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Auditor Reputation, Financial Performance, and Earnings Management

Melinda Lydia Nelwan[1*], Bellatrix K. D. Mambu[1], Billy Ivan Tansuria[1]
[1]*Faculty of Economics and Business, Universitas Klabat (UNKLAB), Indonesia*

Abstract:
This research revisits the topic of audit quality, financial performance, and earnings management. In particular, it investigates whether auditor reputation, which can be a signal of audit quality, has a direct impact on alleviating earnings management, and whether financial performance mediates the impact of auditor reputation on earnings management. The sample of this study consists of 93 listed Indonesian manufacturing companies. By employing structural equation modeling, the results show that auditor reputation has a direct and positive impact on financial performance but not on earnings management practices. It is also found that financial performance does not mediate the influence of auditor reputation on corporate earnings management practices. The results suggest that a reputable auditor may enhance the financial performance of a company. It indicates that a reputable auditor could motivate a company to perform better financially. However, there is no indication that auditor reputation influenced the earnings management practices in a company. It could be because a company that has excellent financial performance does not necessarily need to manage earnings to meet certain expectations.
Keywords: *audit reputation, earnings management, financial performance.*

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I. Introduction

The financial reporting which is the final step in the accounting process has an essential role for the measurement and assessment of the company's performance. The financial report is a form of management's accountability to the stakeholders which include shareholders, investors, creditors, governments, and the public (Agustia, 2013).

In the company's financial report, earnings provide essential information for the internal and external parties of the company. However, earnings information is not always accurate. Earnings information, as part of the financial report, often becomes the target for management to maximize their self-interest, which could harm the shareholders or investors. The opportunistic act of management could be done by choosing specific accounting standards in order to manage the company's profit which can maximize the management's interests (Scott, 2015).

The management usually possesses more information about the performance of the company; however, the information may not be fully disclosed to capital owners which causes an asymmetric information between the two parties (Ifonie, 2012). Similarly, information asymmetry occurs when management possesses more information about the current and future prospect of the company than investors and other related parties (Rahmawati, Suparno, & Qomariyah, 2007). Information asymmetry between management (agent) and shareholder (principal) often provides opportunity for managers to do earnings management that can mislead the shareholders regarding the economic performance of the company.

According to Bangun and Vincent (2008), earnings management is the act of a manager in presenting a report which increases or decreases the profit of their business unit without incurring any increase or decrease in economic unit profitability in the long term. Earnings management appears in the process of financial reporting because the management expects some advantages from it. The management may often deviate from the company's vision and mission without being noticed by other parties because of the limited information.

One mechanism to alleviate the harmful risks of earnings management is for the financial reports to be audited by the auditor. This leads to the notion that auditor reputation potentially has an impact on earnings management. In fact, DeAngelo (1981) declared that more prominent CPA firms conduct better audit because they have better reputation and can hire more skilled employees. Moreover, DeAngelo (1981) stated that big-four auditors are often linked with high quality audit than non-big-four auditors. Therefore, more reputable auditors may prevent earnings management.

Several studies have analyzed the influence of auditor reputation on earnings management. Others have analyzed the impact of financial performance on earnings management. However, a study regarding the

mediating role of financial performance on the impact of auditor reputation and earnings management has not yet been conducted in the context of manufacturing companies in Indonesia. This study argues that since studies regarding the influence of auditor reputation on earnings management provide inconclusive results and the influence itself is not obvious, the relation between auditor reputation, financial performance, and earnings management is worth to receive more investigation.

II. Literature Review and Hypothesis Development

Earnings Management

Besides profit maximization, companies may also have incentives to provide timely and trustworthy financial reports. After all, financial reports are what potential investors and creditors consider when they have to make investment decisions or provide capital to a company. In preparing the financial reports, the management may engage in earnings management practices, since they need to meet certain expectations. By looking at the development of modern accounting, earnings management has created many debates among academics, experts, and regulators about the legality of its practices (Dechow & Skinner, 2000).

Gunny (2005) classified earnings management into three categories: fraudulent accounting, accruals management, and real earnings management. Fraudulent accounting involves accounting choices that violate accounting principles. Accruals management is the choice of accounting policies that are aligned with accounting principles to obscure real economic performance (Dechow & Skinner, 2000). Real earnings management occurs when managers undertake actions that deviate from the company's regular operation in order to elevate reported earnings. Thus, fraudulent accounting and accruals management are accomplished through the choice of accounting methods used to represent companies' underlying activities.

