providing conclusion from specific company such as BUMN which has unique characteristic. To conclude, I noted the usage of big accounting firm will reduce the probability of management to manipulate or falsify the financial information. We also recommend that the BUMN should keep using big accounting firm whether or not they should be rotated. When the rotation applied, it should be rotated to another big accounting firm. This may increase the quality of financial statement.

This paper divided into 5 sections. On section 2, this research describe about literature review and hypothesis development. Sample selection and research method explained on section 3. Section 4 describe about statistic descriptive and the result of this empirical research. Then on section 5, I provide conclusion

based on empirical result and provide the recommendation from this research.

## 2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### 2.1 Accounting firm in Indonesia

In Indonesia, the legal entity of accounting firm is partnership not limited liability. They are allowed to use either the local partnership name or global affiliates. Accounting firm allowed to change its name if there is big changes on the composition of partner in the firm so they able to extend the audit period limitless. However, the requirement is rarely used by small company without doing merger as they only have small number of staff in average. This make the objective regulation on rotation may not achieved. However, Li (2010) found that decrease in independence (accounting conservatism) only happened at small company. So there is probability that the accounting firm maintain their audit quality because most of the listed companies (especially BUMN) have higher assets compare to the other non-listed company and non-BUMN in similar industry.

Market type of accounting firm is oligopoly where only few accounting firms owned most of the market share. Generally, many accounting research classify accounting firm into big and non-big four. The big four of accounting firms are *PricewaterhouseCoopers*, *Deloitte Touche Tohmatsu*, *Ernst & Young*, dan *KPMG*<sup>1</sup>. Indonesia affiliates from those

<sup>1</sup> The definition of accounting firms may various, Bandyopadhyay, Chen, & Yu (2014) include more local accounting firm (whether affiliated or not) because based on public accounting institution on China, those accounting firm have big market share.

accounting firm network are KAP Tanudiredja Wibisana Rintis & Rekan, KAP Osman Bing Satrio & Eny, KAP Purwantono, Suherman & Surja, dan KAP Siddharta & Widjaja. As the big accounting firm has resource to increase audit quality provided to their client, DeAngelo (1981) conclude that bigger accounting firm will increase the audit quality. Comprix and Huang (2015) found more specific conclusion that smaller accounting firm does not have ability to prevent opportunistic management but they do not found evidence that shows the smaller accounting firm assist or advise their client to do fraud.

### 2.2 Accounting firm rotation in Indonesia

Decision on choosing accounting firm is based on general meeting of shareholder ("RUPS") in each company. Based law no. 19/2003 article 71, ministry of state owned enterprises Indonesia allow BUMN (limited liability) to choose the accounting firm on RUPS unless for specific type of BUMN. BUMN also should comply with ministry of finance's regulation no. 423/KMK.06/2002 which amended to PMK no. 17/2008 which regulate the duration of auditing services. The service should be no longer than five consecutive years (six year based on PMK). The regulation also stated that the duration of audit partner should be no longer than three consecutive years with cooling period of one year. However, if the accounting firm is currently audit the Company more than five years in 2003, they allowed to finish they service in the current year. Moreover, there is specific sentence to be given by the authority for listed company which does

not comply with this regulation because they concern on quality of financial report.

Audit partner rotation is regulated by authority in most of country in the world, and they have different view on accounting firm rotation. However, European Commission and US' PCAOB considering to implements rotation obligation on the accounting firm recently. The different views come from assumption that the rotation able to maintain the independence and quality of accounting firm, however some countries like Australia and USA view that cost of the rotation is less than its benefit (Bandyopadhyay et al. 2014).

Big accounting firms have a big resource so they do not need to worry by changing its business strategy significantly if they lose profitable client. This is one of the reason on why many researcher use this proxy to control the pressure from client (client importance) (Bandyopadhyay et al. 2014; dan Wahyuni & Fitriani 2012). By observing the advantage of big accounting firm, Carey & Simnet (2006) shows that audit quality in Australia increases because the impact of partner rotation. This research does not discuss those different views but to find the empiric evidence on relationship between audit quality and earning quality.

