

Does Audit Quality on Real Earning Management of an Emerging Economy?

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Abstract

Following the unexpected failure of many well-known multinational and national corporations, shareholders, investors, and the general public began to doubt the quality of audits. At the same time, the question of 'earnings' arose since earnings are the most crucial variable to gauge financial success. Thus, this study aims to examine the impact of audit quality on real earnings management in Sri Lanka. Data were collected from listed non-financial companies from 2019 to 2021. Audit quality is measured using two proxies; audit fees and the presence of Big-4 firms, and real earnings management is measured by operating cash flow, discretionary expenses, and production cost. The panel regression approach was used to analyze data and test hypotheses. The research findings show that audit fees strongly impact abnormal operating cash flow, abnormal discretionary expenses, and aggregate real earnings management. On the other hand, audit fees have no significant influence on abnormal production costs. When the existence of the Big-4 firms is considered, it has a significant and positive impact on abnormal operating cash flow, abnormal discretionary expenses, and aggregate real earnings management but has no significant impact on production cost. These findings will support regulatory bodies and policymakers to regulate the quality of audits well and improve the practices of real earnings management. Other than that, it is important to investors when choosing or reappointing auditors to be cognizant of the quality of financial reporting when making good investment decisions.

Keywords: *abnormal discretionary expenses, abnormal operating cash flow, abnormal production, accrual earnings, audit fees, audit quality, real earnings management*