In contrast, real earnings management are accomplished by changing the firm's underlying operations. It is hard for investors to detect real earnings management in comparison to accruals earnings management, as real earnings management is more natural to camouflage as normal activities compared to accruals earnings management. Therefore, although to some degree, earnings management could be legal, investors may want to know whether the financial reporting of the company is trustworthy, and can hence be used in investment decision making.

Auditor Reputation and Earnings Management

Scott (2015) stated that according to agency theory there are two parties that are interdependent with one another. They are the shareholders, also called principal, and the management as the representation of investors, which is called agent. The management performs daily activities in a company with the general objective of increasing the wealth of shareholders. However, in practice, the management tends to do things that deviate from the general objective. This deviation causes conflict between shareholders and management, which is called an agency conflict (Gitman & Zutter, 2015).

Nevertheless, according to Widyaningdyah (2001), both principal and agent have different purposes that cause complexity in the agency conflict. Agency conflict is intensified especially because the owners of capital cannot monitor the manager's daily activities to ensure they work for the owners' best interests. Consequently, the owners of capital are motivated to make contracts in aligning their interests with those of the management.

A mediator or the third party who is independent is supposedly needed in the relationship between the principal and agent. In this case, an external auditor is a party assumed to be the mediator between principal and agent in assessing the company's financial reporting process. The auditor is responsible in monitoring manager's work through the annual report of companies, providing an opinion on financial statements, and considering the survival of companies (Susanto, 2009). Therefore, when it comes to earnings management practices, the auditor plays a vital role in preventing or detecting earnings management practices within the companies.

CPA firm, in general, has an essential role in the provision of audit and accounting services. According to Susanto (2009), more prominent CPA firms with a better reputation such as the big-four tend to provide better services because these firms will choose the best auditors to hire, and the auditors have been given a series of training and procedures which are considered to have higher quality and be more effective (Christiantie & Christiawan, 2013). Indeed, Kanagaretnam, Lim, and Lobo (2010) found that companies were less likely to practice earnings management when they were audited by more reputable auditors. This was obvious across banking industries in 29 countries. Christiantie and Christiawan (2013) conducted a study regarding the influence of corporate governance and CPA reputation on earnings management practices. The sample included companies that were listed on the stock exchange in the trade and services sectors during 2009 to 2011. They investigated whether independent commissioner, institutional ownership, management ownership, audit committee, and CPA firm reputation have an influence on earnings management. It was found, however, that the reputation of CPA firm had no significant influence on earnings management.

Another study by Iguna and Herawaty (2010) examined the influence of good corporate governance, auditor independence, audit quality and other factors on earnings management. They used companies that were listed on the Indonesia stock exchange, particularly those in the trade and services sectors during 2009 to 2011. The independent variables were independent commissioner, institutional ownership, management ownership, audit committee, and the reputation of CPA firm as the measure of audit quality. They found, in particular, that the CPA firm's reputation had no significant influence on earnings management. Similarly, Piot and Janin (2007) found that big-five auditors do not affect earnings management practices among companies in France.

Puspitasari (2013) also examined the influence of debt policy, managerial ownership, and auditor reputation on earnings management. The sample used in this study were manufacturing companies listed on Indonesia stock exchange in 2008 to 2010. The results of the study indicated that the variables of debt policy, managerial ownership, and the auditor reputation had no significant effect on earnings management.

Auditor Reputation, Financial Performance, and Earnings Management

Studies of Afza and Nazir (2014), Jusoh et al. (2013), as well as Farouk and Hassan (2014), showed that audit quality, which is interrelated with the reputation of external auditors, has positive impact on financial performance. Afza and Nazir (2014) found that reputable external auditors promote motivation to companies to prepare more reliable financial reports that can increase assurance to investors. Jusoh et al. (2013) found that better audit quality lowers the agency costs, thus increasing companies' financial performance. Moreover, Farouk and Hassan (2014) found that increase in audit quality leads to the increase in company performance.

On the other hand, companies that are more politically visible would want to engage in earnings management practices (Scott, 2015). A politically more visible company is a company that is more susceptible to public scrutiny. For instance, when a company has higher profit, that company may have an incentive to minimize income to avoid transfer of wealth. On the other hand, managers in a lower income company may have an incentive to maximize income to obtain more bonus. Nevertheless, Jordan et al. (2008) found evidence that companies with positive earnings manipulate earnings by increasing the earnings' digit which is more obvious on small, low leverage, and less profitable companies. Another study by Sun and Rath (2009) found smaller size and less profitable companies tend to engage in earnings management practices both upwardly and downwardly. Regardless, the financial performance of a company can potentially lead to earnings management practices.