### 2.3 Audit quality and earning quality

On company level, by choosing competent accounting firm may signal the stakeholder that management has keep good corporate governance so the cost of capital will relatively lower compare to company which has weaker corporate governance. However, as rational

people, management loss some of their chance to extract resources from their company for personal needed. So, in general, the Company which has weaker corporate governance will choose accounting firm which has lower competency, vice versa (Lina & Liub 2009; and Houqe, Zijl, Dunstan, & Karim 2015).

Earning quality usually measured by measuring the accretion of management to falsify the financial information or the chances on doing earning management. Earning management is fraudulent act which performed by the management through financial reporting fraudulent to influence the short term performance of company. One of the proxies of earning quality is using discretionary accrual. If the balance is high (in absolute amount), the earning quality of the financial report is low because management able to manage transaction without any business essence or defer the transaction.

There are several methods on calculating discretionary accrual so we use a method which aligns with research objectives. This research use Dechow model because it does not require special specification between discretionary accrual with corporate financial performance (adjusting their performance with industry performance) and defer the excess performance. Dechow model also more appropriate to be used because this research does not observe the changes on company's value in the long run and operating performance in specific but the implication of using big accounting firm.

#### 2.4 Accounting firm choices on BUMN

Earning quality in each BUMN is different because each manager has different views. However, Chen et al. (2011) argue that BUMN does not have higher motivation to manage their earning recognition than other listed company. So BUMN has bigger agency problem because they are profit oriented by nature but the managers does not have enough ownership share on BUMN (Tang et al. 1999).

Similar with most of the company, BUMN has a right to choose the accounting firm so the relationship between accounting firm and client may have impact on the decision on choosing accounting firm and its scope of work. Apparently, the relationship may reduce audit quality but Ball, Tyler, & PeterWells (2015) found factors that can increase audit quality during audit engagement. Those factors are rotation on accounting firm's team member and accounting staff, internal quality review of each accounting firm, and risk of reputation loss for accounting firm (Davis, Soo, & Tompeter 2009). Audit team member and accounting staff rotation may reduce negative interpersonal relationship which could reduce independence and professional scepticism so it will maintain audit quality. Beside that, accounting firm with good internal quality review control will maintain their quality because there is internal sanction for the breacher. For example, *PricewaterhouseCoopers Indonesia* has *Engagement Compliance Reviews* (ECR) which the breacher should explain their judgement during audit. If they failed to explain, it may have impact in their carrier as it included on KPI

(key performance indicators). Each accounting firm have different assessment on their client or prospective client. Audit engagement on BUMN is considered as high risk because they have higher exposure (listed and BUMN). This make accounting firm should keep their independence during engagement because if there is audit failure it will be blown up by mass media. If there is audit failure, the reputation will damaged similar with enron case.

Li (2010) found more comprehensive conclusion about the relationship between audit tenure and independence (accounting conservatism) which negative in small company. The research also concludes that client with higher audit fee (high client importance) play important role on long run relationship between auditor and client. It wil make smaller accounting firm has higher pressure to meet client's demand. To find whether big accounting firm able to reduce fraud on financial reporting (earning management) so we develop hypothesis as follow:

***H: Big accounting firm able to maintain earning quality through financial statement in BUMN.***

### 3. RESEARCH METHOD

#### 3.1 Sample selection

This research use financial data from Thompson Reuters' Datastream ("Datastream") but the unavailable datas (e.g. accounting firm used) are obtained manually from financial statement on each sample. The information on accounting firm used is based on accounting firm's opinion letter on final audited financial statement on respective year.

This research includes all listed BUMN for 10 years from the implementation year of regulation on rotation starts (2003-2012). To avoid inconsistency, if the sample listed after 2003, the observation years are from the listing year to 2012. BUMN on banking and financial service industry are excluded as sample because those companies are highly regulated, using different cash flow process and accrual recognition compare to other industry. As result, the samples used for this research are 109 observations (14 company). Please see table 1 below.

(Francis, Maydew, & Sparks 1999; and Teoh & Wong 1993) argue that big accounting firm able to provide better audit quality for client. Signing partner on big accounting firm able to provide disclaimer, adverse, and qualified audit opinion the company if management unable to provide explanation and evidence on misappropriate accounting practice (DeAngelo 1981). Hence audit quality (accounting firm choice) can be proxied by dummy variable with 1 for big accounting firm and vice versa.

