

AUDIT QUALITY AND ITS IMPACT ON EARNINGS MANAGEMENT: EVIDENCE FROM PUBLIC LISTED COMPANIES IN SRI LANKA.

Thalangama T.A.T.W.¹ and Karunaratne W.V.A.D.²

¹*hisarithalangama2017@gmail.com*; ²*anurawvadk@kln.ac.lk*

Abstract

A strong and well-functioning auditing process can mitigate the manipulation of the company's earnings and performance. Even though companies present excellent earnings growth in their audited financial statement, it arises doubts about the quality of the audit performed by the firm. The agency problem is the most popular issue emphasized by accounting and finance researchers. Hence, auditing is an important mechanism that can be implemented to answer the agency problem. Accordingly, Audit quality could impact the earnings management of the company. Thus, the current study primarily investigates the impact of audit quality on earnings management in publicly listed companies in Sri Lanka. Audit quality was measured in the study using two audit proxies: audit firm size and audit independence. The degree of earnings management was measured using three different perspectives: Discretionary accruals, Small positive earnings, and Earnings smoothing. The study's scope focuses only on external audits and their impact on earnings management. There are several types of audits, but this study area is limited to external audits due to the availability and more reliable access to information. This research is mainly focused on secondary data gathered from publicly listed companies in Sri Lanka. Among 297 publicly listed companies in Sri Lanka, 50 companies were chosen for the study and take recent five years period annual reports issued from 2016 to 2020. Descriptive statistical measures, correlation analysis, and regression analysis were used to analyze the study data. Accordingly, the findings of this study will offer a better understanding of the impact of audit quality on earnings management. The study finds an insignificant association between audit quality and the degree of earnings management in Sri Lankan listed firms. Furthermore, the study reveals ineffectiveness in the oversight mechanism through the insignificant association reported between earnings management and the other variables, audit committee independence, the board size, board independence, and CEO duality.

Keywords: *Audit Quality, Discretionary Accruals, Earnings Management, Audit Firm Size (Big 4 or non-Big 4), Audit Independence, Audit Fee*