Despite the fact that several studies have shown that auditor reputations have no influence on earnings management (e.g., Christiantie & Christiawan, 2013; I Guna & Herawaty, 2010; Piot & Janin, 2007; Puspitasari, 2013), auditor reputation provides a significant role in the quality of financial reporting (e.g., Afza & Nazir, 2014; Farouk & Hassan, 2014; Jusoh et al., 2013). On the other hand, studies have also shown that financial performance has influence on earnings management (e.g., Jordan et al., 2008; Sun & Rath, 2009). This present study argues that if auditor reputation does not have a direct influence towards earnings management, it may potentially have an indirect influence through financial performance. This is because a more reputable auditor may not be directly involved in the financial reporting process, but could cultivate the motivation for the company to provide reliable financial reports. Therefore, the hypotheses of this study are

H_1: Auditor reputation influences financial performance.
H_2: Financial performance mediates the influence of auditor reputation on earnings management.
H_3: Auditor reputation has a direct influence on earnings management.

The conceptual framework is presented in Figure 1.

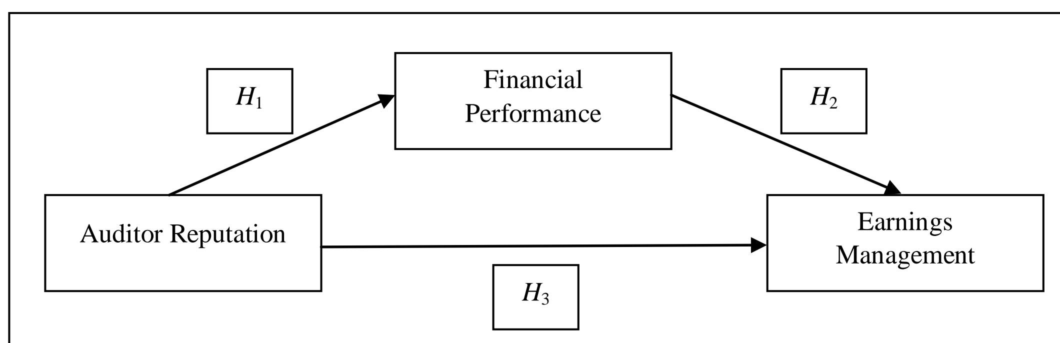

Figure 1. Conceptual Framework

III. Methodology

Population and Sample

The population of this research was the manufacturing companies listed on IDX for the period of 2011 to 2013. The samples were companies that had the following criteria: (1) consistently listed in IDX for the period of 2011 to 2013; (2) consistently published their annual financial statements in those periods; (3) financial statements ended on December 31.

The approximate amount of population that were examined were around 132 manufacturing companies. That number was assumed had each of the manufacturing companies met the sampling criteria. However, the final sample consisted only of 93 companies.

Variable Measurement

Earnings management was proxied by discretionary accruals and was obtained using the modified Jones model. This model was used because it better than other models in detecting earnings management practices (Dechow, Sloan & Sweeney, 1995). Therefore, this study applied the specific model because this model has been used widely by the academics and practitioners. The model is as follows:

$$TACC_{i,t} = EBIT_{i,t} - OCF_{i,t} \quad (1)$$

$$\frac{TACC_{i,t}}{TA_{i,t-1}} = \propto_1 \left(\frac{1}{TA_{i,t-1}}\right) + \propto_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{TA_{i,t-1}}\right) + \propto_3 \left(\frac{PPE_{i,t}}{TA_{i,t-1}}\right) + \varepsilon \quad (2)$$

From the equation above, NDACC can be calculated as follows:

$$NDACC_{i,t} = \propto_1 \left(\frac{1}{TA_{i,t-1}}\right) + \propto_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{TA_{i,t-1}}\right) + \propto_3 \left(\frac{PPE_{i,t}}{TA_{i,t-1}}\right) \quad (3)$$

Furthermore, to get the DACC, the equation will be:

$$\left(\frac{TACC_{i,t}}{TA_{i,t-1}}\right) = \beta_0 + \beta_1\, NDACC_{i,t} + \beta_2 DACC_{i,t} \quad (4)$$

$$DACC_{i,t} = \left(\frac{TACC_{i,t}}{TA_{i,t-1}}\right) - NDACC_{i,t} \quad (5)$$

where:

$TACC_{i,t}$ = total accruals of firm i at year t
$EBIT_{i,t}$ = operating income of firm i at year t
$OCF_{i,t}$ = operating cash flows of firm i at year t
$TA_{i,t-1}$ = total assets of firm i at year t-1
$\Delta REV_{i,t}$ = changes in revenues
$\Delta REC_{i,t}$ = changes in accounts receivables
$PPE_{i,t}$ = gross property, plant, and equipment of firm i at year t
$DACC_{i,t}$ = discretionary accruals of firm i at year t is the residual error used to proxy for earnings management
$NDACC_{i,t}$ = non-discretionary accruals of firm i at year t

The earnings management proxy (DACC) will then use the absolute value (ABSDACC), given that this study does not observe the direction of the earnings management. The proxy used in auditor reputation was CPA firm included in big-four and non-big-four. In Indonesia, CPA firms that are affiliated with big-four CPA firms according to Leonora, Tan, and Sutanto (2012) are (1) Purwantono, Suherman & Surja CPA firm, affiliated with Ernst & Young; (2) Osman Bing Satrio CPA firm, affiliated with Deloitte Touché Tohmatsu; (3) CPA Siddharta & Widjaja, affiliated with KPMG; and (4) CPA Tanudiredja, Wibisana and friends, affiliated with PriceWaterhouse Coopers. The measurement used dummy variable in which the big-four auditors were given the value 1, and 0 otherwise. This variable is denoted by AUD in the equation.

The financial performance is measured by return on assets (ROA), calculated as earnings before interests and taxes divided by average total assets. There are two control variables in this study which are company size (SIZE) measured by total assets and leverage (LEV) measured by the ratio of total liabilities to total assets. The size of a company can affect earnings management, in the context that large companies may receive more public scrutiny, and are thus more susceptible to increased political costs. Besides, a more

leveraged company may engage in earnings management to avoid violating the debt covenants (Scott, 2015). Therefore, these two variables are controlled in this study to confine the analysis.

Statistical Model

This study uses single-level structural equation modelling to address whether auditor reputation has direct effect towards earnings management practices, or whether the effect is mediated by corporate financial performance. The equation is listed below:

$$ROA = \delta_0 + \delta_1 AUD + \delta_2 SIZE + \delta_4 LEV + \varepsilon \quad (6)$$

$$ABSDACC = \gamma_0 + \gamma_1 AUD + \gamma_2 ROA + \gamma_3 SIZE + \gamma_4 LEV + \varepsilon \quad (7)$$

IV. Results and Discussion

Descriptive Statistics

The descriptive statistics on Table 1 shows that the average absolute value of discretionary accruals is approximate 0.071. On average, 35% of the observations were being audited by reputable auditors. The profitability of the average observations is approximately 11%. The average size is 27.76, which is around 6.2 trillion Rupiahs. On the other hand, the average observations have approximately 51% leverage, which means the total liabilities are more than 50% of the total assets.

Table 1. Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
ABSDACC	279	0.070853	0.078384	0.0004662	0.501157
AUD	279	0.354839	0.479324	0	1
ROA	279	0.10596	0.140236	-0.321699	1.039415
SIZE	279	27.76076	1.902825	18.81193	32.99697
LEV	279	0.513513	0.39633	0	3.08

Hypothesis Testing Results

The results of the hypothesis testing are obtained after performing the structural equation modelling, which are found on Table 2.

Table 2. Results of Structural Equation Model

	Coef.	OIM Std. Err.	z	P>|z|	[95% Conf.	Interval]
Structural						
roa <-						
aud	.1001121	.018051	5.55	0.000	.0647327	.1354914
size	.003941	.0045329	0.87	0.385	-.0049433	.0128252
lev	-.0553514	.0193778	-2.86	0.004	-.0933312	-.0173717
_cons	-.0105442	.1240339	-0.09	0.932	-.2536463	.2325578
absdacc <-						
roa	.0133037	.0366101	0.36	0.716	-.0584509	.0850582
aud	-.0150175	.0116309	-1.29	0.197	-.0378137	.0077787
size	.0028643	.0027756	1.03	0.302	-.0025758	.0083045
lev	.0150281	.0120217	1.25	0.211	-.008534	.0385903
_cons	-.0124607	.0758489	-0.16	0.870	-.1611219	.1362005
Variance						
e.roa	.0161635	.0013685			.013692	.0190811
e.absdacc	.0060443	.0005117			.00512	.0071353

The simultaneous regression showed that auditor reputation has an impact on the financial performance of the company only, but not on the earnings management practices (p-value = 0.000). This result supports hypothesis 1. The coefficient is positive, which indicates that a more reputable auditor has a tendency to improve the financial performance of the company. This particular result is consistent with the previous studies of Afza and Nazir (2014), Farouk and Hassan (2014), and Jusoh et al. (2013). Thus, it is evident that companies with a more reputable auditor signal higher financial performance. They are more confident to be audited by big CPA firms because their financial reporting is of higher quality, thus more reliable and trustworthy.