Earning quality on this research define by how big the discretionary accrual on each

**Table 1**  
**Research sample**

Quote	Industry*	Listing date	Observation
ANTM	<i>Mining</i>	1997	10
PTBA	<i>Mining</i>	2002	10
TINS	<i>Mining</i>	1995	10
KRAS	<i>Basic industry and chemical</i>	2010	3
SMGR	<i>Basic industry and chemical</i>	1991	10
INAF	<i>Consumer goods industry</i>	2001	10
KAEF	<i>Consumer goods industry</i>	2001	10
ADHI	<i>Property, real estate, and building construction</i>	2004	9
PTPP	<i>Property, real estate, and building construction</i>	2010	3
WIKA	<i>Property, real estate, and building construction</i>	2007	6
GIAA	<i>Infrastructure, utilities &amp; transportation</i>	2011	2
JSMR	<i>Infrastructure, utilities &amp; transportation</i>	2007	6
PGAS	<i>Infrastructure, utilities &amp; transportation</i>	2003	10
TLKM	<i>Infrastructure, utilities &amp; transportation</i>	1995	10
*Industry classification is based on <i>Jakarta Stock Industrial Classification</i> ("JASICA").		<b>TOTAL</b>	<b>109</b>

### 3.2 Definition of audit quality and earning earning quality

Basically, the proxy of audit quality is fluctuative because it influenced by the audit competence, the depth of audit procedure, and the corporate governance. Previous studies

sample. The use of discretionary accrual is commonly used by previous study which in general able to prove that the relationship between audit quality and earning quality is positive (Balsam, Krishnan, & Yang 2003; and Jiang, Habib, & Zhou 2015). Previous researchs

use various discretionary accrual measurements like the nominal value, the absolute value, or positive/negative value (with the indicator). This research use absolute value because Kim, Chung, & Firth (2003) and Francis et al. (1999) found that manager decision on doing earning management may endogenous which means it may depend on other circumstances. Those management's actions does not oversees by auditor (internal or external) but also the shareholders which try to mitigate that risk by using competent auditor. We do not use the calculated value because it is more suitable for specific sample such as Chinese which has stricter regulation on corporate action in stock exchange (Bandyopadhyay et al. 2014).

The proxy of discretionary accrual is developed by Jones (1991) which modified by researchers like Dechow, Sloan, & Sweeney (1995), Kothari, Leone, & Wasley (2005), and others. Ayers, Jiang, & Yeung (2006) argue that the advantage from using modified Jones (Dechow) model compared to performance-matched Jones (Kothari) model is Dechow model does not require further specification between correlation between discretionary accrual and financial performance of the company compared to the average industrial performance. Moreover, Dechow model may better used for this research because this research does not see the increase of company's value on the long run and operating performance in specific but the implication from using big accounting firm. The model of discretionary accrual proposed by Dechow et al (1995) are the residual between equation of

total accrual and its component or estimated by using model below:

$$\text{Total accrual}_{it} = \alpha + \beta_1 (\Delta \text{sales}_{it} - \Delta \text{receivables}_{it}) + \beta_2 \text{PPE}_{it}$$

Where  $\Delta \text{sales}$  is the changes of sales from previous period observation,  $\Delta \text{receivables}$  is the changes of receivables from previous period observation, PPE is net balance of property, plant and equipment, and total accrual is the difference between net income and cashflow from operating activity. All variable is denominated by using lagged total assets. The residual of Dechow model in this paper is estimated (regressed) on each industry (JASICA / Jakarta Stock Industrial Classification) because lack of annual observation. This research use absolute value of discretionary accrual.

### 3.3 Research model

By using BUMN as sample, this research estimates the hypothesis by using following model.

$$\text{DACC}_{it} = \alpha_i + \beta_1 \text{BIG4}_{it} + \beta_2 \text{EXPR}_{it} + \beta_3 \text{SIZE}_{it} + \beta_4 \text{CFO}_{it} + \beta_5 \text{ROA}_{it} + \beta_6 \text{AGE}_{it} + \beta_7 \text{SHAR}_{it} + \beta_8 \text{POWR}_{it} + \epsilon_{it}$$

Where DACC is discretionary accrual and BIG4 is audit quality (see 3.2 for detail explanation).

Different with previous studies (Bandyopadhyay et al., 2014; dan Jenkins & Velury, 2008), this paper does not control familiarization auditor with audit tenure because audit engagement in Indonesia should be rotated at maximum five (six year based on amended regulation). To compensate that,

this paper uses percentage of audit tenure by big accounting firm on observation time (EXPR) because although they have different methodology, their credibility and competency almost similar. This proxy is inline with research objective and able to control the company's expertise on assisting BIG4 on performing audit procedure.

Research conduct by Lawrence, Minutti-Meza, & Zang (2011) conclude that the difference on quality between BIG4 and non-BIG4 may depend on their client characteristic. So, if the client assists the auditor on doing their procedure, there may smaller gap between audit quality done by BIG4 and non-BIG4. Hence, it is important to include control variable that indicate company's characteristic such as SIZE, CFO, AGE, and ROA. Furthermore, to control pressure on accounting firm's independence, this research include control variable such as SHAR and POWR.

SIZE measured by natural logarithm from total assets to control company's resources. Similar with Bandyopadhyay et al. (2014), this paper use variable CFO (cash flow from operating activity) because it may negatively correlated with accrual. ROA is included to control the profitability of companies which show how big the intention of the companies to maximise the profit. Both ROA and CFO are divided by lag total assets. AGE shows how long the companies listed on IDX (Indonesia stock exchange) to control the attention of the stakeholder. Listed companies should disclose more information (e.g. annual report

information) than unlisted companies and the attention is higher for long listed companies.

Variable SHAR used to control company's experience on industry specific company. This paper use variable POWR to control the pressure from client. SHAR measured by using portion of total asset of the compay to total asset in related industry, where POWR is the portion of total asset compare to total asset audited by same accounting firm. SHAR and POWR calculated on each year by using data from Datastream for all listed BUMN.

#### 4. RESEARCH RESULT

Descriptive statistics on listed BUMN on IDX is described at Table 2. DACC has big variation by seeing on maximum and minimum value. As the average value of DACC is higher than the median, it shows that most of BUMN doing more aggressive financial reporting compare to the other. By seeing the median of BIG4 amounted 1 and based on average value of 60.55%, it shows that most of listed BUMN use big accounting firm. This result is consistent with EXPR which shows that BUMN may use BIG4 based on previous engagement. Auditor experience on industry is different on each accounting firm because the standard deviation of SHAR is big. Maximum value of those variable much bigger than minimum value which shows that there is BUMN which use less experienced accounting firm. This may result on reliability of financial statement because that accounting firm may has less competence. By seeing the maximum value of POWR of 1, it shows that there is auditor (smaller accounting

firm) which audit one company on IDX which also BUMN. This may causes the company has higher ability to disobey and/or negotiate the procedure audit.

On average, SIZE is relatively higher compare to other company, it indicate that BUMN is one of the market leader in their industry. Given average value of ROA in BUMN is higher than inflation level in Indonesia (approximately 7% in last 10 years) shows that they have good resource and participate in profitable market to generate profit so they are profit oriented. Average value of AGE is higher than its median because most of BUMN has listed on IDX. By considering only those factors, investor will attracted to invest on BUMN because they have high assets, ROA, and high continuity. This may add a pressure for management to create higher profit.

financial statement is lower by 0,0234 point (DACC measurement) or there is increasing on earning quality. This parameter is big enough compare to average value of DACC (0,0454). This conclusion is consistent with previous research where they argue that big accounting firm may provide better audit quality for their client (Francis, Maydew, & Sparks, 1999; dan Teoh & Wong, 1993).