Among the control variables, the leverage also significantly affects the financial performance of a company (p-value = 0.004). The coefficient is negative, which is consistent with the theory that when the leverage ratio increases (i.e., the company is less solvent), the financial performance of the company decreases. In other words, if the company's debts are more significant than the total assets, the risk of default may also increase, which puts the company in a more vulnerable position financially.

However, the significant results cannot be found on the relation between financial performance and earnings management practices, as well as between auditor reputation and earnings management practices. This shows that financial performance does not directly affect earnings management practices. Thus, hypotheses 2 and 3 are not supported. The nonexistence impact of auditor reputation on earnings management are consistent with previous studies of Christiantie and Christiawan (2013), I Guna and Herawaty (2010), Piot and Janin (2007), and Puspitasari (2013). This possibly happened because as the financial performance of the company increases, the company may tend to maintain their reputation by avoiding aggressive earnings management practices. It could also be that the control mechanism in the company has been well established, which creates a prevention towards engaging in earnings management. It can be argued that whenever a company hires a more reputable auditor to perform an audit service to the company, the management may have higher confidence that the company has been able to maintain the trustworthiness of the financial reporting process.

Using the standardized estimates, the model specification is shown in Figure 2.

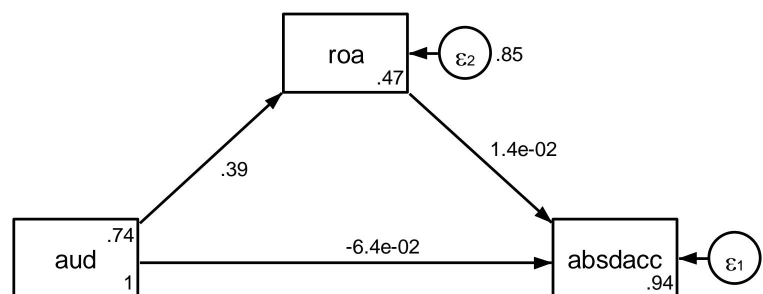

Figure 2. Model Specification

V. Conclusions

This research examines the relation between auditor reputation, which can be a signal of audit quality, earnings management, and financial performance. It was conducted because of the inconclusive results on the influence of auditor reputation on earnings management. Previous research has shown that auditor reputation has influence on the company's financial performance; moreover, there is evidence that financial performance affects earnings management. Therefore, besides investigating whether auditor reputation has a direct influence on earnings management, this research also investigates whether the influence of auditor reputation on earnings management is mediated by financial performance.

It is found that auditor reputation has an impact on financial performance only but not on earnings management, either direct nor indirect. The impact of auditor reputation on financial performance is positive, which is evident that auditor reputation improves the financial performance of a company. This in line with the notion that companies may be confident to be audited by more reputable auditors because they provide quality financial reports. Furthermore, a more reputable auditor may be an effective monitoring role which in turn can be a safeguard towards a better financial reporting process, thus improving the company's financial performance. However, this research did not find evidence that auditor reputation affects earnings management; neither did it find that financial performance has an impact on earnings management. Thus, overall, it found that there is no direct or indirect impact of auditor reputation on earnings management. It can be argued that because the auditor reputation determines the quality of financial reporting process, and since it positively affects financial performance, the company may not necessarily need to practice earnings management. To a larger extent, this can also be a signal to investors that the financial reports are more reliable; hence they can be confidently used in investment decision-making process.

The implications of this research is twofold. First, for the companies to consider hiring a more reputable auditor. This is because a more reputable auditor can improve not only the financial reporting process but also the overall financial performance. Second, for current and potential investors to regard companies that were audited by a more reputable auditor to be of higher quality than their counterparts.

Finally, there are several limitations to this study. First, it is only confined to a single industry; thus, this study has low external validity. Further research can be done by incorporating more industries and comparing the possibility of various impacts that could occur across industries. Second, there may be other factors which mediate the relation between auditor reputation and earnings management that could be explored in future studies.

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