Regression result on variable control shows that SIZE positively correlated with DACC, however AGE has negative relationship. The bigger company has bigger resource such as high skill staff and bigger political power (Zimmerman, 1983). Bigger company also has ability to customize their business strategy so they may has a tendency to do fraud. Increasing growth of BUMN 1% may increase fraud level by 0,00026 with DACC measurement. On the

**Table 2**  
**Statistic descriptive**

	DACC	BIG4	EXPR	SIZE	CFO	ROA	AGE	SHAR	POWR
<b>Mean</b>	0.0454	0.6055	0.6294	29.5834	0.1346	0.1006	7.5505	0.2097	0.2519
<b>Std. dev</b>	0.0428	0.4910	0.4484	1.3032	0.1277	0.0924	5.3324	0.1743	0.3129
<b>Min.</b>	0.0009	0	0	26.8894	-0.1972	-0.2254	0	0.0051	0.0045
<b>25%</b>	0.0102	0	0	28.6382	0.0414	0.0370	3	0.0466	0.0329
<b>Median</b>	0.0280	1	1	29.5674	0.1174	0.0651	7	0.1427	0.0734
<b>75%</b>	0.0807	1	1	30.4144	0.2382	0.1465	11	0.3809	0.3892
<b>Max.</b>	0.1413	1	1	32.3431	0.4800	0.4376	21	0.5533	1

Table 3 shows the regression result by using fixed effect model with robust standard error. Variable BIG4 has negative relationship with DACC (dependend variable), in average observation, changes from non-big accounting firm to big accounting firm may increase the earning quality. As result, the fraudulent of

other side, company's experience may increase earning quality. The longer BUMN listed on IDX may reduce fraud level by 0,006 annually on DACC measurement. The longer companies listed on IDX, it will attract more stakeholders which monitor their activity such as public investor, mass media, researcher, and others.

In this paper, we do not found relationship on some control variable such as EXPR, CFO, ROA, SHAR, and POWR does not have impact on earning quality. Profitable company is not always doing fraudulent on financial reporting. This is because BUMN operate in profitable and strategic industry such as mining, infrastructure, and others. The expertise on BUMN to assist audit process also does not increase earning quality because the decision is made on top level management. Although the audit process goes smooth, if management has power to influence audit process, the quality may lower. Moreover, this paper shows that SHAR and POWR is not important factor on earning quality.

**Table 3**  
**Regression result**

Variable	Prediction	Coefficient	t-stat
BIG4 #	-	-0.0243	-2.46**
EXPR	-	-0.0198	-1.66
SIZE	+	0.0259	3.24***
CFO	-	0.0227	0.78
ROA	+	0.0390	1.1
AGE	?	-0.0058	-5.88***
SHAR	-	0.0001	0.01
POWR	+	-0.0217	-1.3
_CONSTANT	?	-0.6499	-2.87***
R Square	0.2671		
N	109		
***Significant on 1%			
** Significant on 5%			
* Significant on 10%			
# The coefficient is similar with <i>marginal effect</i> estimation			

#### 4.1 Additional analysis

By using same observation, researcher perform robustness test by using only positive

and negative balance on DACC. Compare to main research, this test may able to provide more specific findings on the impact of big accounting firm to reduce BUMN strategy on reduce earning for tax purpose or increase the earning to attract investor. The regression result by using negative DACC has positive relationship so it may conclude that big accounting firm able to reduce company ability to reduce their earnings. Unfortunately, we do not found conclusion on DACC positif because the observation is low because the model unable to estimated. Additional analysis

#### 5. CONCLUSION

This research test the relationship between audit quality and earning quality on listed BUMN on IDX. The findings are BUMN able to maintain audit quality by using big accounting firm which may reduce manager's ability to manipulate or doing aggressive financial reporting. In additional analysis, this paper found that big accounting firms are able to reduce management ability on reduce the earning.

Government may advise BUMN including non-listed BUMN and other government related entity to use more competent auditor such as big accounting firm. Big accounting firm has better audit procedure and able to provide recommendation on any control deficiency which may has potential material impact on financial statement. They also has better experience on auditing bigger company and industry so they understand the best practice which should be done on the Company. As

result, BUMN may able to present unqualified financial statement and increase corporate governance.

Next research should include listed and non-listed BUMN so it will provide better conclusion. Furthermore, in measuring auditor's expertise, the researcher may include all client audited by the accounting firm. Although dechow model more suitable to use on this resource, next reseach should consider on their additional analysis to compare the result with Kothari, Kaznik, Jones and other measurement of discretionary accrual.

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